ANNUAL REPORT

2007

CONTENTS

ISTARSKA KREDITNA BANKA UMAG d.d.

FINANCIAL HIGHLIGHTS

Balance Sheet	in thousands of HRK
Total assets	2,110,564
Total shareholders' equity	173,740

Income Statement	in thousands of HRK
Net operating income	103,889
Profit before tax	35,021
Profit after tax	27,262

MANAGEMENT BOARD

Chairman

Miro Dodić, B.Econ.

Member

Marina Vidič, B.Econ.

SUPERVISORY BOARD

Chairman	Milan Travan, B.Econ.
Vice Chairman	Edo Ivančić, B.Econ.
Members	Marijan Kovačić, B.Econ.
	Vlatko Reschner, B.Econ.
	Vlado Kraljević

REPORT OF THE MANAGEMENT BOARD

Dear shareholders and business partners,

On behalf of the Bank's Management Board it is a great honour and pleasure for me to be able to present you with very good business results of Istarska Kreditna Banka Umag in 2007.

The previous year, 2007, was yet another successful year for Istarska Kreditna Banka. Operations during the year, which marked the 51st anniversary of the Bank's existence, were mainly characterized by steady growth continued from previous years while maintaining the market position. One of our primary objectives to strengthen the assets based on the primary sources of funds arising from the longstanding customer confidence towards the Bank, was achieved entirely, as taking up of international borrowings was not adopted as a business policy to increase the Bank's assets.

Maintaining the stability and security in all operating segments of the Bank and retaining a professional relationship based on the mutual confidence with all our customers, continue to be our basic guidelines in daily operations. In the Croatian banking and financial market the year which is now behind us was yet another year of transition and adjustments to the guidelines of the European Union. The keeping of the acquired reputation and the market position in our region were also important for the operations in 2007.

Restrictive policy of the Croatian National Bank in the monetary and lending segments of business, moderate growth of banking assets, growing competition in the financial market, with a considerably large increase of competition from non-banking financial institutions, as well as the rapid growth and development of the securities market – this is a brief description of the environment in which were were performing business last year. The Bank's strategy, based on the continuous improvement, modernization and development of a wide range of products and services, made it possible for the Bank in its narrower and broader environment to remain a significant regional bank of universal type with the continuous growing trend.

Special attention during the last year was devoted to the increase of profitability in the conditions of the new organizational structure of the branch network set up in 2006. The effects arising from the new organization of business activities are rather satisfactory and can be confirmed by looking at the results we managed to achieve in 2007. With the total of 22 branches and offices and 26 ATMs Istarska Kreditna Banka has a very good coverage throughout the region, which has enabled us to get closer to our customers and their needs. I would like to emphasize that the projects of business network expansion, maintenance and modernization are continuouslyin progress and therefore play the most important part of our investment plans each year.

Objectives to be achieved in 2007 were set out in the 2007 Business Plan and the Strategy Plan as well. As we move on, I would like to inform you about the Bank's successful performance and the results achieved. The 2007 Business Plan was fully realized in all segments, which only confirms that the strategy was well planned.

BALANCE SHEET

In 2007 the assets within the balance sheet increased by HRK 224 million, or 11.84 percent, mainly through deposits and without any borrowings, so that the total assets as at 31 December 2007 amounted to HRK 2,118 million. The increase made on the basis of primary sources of funds – own customers' deposits – amounted to HRK 194 million, including the increase of individual customer deposits by HRK 128 million and those of legal entities by HRK 66 million. It is worth mentioning that increases were observed in all operational segments and across the branch network.

As for the increase in the amount of the loan portfolio, the approval of loans during the previous year was performed under the requirements of the Croatian National Bank's restrictive policy to limit the lending and investment volumes. More specifically, in the first semi-annual period the increase was restricted to 1 percent per month, i.e. to 12 percent on an annual level. However, on 1 July the decision was changed and the increase was restricted to only 0.5 percent per month, i.e. to a semi-annual rate of merely 3 percent for the second half of 2007. The same decision also stipulated the mandatory purchase of government treasury bills at a monthly rate of 50 percent on the increase in the placement of funds exceeding the level imposed by the National Bank. These restrictive measures were applicable to the lending business and investments in securities other than those issued by banks and government institutions. It is a well known fact, that the main reason for imposing such restrictions was to stop further increase of foreign debt and to reduce the credit debt of Croatian citizens. However, these restrictive policy applied to all banks regardless of the sources of funding for their lending business, one of them being our Bank as well. This decision did have an impact on our realization of the projected figures to a certain extent, because the measures of the National

Bank were extremely strict. In spite of these restrictions, our total loan portfolio was increased by 24.89 percent amounting to HRK 1,246 million at year end 2007, representing an increase of HRK 231 million as compared to year end 2006. Within the structure of approved loans, legal entities i.e. businesses and small entrepreneurs, and individual customers accounted for 67 and 28 percent of the entire loan portfolio, respectively. During the year there was a significant increase in lending funds to financial institutions through overnight and short-term advances.

Loans were approved throughout the year across the entire branch network and in all business segments with a slightly higher proportion of lending to small and medium enterprises. We expect that the successful and prudent approval of low risk loans will be reflected in the results of future financial periods. As for the individual customer loans, the highest efficiency rate was shown in the segment of housing loans.

It has already been announced that Istarska Kreditna Banka plans to increase its share capital within the first six months of 2008 by the private issue of shares in order to be able to expand its operation volumes, so that the increase of assets will be followed by an adequate increase of the capital.

PROFIT AND LOSS ACCOUNT

Thanks to extraordinary efforts, abilities and engagement of all employees of the Bank, in 2007 we were able to achieve a considerable increase of the net profit by 26.83 percent as compared to the previous year. The profit before tax amounted to HRK 35 million and the net profit was HRK 27.26 million, which we were able to achieve based on fact that the operating income was growing faster than the expenses, that the lending volumes were significantly increased during the second half of 2006 and in 2007, as well as through restructuring of assets in favour of the loan portfolio. An important profit was realized from non-interest income, as in February 2007 the Bank assumed the payment operations processing from the Financial Agency according to model III, which led to significant reductions in the payment transactions cost for the Bank, accounting for the increase of the net profit for this segment by HRK 3 million. The administrative expenses and depreciation cost increased at a slower rate than the net interest and non-interest income, which also contributed to the increase of the net profit. I would like to emphasize that, as recommended by the Croatian National Bank, we changed our accounting policy in terms of the recognition of loan approval fees in the income statement, which resulted in the decrease of operating income by HRK 2.3 million.

The net profit for the financial year 2007 amounting to HRK 27,262 thousand will be partly transferred to the Bank's reserves and partly distributed to the shareholders as dividends. The portion of the profit which is to be transferred to the reserves was determined in line with the new regulation of the Croatian National Bank in effect as from 2006 and it depends on the rate of growth of a bank's assets over a relevant year. Due to this regulation, a part of the profit derived by such calculation has to be transferred to the general banking reserves.

Istarska Kreditna Banka is becoming a true regional bank with its primary aim to service individual and corporate customers while maintaining its distinguishing features in terms of liquqidity, successfulness and safety.

This is the reason why we continuously focus our efforts on the development of new financial services, following the trends of modern banking, in order to satisfy customer requirements and at the same time to increase the efficiency and profitability, to satisfy the shareholders as well.

We are convinced in our further growth and success, which are possible to achieve with the support of our professional employees and high quality information technology, through the Bank's presence at various locations across the regions of Istrian and Primorsko-Goranska Counties, and by offering diversified and wide range of products and services which will satisfy the requirements of the most demanding customers.

I would like to thank our shareholders for their support, all our customers and business partners for their trust placed in the Bank, the Supervisory Board, the Bank management and staff on their contribution to the results achieved.

Chairman of the Management Board
Miro Dodić, B.Econ.

REPORT ON THE ACTIVITIES OF THE SUPERVISORY BOARD OF ISTARSKA KREDITNA BANKA UMAG D.D. UMAG IN 2007

The General Meeting of the Bank's shareholders constituted the Supervisory Board of Istarska Kreditna Banka Umag d.d by decision dated April 2003. The Supervisory Board has performed its functions ever since in compliance with legal reulations, especially the Company Law, the Banking Law, the Articles of Incorporation and other internal by-laws of the Bank.

During the year the Supervisory Board held 14 meetings, six of them being ordinary meetings, and in eight cases, when fast and operative decision-making was required, decisions were made by written declaration of opinion by the Board members.

Management reports on the Bank's performance and operating results, adoption of the 2008 Business Plan and Projections, as well as the discussions concerning the level of the Bank's regulatory capital and the capital adequacy i.e. the share capital increase, were the main topics that were discussed in the meetings of the Supervisory Board.

The Supervisory Board exercised its supervisory function also through the Audit Committee based on the reports presented at ordinary meetings of the Audit Committee, which were held before each ordinary meeting of the Supervisory Board. Through various reports drawn up by the Internal Audit and Control Department the Supervisory Board monitored and controlled the Bank's liquidity and the activities of various departments and bodies of the Bank. The Supervisory Board is also competent for the adoption of certain decisions and giving consents according to legal regulations, so that in a number of cases necessary decisions were made concerning mostly the Bank's lending business, exposure and the risk management in the performance of the Bank's activities.

According to all the reports submitted to us and based on detailed information received from the Management Board, it is our opinion that the overall business operation throughout 2007 was conducted in line with the business policy and within the legal framework. The audit of financial statements was performed by the company PriceWaterhouseCoopers, whose report and opinion were fully accepted by the Supervisory Board as a professional and fair view of the financial position and the business results as stated in the Bank's financial records.

The Supervisory Board agreed to the proposal of the Management Board as to the adoption of the annual accounts and the distribution of profits for the current year. The profit earned in 2007 will be distributed partly to the general banking reserves, partly to the retained reserves in order to strengthen the Bank's capital base, and partly to the dividends for shareholders. The Supervisory Board also agreed to the proposed share capital increase from the Bank's retained earnings and reserves as well as by cash contributions, which will be carried out after the adoption of proposed decisions by the General Meeting.

This Report will be submitted to the General Meeting of shareholders with the proposal to adopt the same.

On behalf of the Supervisory Board I would like to express our appreciation to the Bank's customers for their continued confidence, the shareholders, employees and the management of Istarska Kreditna Banka Umag for the results they managed to achieve. I would especially like to thank the members of the Supervisory Board on their engagement and cooperation throughout the year.

Umag, 18 February 2008

Chairman of the Supervisory Board
Milan Travan, B.Econ.

ISTARSKA KREDITNA BANKA UMAG D.D., UMAG

FINANCIAL STATEMENTS
AND INDEPENDENT AUDITORS' REPORT
FOR THE YEAR ENDED 31 DECEMBER 2007

This version of the accompanying documents is a translation from the original, which was prepared in Croatian language. All possible care has been taken to ensure that the translation is an accurate representation of the original. However, in all matters of interpretation of information, views or opinions, the original language version of our report takes precedence over this translation.

PRICEWATERHOUSECOOPERS

INDEPENDENT AUDITORS' REPORT

PricewaterhouseCoopers d.o.o.
A. von Humboldta 4
HR-10000 Zagreb
CROATIA
Telephone (385 1) 6328 888
Facsimile (385 1) 6111 556

TO THE SHAREHOLDERS OF ISTARSKA KREDITNA BANKA UMAG D.D., UMAG

We have audited the accompanying financial statements of Istarska kreditna banka Umag d.d., Umag (the Bank) which comprise the balance sheet as of 31 December 2007 and the income statement, statement of changes in equity and cash flow statement for the year then ended and a summary of significant accounting policies and other explanatory notes.

MANAGEMENT'S RESPONSIBILITY FOR THE FINANCIAL STATEMENTS

Management is responsible for the preparation and fair presentation of these financial statements in accordance with International Financial Reporting Standards. This responsibility includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

AUDITOR'S RESPONSIBILITY

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free from material misstatement. An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

OPINION

In our opinion, the accompanying financial statements present fairly, in all material respects, the financial position of the Bank as of 31 December 2007, and of its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards.

PricewaterhouseCoopers d.o.o.

PricewaterhouseCoopers d.o.o.
18 February 2008

REPORT OF THE BOARD OF DIRECTORS

Pursuant to the Croatian Accounting Law, the Management Board of Istarska Kreditna Banka Umag d.d. (the "Bank") is responsible for ensuring that financial statements are prepared for each financial year in accordance with International Financial Reporting Standards (IFRS) as published by the International Accounting Standards Board (IASB) which give a true and fair view of the state of affairs and results of the Bank for that period.

After making enquiries, the Management Board has a reasonable expectation that the Bank has adequate resources to continue in operational existence for the foreseeable future. For this reason, the Management Board continues to adopt the going concern basis in preparing the financial statements.

In preparing those financial statements, the responsibilities of the Management Board include ensuring that:

- suitable accounting policies are selected and then applied consistently;
- judgements and estimates are reasonable and prudent;
- applicable accounting standards are followed, subject to any material departures disclosed and explained in the financial statements; and
- the financial statements are prepared on the going concern basis unless it is inappropriate to presume that the Bank will continue in business.

The Management Board is responsible for keeping proper accounting records, which disclose with reasonable accuracy at any time the financial position of the Bank and must also ensure that the financial statements comply with the Croatian Accounting Law (Official Gazette 146/05). The Board is also responsible for safeguarding the assets of the Bank and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

Signed on behalf of the Management Board

Miro Dodić

Istarska kreditna banka Umag d.d., Umag
Ernesta Miloša 1
52470 Umag
Republic of Croatia
18 February 2008

Istarska kreditna banka Umag d.d., Umag
INCOME STATEMENT
FOR THE YEAR ENDED 31 DECEMBER 2007

(all amounts are expressed in thousands of HRK)	**Notes**	**2007**	**2006**
Interest and similar income		112,566	96,722
Interest expense and similar charges		(41,465)	(35,771)
Net interest income	6	**71,101**	**60,951**
Fee and commission income		21,046	20,974
Fee and commission expense		(5,285)	(8,259)
Net fee and commission income	7	**15,761**	**12,715**
Foreign exchange differences-net	8	14,542	12,740
Result of trading assets	9	307	(2,686)
Gains from investment securities	21	393	298
Impairment charge for credit losses -net	13	(5,860)	395
Other operating income	10	1,785	834
Administrative expenses	11	(55,018)	(51,030)
Other operating expenses	12	(7,990)	(6,898)
Profit before income tax		**35,021**	**27,319**
Income tax expense	14	(7,759)	(5,823)
Profit for the year		**27,262**	**21,496**
Basic and diluted earnings per shares –ordinary and preference (in HRK)	15	**462,16**	**364,41**

The accompanying notes form an integral part of these financial statements.

Istarska kreditna banka Umag d.d., Umag
Balance sheet
as at 31 December 2007

(all amounts are expressed in thousands of HRK)	Notes	2007	2006
ASSETS			
Cash and balances with Central bank	16	350,385	341,193
Treasury bills and other eligible bills	17	60,089	139,630
Loans and advances to banks	18	410,304	290,278
Loans and advances to customers	19	1,151,079	963,175
Trading assets	20	13,435	37,489
Investment securities:			
- available for sale	21	63,723	47,616
- held-to-maturity	21	21,288	20,108
Intangible assets	22	2,861	3,001
Property and equipment	23	32,736	28,965
Non-current assets held for sale	24	1,331	14,938
Other assets	24	3,333	3,210
Total assets		**2,110,564**	**1,889,603**
LIABILITIES			
Due to banks	25	24,669	26,003
Due to customers	26	1,891,547	1,692,447
Current income tax liability	14	1,963	116
Other liabilities	27	18,645	12,407
Total liabilities		**1,936,824**	**1,730,973**
EQUITY			
Share capital	28	65,054	65,054
Retained earnings	29	53,935	48,155
Reserves	30	54,751	45,421
Total equity		**173,740**	**158,630**
Total equity and liabilities		**2,110,564**	**1,889,603**

Signed on behalf of the Management Board of Istarska kreditna banka Umag d.d., Umag, on 18 February 2008:

Miro Dodić
President of the Management Board

Marina Vidič
Member of the Management Board

Istarska kreditna banka Umag d.d., Umag
Statement of changes in equity
For the year ended 31 December 2007

(in thousands of HRK)	Note	Share capital	Treasury shares	Share premium	Reserves	Retained earnings	Total
At 1 January 2006		**64,900**	**-**	**180**	**45,421**	**42,000**	**152,501**
Net profit		-	-	-	-	21,496	21,496
Dividend relating to 2005		-	-	-	-	(15,341)	(15,341)
Purchase/sale of treasury shares	28	-	(13)	(13)	-	-	(26)
At 1 January 2007		**64,900**	**(13)**	**167**	**45,421**	**48,155**	**158,630**
Net profit		-	-	-	-	27,262	27,262
Dividend relating to 2006		-	-	-	-	(12,152)	(12,152)
Transfer to general banking reserves	29	-	-	-	9,330	(9,330)	-
At 31 December 2007		**64,900**	**(13)**	**167**	**54,751**	**53,935**	**173,740**

The accompanying notes form an integral part of these financial statements.

Istarska kreditna banka Umag d.d., Umag
Cash flow statement
For the year ended 31 December 2007

(all amounts expressed in thousands of HRK)	Notes	2007	2006
Cash flows from operating activities			
Profit before taxation		35,021	27,319
Income tax	14	(5,796)	(5,707)
Depreciation and amortisation	11	4,488	5,529
Increase/(decrease) in impairment provisions	13	5,860	(395)
Net gains from trading assets	9	(811)	(643)
Gains from investment securities	21	(393)	(298)
Change in fair value of trading assets	9	504	3,329
Other non-cash items		(2,658)	1,721
Cash flows from operating activities before changes in operating assets and liabilities		36,215	30,855
- net increase in assets with the Croatian National Bank		(29,010)	(28,983)
- net decrease/(increase) in treasury bills and other eligible bills		52,469	(83,855)
- net increase in loans and advances to customers		(188,478)	(259,586)
- net increase in loans and advances to banks		(341)	-
- net decrease/(increase) in other assets		13,341	(607)
- net decrease in due to banks		(670)	(509)
- net increase in due to customers		188,079	177,807
- net increase/(decrease) in other liabilities		6,122	(440)
Net cash from/(used in) operating activities		**77,727**	**(165,318)**
Cash flows from investing activities			
Purchase of intangible assets	22	(769)	(1,591)
Purchase of property and equipment	23	(7,419)	(2,165)
Purchase of securities		(1,981)	(19,328)
Proceeds on sale of securities		26,131	61,032
Net cash from investing activities		**15,962**	**37,948**
Cash flows from financing activities			
Proceeds from other borrowed funds		21,167	20,969
Repayments of other borrowed funds		(21,892)	(12,013)
Purchase of treasury shares	28	-	(26)
Dividends paid		(12,152)	(15,341)
Net cash used in financing activities		**(12,877)**	**(6,411)**
Effect of exchange rate changes		786	180
Net increase/(decrease) in cash and cash equivalents		**81,598**	**(133,601)**
Cash and cash equivalents at beginning of year	31	503,663	637,264
Cash and cash equivalents at end of year	31	585,261	503,663

The accompanying notes form an integral part of these financial statements.

Note 1 – general information

HISTORY AND INCORPORATION

Istarska kreditna banka Umag d.d., Umag (the "Bank") was registered as a joint stock company on 19 December 1989. The address of the Bank's registered office is Ernesta Miloša 1, Umag, Croatia.

Principal activities of the Bank

1. accepting and placing of deposits,
2. providing current and term deposit accounts;
3. granting short and long-term loans and guarantees to the Ministry of Finance, local municipalities, corporate customers, private individuals and other credit institutions dealing with finance lease and foreign exchange transactions,
4. treasury operations in the interbank market,
5. trust management and investment banking services,
6. performing local and international payments,
7. providing banking services through an extensive branch network in the Republic of Croatia

GOVERNANCE AND MANAGEMENT

GENERAL ASSEMBLY

Marijan Kovačić	President

SUPERVISORY BOARD

Milan Travan	President
Edo Ivančić	Vice president
Marijan Kovačić	Member
Vlatko Reschner	Member
Vlado Kraljević	Member

MANAGEMENT BOARD

Miro Dodić	President
Marina Vidič	Member

The shareholders of the Bank as at 31 December 2007 and 2006 are disclosed in note 28.

The Bank has its primary listing on the Zagreb Stock Exchange.

The Bank is subject to the regulatory requirements of the Croatian National Bank. These regulations include limits and other restrictions pertaining to minimum capital adequacy requirements, classification of loans and off-balance sheet commitments and provisioning to cover credit risk, liquidity, interest rate and foreign currency position. At year-end, the Bank was substantially in compliance with all regulatory requirements.

Note 2 – summary of significant accounting policies

The principal accounting policies adopted in the preparation of these financial statements are set out below. These policies have been consistently applied to all the years presented, unless otherwise stated.

2.1 Basis of presentation

These financial statements are prepared in accordance with International Financial Reporting Standards ('IFRS') as published by the International Accounting Standards Board. The financial statements have been prepared under the historical cost basis, except for the revaluation of certain financial instruments at fair value.

The preparation of financial statements in conformity with IFRS requires the use of certain critical accounting estimates. It also requires management to exercise its judgement in the process of applying the Bank's accounting policies. The areas involving a higher degree of judgement or complexity, or areas where assumptions and estimates are significant to the financial statements, are disclosed in Note 4.

(a) Standards, amendments and interpretations effective in 2007

- *IFRS 7, 'Financial instruments: Disclosures', and the complementary amendment to IAS 1, 'Presentation of financial statements – Capital disclosures'*, introduces new disclosures relating to financial instruments and does not have any impact on the classification and valuation of the Bank's financial instruments, or the disclosures relating to taxation and trade and other payables.

- *IFRIC 8, 'Scope of IFRS 2'*, requires consideration of transactions involving the issuance of equity instruments, where the identifiable consideration received is less than the fair value of the equity instruments issued in order to establish whether or not they fall within the scope of IFRS 2. This standard does not have any impact on the Bank's financial statements.

- *IFRIC 10, 'Interim financial reporting and impairment'*, prohibits the impairment losses recognised in an interim period on goodwill and investments in equity instruments and in financial assets carried at cost to be reversed at a subsequent balance sheet date. This standard does not have any impact on the banks financial statements.

(b) Interpretation early adopted by the Bank

- *IFRIC 11, 'IFRS 2 – Group and treasury share transactions'*, was early adopted in 2007. IFRIC 11 provides guidance on whether share-based transactions involving treasury shares or involving group entities (for example, options over a parent's shares) should be accounted for as equity-settled or cash-settled share-based payment transactions in the stand-alone accounts of the parent and group companies. This interpretation does not have an impact on the group's financial statements.

(c) Standards, amendments and interpretations effective in 2007 but not relevant

The following standards, amendments and interpretations to published standards are mandatory for accounting periods beginning on or after 1 January 2007 but they are not relevant to the Bank's operations:

- *IFRS 4, 'Insurance contracts';*
- *IFRIC 7, Applying the restatement approach under IAS 29, Financial reporting in hyper-inflationary economies'*; and
- *IFRIC 9, 'Re-assessment of embedded derivatives'*.

Note 2 – summary of significant accounting policies (continued)

2.1 Basis of presentation (continued)

(d) Standards, amendments and interpretations to existing standards that are not yet effective and have not been early adopted by the Bank

The following standards, amendments and interpretations to existing standards have been published and are mandatory for the Bank's accounting periods beginning on or after 1 January 2008 or later periods, but the Bank has not early adopted them:

– *IAS 23 (Amendment), 'Borrowing costs' (effective from 1 January 2009)*. It requires an entity to capitalise borrowing costs directly attributable to the acquisition, construction or production of a qualifying asset (one that takes a substantial period of time to get ready for use or sale) as part of the cost of that asset. The option of immediately expensing those borrowing costs will be removed. The Bank will apply IAS 23 (Amended) from 1 January 2009 but is currently not applicable to the Bank as there are no qualifying assets.

– *IFRS 8, 'Operating segments' (effective from 1 January 2009)*. IFRS 8 replaces IAS 14 and aligns segment reporting with the requirements of the US standard SFAS 131, 'Disclosures about segments of an enterprise and related information'. The new standard requires a 'management approach', under which segment information is presented on the same basis as that used for internal reporting purposes. The Bank will apply IFRS 8 from 1 January 2009. The expected impact is still being assessed in detail by management, but it appears likely that the number of reportable segments, as well as the manner in which the segments are reported, will change in a manner that is consistent with the internal reporting provided to the chief operating decision-maker.

– *IFRIC 14, 'IAS 19 – The limit on a defined benefit asset, minimum funding requirements and their interaction' (effective from 1 January 2008)*. IFRIC 14 provides guidance on assessing the limit in IAS 19 on the amount of the surplus that can be recognised as an asset. It also explains how the pension asset or liability may be affected by a statutory or contractual minimum funding requirement. The Bank will apply IFRIC 14 from 1 January 2008, but it is not expected to have any impact on the Bank's accounts.

(e) Interpretations to existing standards that are not yet effective and not relevant for the Bank's operations

The following interpretations to existing standards have been published and are mandatory for the Bank's accounting periods beginning on or after 1 January 2008 or later periods but are not relevant for the Bank's operations:

– *IFRIC 12, 'Service concession arrangements' (effective from 1 January 2008)*. IFRIC 12 applies to contractual arrangements whereby a private sector operator participates in the development, financing, operation and maintenance of infrastructure for public sector services. IFRIC 12 is not relevant to the Bank's operations because the Bank does not have such contractual arrangements.

– *IFRIC 13, 'Customer loyalty programmes' (effective from 1 July 2008)*. IFRIC 13 clarifies that where goods or services are sold together with a customer loyalty incentive (for example, loyalty points or free products), the arrangement is a multiple-element arrangement and the consideration receivable from the customer is allocated between the components of the arrangement using fair values. IFRIC 13 is not relevant to the Bank's operations because the Bank does not operate any loyalty programmes.

Note 2 – summary of significant accounting policies (continued)

2.2 Investment in subsidiaries

Subsidiary companies are companies in which the Bank, directly or indirectly, has more than one half of voting rights or otherwise controls the operations of the companies.

The Bank has one fully owned subsidiary undertaking - FIDUCIA d.o.o., Umag (see Note 21), which is carried at cost and has not been consolidated in these financial statements. The effect of not consolidating the entity is not significant to the financial statements.

2.3 Segment reporting

A business segment is a group of assets and operations engaged in providing products or services that are subject to risks and returns that are different from those of other business segments. A geographical segment is engaged in providing products or services within a particular economic environment that are subject to risks and returns different from those of segments operating in other economic environments.

2.4 Foreign currency translation

(a) Functional and presentation currency

Items included in the financial statements of the Bank are measured using the currency of the primary economic environment in which the Bank operates ('the functional currency').

The financial statements are presented in Croatian kuna (HRK), which is the Bank's functional and presentation currency. As at 31 December 2007, the conversion rate was HRK 4.985 to USD 1 and HRK 7.325 to EUR 1 (31 December 2006: HRK 5.578 to USD 1 and HRK 7.345 to EUR 1).

(b) Transactions and balances

Foreign currency transactions are translated into the functional currency using the exchange rates prevailing at the dates of the transactions. Foreign exchange gains and losses resulting from the settlement of such transactions and from the translation at year-end exchange rates of monetary assets and liabilities denominated in foreign currencies are recognised in the income statement.

2.5 Financial assets

The Bank classifies its financial assets in the following categories: financial assets at fair value through profit or loss, loans and receivables, investment securities available for sale and held to maturity. The classification depends on the purpose for which the financial assets were acquired. Management determines the classification of its investments at initial recognition.

Note 2 – summary of significant accounting policies (continued)

2.5 Financial assets (continued)

(a) Financial assets at fair value through profit or loss

This category has two sub-categories: financial assets held for trading, and those designated at fair value through profit or loss at inception. A financial asset is classified as held for trading if it is acquired or incurred principally for the purpose of selling or repurchasing in the near term or if it is part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking.

(b) Loans and receivables

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market, other than: (a) those that the entity intends to sell immediately or in the short term, which are classified as held for trading, and those that the entity upon initial recognition designates as at fair value through profit or loss; (b) those that the entity upon initial recognition designates as available for sale; or (c) those for which the holder may not recover substantially all of its initial investment, other than because of credit deterioration.

(c) Held-to-maturity financial assets

Held-to-maturity investments are non-derivative financial assets with fixed or determinable payments and fixed maturities that the Bank's management has the positive intention and ability to hold to maturity. If the Bank were to sell other than an insignificant amount of held-to-maturity assets, the entire category would be reclassified as available for sale.

d) Available-for-sale financial assets

Available-for-sale investments are those intended to be held for an indefinite period of time, which may be sold in response to needs for liquidity or changes in interest rates, exchange rates or equity prices. Regular-way purchases and sales of financial assets at fair value through profit or loss, held to maturity and available for sale are recognised on trade-date – the date on which the Bank commits to purchase or sell the asset.

Financial assets are initially recognised at fair value plus transaction costs for all financial assets not carried at fair value through profit or loss. Financial assets carried at fair value through profit and loss are initially recognised at fair value, and transaction costs are expensed in the income statement. Financial assets are derecognised when the rights to receive cash flows from the financial assets have expired or where the Bank has transferred substantially all risks and rewards of ownership. Financial liabilities are derecognised when they are extinguished – that is, when the obligation is discharged, cancelled or expires.

Note 2 – summary of significant accounting policies (continued)

2.5 Financial assets (continued)

Available-for-sale financial assets and financial assets at fair value through profit or loss are subsequently carried at fair value. Loans and receivables and held-to-maturity investments are carried at amortised cost using the effective interest method. Gains and losses arising from changes in the fair value of the 'financial assets at fair value through profit or loss' category are included in the income statement in the period in which they arise. Gains and losses arising from changes in the fair value of available-for-sale financial assets are recognised directly in equity, until the financial asset is derecognised or impaired. At this time, the cumulative gain or loss previously recognised in equity is recognised in profit or loss. However, interest calculated using the effective interest method and foreign currency gains and losses on monetary assets classified as available for sale are recognised in the income statement. Dividends on available-for-sale equity instruments are recognised in the income statement when the entity's right to receive payment is established.

The fair values of quoted investments in active markets are based on current bid prices. If there is no active market for a financial asset, the Bank establishes fair value using valuation techniques. These include the use of recent arm's length transactions, discounted cash flow analysis, option pricing models and other valuation techniques commonly used by market participants.

2.6 Offsetting financial instruments

Financial assets and liabilities are offset and the net amount reported in the balance sheet when there is a legally enforceable right to set off the recognised amounts and there is an intention to settle on a net basis or realise the asset and settle the liability simultaneously.

2.7 Derivative financial instruments

Derivative financial instruments include foreign exchange rate forward contracts and are initially recognised in the balance sheet at fair value and subsequently re-measured at their fair value. Fair values are obtained from quoted market prices or pricing models as appropriate. All derivatives are carried as assets when fair value is positive and as liabilities when fair value is negative.

The Bank's derivative instruments do not qualify for hedge accounting. Changes in the fair value of any derivative instrument that does not qualify for hedge accounting are recognised immediately in the income statement under net trading income. However, the gains and losses arising from changes in the fair value of derivatives that are managed in conjunction with designated financial assets or financial liabilities are included in 'net income from financial instruments designated at fair value'.

Note 2 – summary of significant accounting policies (continued)

2.8 Interest income and expense

Interest income and expense for all interest-bearing financial instruments, except for those classified as held for trading or designated at fair value through profit or loss, are recognised within 'interest income' and 'interest expense' in the income statement using the effective interest method. The effective interest method is a method of calculating the amortised cost of a financial asset or a financial liability and of allocating the interest income or interest expense over the relevant period. The effective interest rate is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument or, when appropriate, a shorter period to the net carrying amount of the financial asset or financial liability. When calculating the effective interest rate, the Bank estimates cash flows considering all contractual terms of the financial instrument (for example, prepayment options) but does not consider future credit losses. The calculation includes all fees and points paid or received between parties to the contract that are an integral part of the effective interest rate, transaction costs and all other premiums or discounts.

2.9 Fee and commission income

Fees and commissions are recognized on an accrual basis. Loan origination fees for loans which are probable of being drawn down are deferred (together with related direct costs) and recognized as an adjustment to the effective yield of the loan. Commission and fees arising from negotiating, or participating in the negotiation of a transaction for a third party, such as the acquisition of loans, shares or other securities or the purchase or sale of businesses, are recognised on completion of the underlying transaction.

Fees and commissions consist mainly of fees received from foreign currency transactions, guarantees, letters of credit and other services that the Bank provides.

2.10 Dividend income

Dividends are recognised in the income statement when the entity's right to receive payment is established.

2.11 Impairment of financial assets

(a) Assets carried at amortised cost

The Bank assesses at each balance sheet date whether there is objective evidence that a financial asset or group of financial assets is impaired. A financial asset or a group of financial assets is impaired and impairment losses are incurred if, and only if, there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset (a 'loss event') and that loss event (or events) has an impact on the estimated future cash flows of the financial asset or group of financial assets that can be reliably estimated.

Note 2 – summary of significant accounting policies (continued)

2.11 Impairment of financial assets (continued)

The criteria that the Bank uses to determine that there is objective evidence of an impairment loss include:

- Delinquency in contractual payments of principal or interest;
- Cash flow difficulties experienced by the borrower (for example, equity ratio, net income percentage of sales);
- Breach of loan covenants or conditions;
- Initiation of bankruptcy proceedings;
- Deterioration of the borrower's competitive position;
- Deterioration in the value of collateral; and
- Downgrading below investment grade level.

The estimated period between a loss occurring and its identification is determined by management for each identified portfolio. In general, the periods used vary between three months and 12 months; in exceptional cases, longer periods are warranted.

The Bank first assesses whether objective evidence of impairment exists individually for financial assets that are individually significant, and individually or collectively for financial assets that are not individually significant. If the Bank determines that no objective evidence of impairment exists for an individually assessed financial asset, whether significant or not, it includes the asset in a group of financial assets with similar credit risk characteristics and collectively assesses them for impairment. Assets that are individually assessed for impairment and for which an impairment loss is or continues to be recognised are not included in a collective assessment of impairment.

The amount of the loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows (excluding future credit losses that have not been incurred) discounted at the financial asset's original effective interest rate. The carrying amount of the asset is reduced through the use of an allowance account and the amount of the loss is recognised in the income statement. If a loan or held-to-maturity investment has a variable interest rate, the discount rate for measuring any impairment loss is the current effective interest rate determined under the contract. As a practical expedient, the Bank may measure impairment on the basis of an instrument's fair value using an observable market price.

The calculation of the present value of the estimated future cash flows of a collateralised financial asset reflects the cash flows that may result from foreclosure less costs for obtaining and selling the collateral, whether or not foreclosure is probable.

For the purposes of a collective evaluation of impairment, financial assets are grouped on the basis of similar credit risk characteristics (i.e. on the basis of the Bank's grading process that considers asset type, industry, geographical location, collateral type, past-due status and other relevant factors). Those characteristics are relevant to the estimation of future cash flows for groups of such assets by being indicative of the debtors' ability to pay all amounts due according to the contractual terms of the assets being evaluated.

Future cash flows in a group of financial assets that are collectively evaluated for impairment are estimated on the basis of the contractual cash flows of the assets in the Bank and historical loss experience for assets with credit risk characteristics similar to those in the Bank. Historical loss experience is adjusted on the basis of current observable data to reflect the effects of current conditions that did not affect the period on which the historical loss experience is based and to remove the effects of conditions in the historical period that do not exist currently.

Note 2 – summary of significant accounting policies (continued)

2.11 Impairment of financial assets (nastavak)

Estimates of changes in future cash flows for groups of assets should reflect and be directionally consistent with changes in related observable data from period to period (for example, changes in unemployment rates, property prices, payment status, or other factors indicative of changes in the probability of losses in the group and their magnitude). The methodology and assumptions used for estimating future cash flows are reviewed regularly by the Bank to reduce any differences between loss estimates and actual loss experience.

When a loan is uncollectible, it is written off against the related provision for loan impairment. Such loans are written off after all the necessary procedures have been completed and the amount of the loss has been determined. Subsequent recoveries of amounts previously written off decrease the amount of the provision for loan impairment in the income statement.

If, in a subsequent period, the amount of the impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognised (such as an improvement in the debtor's credit rating), the previously recognised impairment loss is reversed by adjusting the allowance account. The amount of the reversal is recognised in the income statement in impairment charge for credit losses.

(b) Assets classified as available for sale

The Bank assesses at each balance sheet date whether there is objective evidence that a financial asset or a group of financial assets is impaired. In the case of equity investments classified as available-for-sale, a significant or prolonged decline in the fair value of the security below its cost is considered in determining whether the assets are impaired. If any such evidence exists for available for- sale financial assets, the cumulative loss – measured as the difference between the acquisition cost and the current fair value, less any impairment loss on that financial asset previously recognised in profit or loss – is removed from equity and recognised in the income statement. Impairment losses recognised in the income statement on equity instruments are not reversed through the income statement.

If, in a subsequent period, the fair value of a debt instrument classified as available for sale increases and the increase can be objectively related to an event occurring after the impairment loss was recognised in profit or loss, the impairment loss is reversed through the income statement.

2.12 Intangible assets

Acquired computer software licences are capitalised on the basis of the costs incurred to acquire and bring to use the specific software. These costs are amortised over their estimated useful lives (4 years).

Note 2 – summary of significant accounting policies (continued)

2.13 Property and equipment

Property and equipment are included in the balance sheet at historical cost less accumulated depreciation. Historical cost includes expenditure that is directly attributable to the acquisition of the items.

Subsequent costs are included in the asset's carrying amount or recognised as a separate asset, as appropriate, only when it is probable that future economic benefits associated with the item will flow to the Bank and the cost of the item can be measured reliably. All other repairs and maintenance are charged to the income statement during the financial period in which they are incurred.

Land is not depreciated. Depreciation of other assets is calculated using the straight-line method to allocate their cost over their estimate useful lives as follows:

Property	33 years
Computers	4 years
Equipment and other	3-10 years

Depreciation is calculated for each asset until the asset is fully depreciated or to its residual value, if significant.

The assets' residual values and useful lives are reviewed, and adjusted if appropriate, at each balance sheet date. An asset's carrying amount is written down immediately to its recoverable amount if the asset's carrying amount is greater than its estimated recoverable amount (Note 2.15).

Gains and losses on disposals are determined by comparing proceeds with carrying amount. These are included in the income statement.

2.14 Computer software development costs

Generally, costs associated with developing computer software programmes are recognised as an expense as incurred. However, expenditure that enhances and extends the benefits of computer software programmes beyond their original specifications and lives is recognised as a capital improvement and added to the original cost of the software. Computer software development costs recognised as assets are amortised using the straight-line method over their useful lives. Costs associated with the maintenance of existing computer software programmes are expensed as incurred.

2.15 Impairment of non-financial assets

Assets that have an indefinite useful life are not subject to amortisation and depreciation are tested annually for impairment. Assets that are subject to amortisation and depreciation are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. An impairment loss is recognised for the amount by which the asset's carrying amount exceeds its recoverable amount. The recoverable amount is the higher of an asset's fair value less costs to sell and value in use. For the purposes of assessing impairment, assets are grouped at the lowest levels for which there are separately identifiable cash flows (cash-generating units). Non-financial assets other than goodwill that suffered impairment are reviewed for possible reversal of the impairment at each reporting date.

Note 2 – summary of significant accounting policies (continued)

2.16 Non-current assets held for sale

Non-current assets (or disposal groups) are classified as assets held for sale and stated at the lower of carrying amount and fair value less costs to sell if their carrying amount is recovered principally through a sale transaction rather than through continuing use.

2.17 Leases

The leases entered into by the Bank are primarily operating leases. The total payments made under operating leases are charged to other operating expenses in the income statement on a straight-line basis over the period of the lease.

When an operating lease is terminated before the lease period has expired, any payment required to be made to the lessor by way of penalty is recognised as an expense in the period in which termination takes place.

2.18 Cash and cash equivalents

For the purposes of the cash flow statement, cash and cash equivalents comprise balances with less than 90 days maturity from the date of acquisition including: cash and current accounts with banks, amounts due from other banks and investment securities available for sale and held to maturity.

2.19 Provisions

Provisions are recognised when: the Bank has a present legal or constructive obligation as a result of past events; it is more likely than not that an outflow of resources will be required to settle the obligation; and the amount has been reliably estimated.

Provisions are measured at the present value of the expenditures expected to be required to settle the obligation using a pre-tax rate that reflects current market assessments of the time value of money and the risks specific to the obligation. The increase in the provision due to passage of time is recognised as interest expense.

2.20 Financial guarantee contracts

Financial guarantee contracts are contracts that require the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payments when due, in accordance with the terms of a debt instrument. Such financial guarantees are given to banks, financial institutions and other bodies on behalf of customers to secure loans, overdrafts and other banking facilities.

Note 2 – summary of significant accounting policies (continued)

2.20 Financial guarantee contracts (continued)

Financial guarantees are initially recognised in the financial statements at fair value on the date the guarantee was given. Subsequent to initial recognition, the bank's liabilities under such guarantees are measured at the higher of the initial measurement, less amortisation calculated to recognise in the income statement the fee income earned on a straight line basis over the life of the guarantee and the best estimate of the expenditure required to settle any financial obligation arising at the balance sheet date. These estimates are determined based on experience of similar transactions and history of past losses, supplemented by the judgment of Management.

Any increase in the liability relating to guarantees is taken to the income statement under other operating expenses.

2.21 Employee benefits

(a) Pension obligations and post-employment benefits

In the normal course of business through salary deductions, the Bank makes payments to mandatory pension funds on behalf of its employees as required by law. All contributions made to the mandatory pension funds are recorded as salary expense when incurred. The Bank does not have any other pension scheme and consequently, has no other obligations in respect of employee pensions. In addition, the Bank is not obliged to provide any other post-employment benefits.

(b) Termination benefits

Termination benefits are payable when employment is terminated by the Bank before the normal retirement date, or whenever an employee accepts voluntary redundancy in exchange for these benefits. The Bank recognises termination benefits when it is demonstrably committed to either: terminating the employment of current employees according to a detailed formal plan without possibility of withdrawal; or providing termination benefits as a result of an offer made to encourage voluntary redundancy. Benefits falling due more than 12 months after the balance sheet date are discounted to present value.

(c) Short-term employee benefits

The Bank recognises a provision for bonuses where contractually obliged or where there is a past practice that has created a constructive obligation. In addition, the Bank recognises a liability for accumulated compensated absences based on unused vacation days at the balance sheet date.

2.22 Current and deferred income tax

Current income tax is calculated at a rate of 20% on the tax base, which represents the difference between the income and expenses at the end of a business year, deductible for tax purposes, increased by disallowable expenses.

Note 2 – summary of significant accounting policies (continued)

2.22 Current and deferred income tax (continued)

Deferred income tax is provided in full, using the liability method, on temporary differences arising between the tax bases of assets and liabilities and their carrying amounts in the financial statements. However, the deferred income tax is not accounted for if it arises from initial recognition of an asset or liability in a transaction other than a business combination that at the time of the transaction affects neither accounting nor taxable profit or loss. Deferred income tax is determined using tax rates (and laws) that have been enacted or substantially enacted by the balance sheet date and are expected to apply when the related deferred income tax asset is realised or the deferred income tax liability is settled.

Deferred income tax assets are recognised to the extent that it is probable that future taxable profit will be available against which the temporary differences can be utilised.

2.23 Borrowings

Borrowings are recognised initially at fair value, net of transaction costs incurred. Borrowings are subsequently stated at amortised cost; any difference between the proceeds (net of transaction costs) and the redemption value is recognised in the income statement over the period of the borrowings using the effective interest method.

Borrowings are classified as current liabilities unless the Bank has an unconditional right to defer settlement of the liability for at least 12 months after the balance sheet date.

2.24 Share capital

Ordinary and preference shares are classified as equity. Incremental costs directly attributable to the issue of new shares are shown in equity as a deduction, net of tax, from the proceeds. Where the Bank purchases its equity share capital (treasury shares), the consideration paid, including any directly attributable incremental costs (net of income taxes) is deducted from equity attributable to the Bank's equity holders until the shares are cancelled, reissued or disposed of. Where such shares are subsequently sold or reissued, any consideration received, net of any directly attributable incremental transaction costs and the related income tax effects, is included in equity attributable to the Bank's equity holders.

Dividend distribution to the Bank's shareholders is recognised as a liability in the financial statements in the period in which the dividends are approved by the Bank's shareholders.

2.25 Fiduciary activities

The Bank manages assets for and on behalf of legal entities and individuals, and charges a fee for such services. Given that those assets do not represent the assets of the Bank, they have not been included in the balance sheet.

Note 3 – financial risk management

The Bank's activities expose it to a variety of financial risks and those activities involve the analysis, evaluation, acceptance and management of some degree of risk or combination of risks. Taking risk is core to the financial business, and the operational risks are an inevitable consequence of being in business. The Group's aim is therefore to achieve an appropriate balance between risk and return and minimise potential adverse effects on the Bank's financial performance.

The Bank's risk management policies are designed to identify and analyse these risks, to set appropriate risk limits and controls, and to monitor the risks and adherence to limits by means of reliable and up-to-date information systems. The Bank regularly reviews its risk management policies and systems to reflect changes in markets, products and emerging best practice.

Risk management is carried out by the Risk Management and Loan Recovery Department under policies approved by the Management Board. The Risk Management and Loan Recovery Department identifies, evaluates and hedges financial risks in close co-operation with the Bank's operating units. The Board provides written principles for overall risk management, as well as written policies covering specific areas, such as foreign exchange risk, interest rate risk, credit risk, use of derivative financial instruments and non-derivative financial instruments. In addition, internal audit is responsible for the independent review of risk management and the control environment.

The most important types of risk are credit risk, liquidity risk, market risk and other operational risks. Market risk includes currency risk, interest rate and other price risks.

3.1 Credit risk

The Bank takes on exposure to credit risk, which is the risk that a counterparty will cause a financial loss for the Bank by failing to discharge an obligation. Significant changes in the economy, or in the health of a particular industry segment that represents a concentration in the Bank's portfolio, could result in losses that are different from those provided for at the balance sheet date. Management therefore carefully manages its exposure to credit risk. Credit exposures arise principally in loans and advances, debt securities and other bills. There is also credit risk in off-balance sheet financial arrangements such as loan commitments. The credit risk management and control are centralised in a credit risk management team in the Risk Management and Loan Recovery Department and reported to the Management Board and head of each business unit regularly.

3.1.1 Credit risk measurement

(a) Loans and advances

In measuring credit risk of loan and advances to customers and to banks at a counterparty level, the Bank reflects three components (i) the 'probability of default' by the client or counterparty on its contractual obligations; (ii) current exposures to the counterparty and its likely future development, from which the Bank derive the 'exposure at default'; and (iii) the likely recovery ratio on the defaulted obligations (the 'loss given default').

Note 3 – financial risk management (continued)

(i) The Bank assesses the probability of default of individual counterparties using internal rating tools tailored to the various categories of counterparty. They have been developed internally and combine statistical analysis with credit officer judgment and are validated, where appropriate, by comparison with externally available data. Clients of the Bank are segmented into three rating classes. The Bank's rating scale, which is shown below, reflects the range of default probabilities defined for each rating class. This means that, in principle, exposures migrate between classes as the assessment of their probability of default changes. The rating tools are kept under review and upgraded as necessary. The Bank regularly validates the performance of the rating and their predictive power with regard to default events.

Bank's internal ratings scale and mapping of external ratings

Bank's rating	Description of the grade	External rating: Central bank
1	Fully recoverable investments	A, A1
2	Partially recoverable investments	B1, B2, B3
3	Unrecoverable investments	C

Observed defaults per rating category vary year on year, especially over an economic cycle.

(ii) Exposure at default is based on the amounts the Bank expects to be owed at the time of default. For example, for a loan this is the face value. For a commitment, the Bank includes any amount already drawn plus the further amount that may have been drawn by the time of default, should it occur.

(iii) Loss given default or loss severity represents the Bank's expectation of the extent of loss on a claim should default occur. It is expressed as percentage loss per unit of exposure and typically varies by type of counterparty, type and seniority of claim and availability of collateral or other credit mitigation.

(b) Debt securities and other bills

The investments in those securities and bills are viewed as a way to gain a better credit quality mapping and maintain a readily available source to meet the funding requirement at the same time.

3.1.2 Risk limit control and mitigation policies

The Bank manages, limits and controls concentrations of credit risk wherever they are identified - in particular, to individual counterparties and groups, and to industries and countries.

The Bank structures the levels of credit risk it undertakes by placing limits on the amount of risk accepted in relation to one borrower, or banks of borrowers, and to geographical and industry segments. Such risks are monitored on a revolving basis and subject to an annual or more frequent review, when considered necessary. Limits on the level of credit risk by product, industry sector and by country are approved quarterly by the Management Board.

Note 3 – financial risk management (continued)

3.1.2 Risk limit control and mitigation policies (continued)

The exposure to any one borrower including banks and brokers is further restricted by sub-limits covering on- and off-balance sheet exposures, and daily delivery risk limits in relation to trading items. Actual exposures against limits are monitored daily.

Exposure to credit risk is also managed through regular analysis of the ability of borrowers and potential borrowers to meet interest and capital repayment obligations and by changing these lending limits where appropriate.

Some other specific control and mitigation measures are outlined below.

(a) Collateral

The Bank employs a range of policies and practices to mitigate credit risk. The most traditional of these is the taking of security for funds advances, which is common practice. The Bank implements guidelines on the acceptability of specific classes of collateral or credit risk mitigation. The principal collateral types for loans and advances are:

- Mortgages over residential properties;
- Charges over business assets such as premises, inventory and accounts receivable;
- Charges over financial instruments such as debt securities and equities.

Longer-term finance and lending to corporate entities are generally secured; revolving individual credit facilities are generally unsecured. In addition, in order to minimise the credit loss the Bank will seek additional collateral from the counterparty as soon as impairment indicators are noticed for the relevant individual loans and advances.

Collateral held as security for financial assets other than loans and advances is determined by the nature of the instrument. Debt securities, treasury and other eligible bills are generally unsecured, with the exception of asset-backed securities and similar instruments, which are secured by portfolios of financial instruments.

(b) Credit-related commitments

The primary purpose of these instruments is to ensure that funds are available to a customer as required. Guarantees and standby letters of credit carry the same credit risk as loans. Documentary and commercial letters of credit – which are written undertakings by the Bank on behalf of a customer authorising a third party to draw drafts on the Bank up to a stipulated amount under specific terms and conditions – are collateralised by the underlying shipments of goods to which they relate and therefore carry less risk than a direct loan.

Commitments to extend credit represent unused portions of authorisations to extend credit in the form of loans, guarantees or letters of credit. With respect to credit risk on commitments to extend credit, the Bank is potentially exposed to loss in an amount equal to the total unused commitments. However, the likely amount of loss is less than the total unused commitments, as most commitments to extend credit are contingent upon customers maintaining specific credit standards. The Bank monitors the term to maturity of credit commitments because longer-term commitments generally have a greater degree of credit risk than shorter-term commitments.

Note 3 – financial risk management (continued)

3.1.3 Impairment and provisioning policies

The internal and external rating systems described in Note 3.1.1 focus more on credit-quality mapping from the inception of the lending and investment activities. In contrast, impairment provisions are recognised for financial reporting purposes only for losses that have been incurred at the balance sheet date based on objective evidence of impairment (see Note 2.15). Due to the different methodologies applied, the amount of incurred credit losses provided for in the financial statements are usually lower than the amount determined from the expected loss model that is used for internal operational management and banking regulation purposes.

The impairment provision shown in the balance sheet at year-end is derived from each of the three internal rating grades. However, the majority of the impairment provision comes from the bottom two grades. The table below shows the percentage of the Bank's on- and off-balance sheet items relating to loans and advances and the associated impairment provision for each of the Bank's internal rating categories:

Bank's rating

	2007		2006	
	Loans and advances (%)	Impairment provision (%)	Loans and advances (%)	Impairment provision (%)
1 Fully recoverable investments	97.61%	-	97.99%	-
2 Partially recoverable investments	1.82%	41.85%	1.42%	39.78%
3 Unrecoverable investments	0.57%	58.15%	0.59%	60.22%
	100.00%	**100.00%**	**100.00%**	**100.00%**

The internal rating tool assists management to determine whether objective evidence of impairment exists under IAS 39, based on the following criteria set out by the Bank:

- Delinquency in contractual payments of principal or interest;
- Cash flow difficulties experienced by the borrower (eg equity ratio, net income percentage of sales);
- Breach of loan covenants or conditions;
- Initiation of bankruptcy proceedings;
- Deterioration of the borrower's competitive position;
- Deterioration in the value of collateral; etc.
- Downgrading below fully recoverable level.

The Bank's policy requires the review of individual financial assets that are above materiality thresholds at least annually or more regularly when individual circumstances require. Impairment allowances on individually assessed accounts are determined by an evaluation of the incurred loss at balance-sheet date on a case-by-case basis, and are applied to all individually significant accounts. The assessment normally encompasses collateral held (including re-confirmation of its enforceability) and the anticipated receipts for that individual account.

Collectively assessed impairment allowances are provided according to the applicable regulations currently in force.

Note 3 – financial risk management (continued)

3.1.4 Maximum exposure to credit risk before collateral held or other credit enhancements

	2007	2006
Credit risk exposures relating to on-balance sheet assets are as follows:		
Treasury bills and other eligible bills	60,089	139,630
Loans and advances to banks	410,304	290,278
Loans and advances to customers:		
Loans to individuals:		
– Overdrafts	13,723	12,046
– Housing loans	163,714	127,998
– Mortgages	25,531	20,048
– Credit cards	6,471	5,116
– Other	334,862	321,989
Loans to corporate entities:		
– Large corporate customers	68,484	33,036
– Small and medium size enterprises (SMEs)	498,164	406,531
– Other	40,126	36,411
Trading assets		
– Debt securities	9,205	35,333
Investment securities		
– Debt securities	81,788	65,108
Other assets	2,228	1,646
Credit risk exposures relating to off-balance sheet items are as follows:		
Financial guarantees	25,889	25,860
Loan commitments and other credit related liabilities	129,161	86,809
At 31 December	**1,869,739**	**1,607,839**

The above table represents a worse case scenario of credit risk exposure to the Bank at 31 December 2007 and 2006, without taking account of any collateral held or other credit enhancements attached. For on-balance-sheet assets, the exposures set out above are based on net carrying amounts as reported in the balance sheet.

As shown above, 83.51 % of the total maximum exposure is derived from loans and advances to banks and customers (2006: 77.96 %); 4.87% represents investments in debt securities (2006: 6.25%).

Note 3 – financial risk management (continued)

Management is confident in its ability to continue to control and sustain minimal exposure of credit risk to the Bank resulting from both its loan and advances portfolio and debt securities based on the following:

- 66.84% of the loans and advances portfolio is categorised in the top two grades of the internal rating system (2006: 64.21%);
- Mortgage loans are backed by collateral;
- 94.93% of the loans and advances portfolio are considered to be neither past due nor impaired (2006: 94.06%);
- Of the 1,176,729 thousand HRK of loans and advances assessed on an individual basis, less than 2.18 % is impaired;
- The Bank has introduced a more stringent selection process upon granting loans and advances; and
- Total investments in debt securities and other bills have at least at A- credit rating.

3.1.5 Loans and advances

Loans and advances are summarised as follows:

	31 December 2007		31 December 2006	
	Loans and advances to customers	Loans and advances to banks	Loans and advances to customers	Loans and advances to banks
Neither past due nor impaired	1,117,046	416,921	926,208	295,712
Past due but not impaired	31,576	-	38,628	-
Individually impaired	28,107	-	19,819	-
Gross	**1,176,729**	**416,921**	**984,655**	295,712
Less: allowance for impairment	(25,650)	(6,617)	(21,480)	(5,434)
Net	**1,151,079**	**410,304**	**963,175**	**290,278**

The total impairment provision for loans and advances is HRK 32,267 thousand (2006: HRK 26,914 thousand) of which HRK 14,856 thousand (2006: HRK 11,963 thousand) represents the individually impaired loans and the remaining amount of HRK 17,411 thousand (2006: HRK 14,951 thousand) represents the portfolio provision. Further information of the impairment allowance for loans and advances to banks and to customers is provided in Notes 18 and 19.

During the year ended 31 December 2007, the Bank's total loans and advances increased by 19.51% as a result of the expansion of the lending business, especially in extending loans to corporate customers. When entering into new markets or new industries, in order to minimise the potential increase of credit risk exposure, the Bank focused more on the business with small and medium size enterprises or banks with good credit rating or retail customers providing sufficient collateral.

Note 3 – financial risk management (continued)

(a) Loans and advances neither past due nor impaired

The credit quality of the portfolio of loans and advances that were neither past due nor impaired can be assessed by reference to the internal rating system adopted by the Bank.

31 December 2007

	Loans and advances to customers									
	Individual (retail customers)					Corporate entities				
	Overdrafts	Credit cards	Housing loans	Mortgages	Other	Large corporate customers	SMEs	Other	Total Loans and advances to customers	Loans and advances to banks
Grades:										
Fully recoverable investments	13,440	6,315	162,078	25,276	336,069	67,958	454,619	38,582	**1,104,336**	**416,921**
Partially recoverable investments	92	32	723	-	2,402	-	7,435	-	**10,684**	-
Unrecoverable investments	109	35	109	-	1,617	-	147	8	**2,025**	-
Total	**13,641**	**6,382**	**162,910**	**25,276**	**340,088**	**67,958**	**462,201**	**38,590**	**1,117,046**	**416,921**

Mortgage loans in the "Unrecoverable investments" class were considered not to be impaired after taking into consideration the recoverability from collateral.

31 December 2006

	Loans and advances to customers									
	Individual (retail customers)					Corporate entities				
	Overdrafts	Credit cards	Housing loans	Mortgages	Other	Large corporate customers	SMEs	Other	Total Loans and advances to customers	Loans and advances to banks
Grades:										
Fully recoverable investments	11,840	5,050	126,457	19,241	315,905	33,048	371,130	36,275	**918,946**	295,712
Partially recoverable investments	77	-	213	-	2,766	-	2,366	-	**5,423**	-
Unrecoverable investments	88	33	1	-	1,710	-	-	7	**1,839**	-
Total	**12,005**	**5,083**	**126,671**	**19,241**	**320,381**	**33,048**	**373,497**	**36,282**	**926,208**	**295,712**

Note 3 – financial risk management (continued)

3.1 Credit risk (continued)

(b) Loans and advances past due but not impaired

Loans and advances less than 90 days past due are not considered impaired, unless other information is available to indicate the contrary. Gross amount of loans and advances by class to customers that were past due but not impaired were as follows:

31 December 2007

	Individual (retail customers)					
	Overdrafts	Credit cards	Housing loans	Mortgages	Other	Total
Past due up to 30 days	-	123	1,631	2,304	8,256	12,314
Past due 30 - 90 days	-	-	35	91	2,134	2,260
Total	-	123	1,666	2,395	10,390	14,574
Fair value of collateral	-	-	196,307	77,962	26,994	301,263

	Large corporate customers	SMEs	Other	Total
Past due up to 30 days	598	13,864	-	14,462
Past due 30 - 90 days	-	2,540	-	2,540
Total	598	16,404	-	17,002
Fair value of collateral	31,937	934,273	-	966,210

Upon initial recognition of loans and advances, the fair value of collateral is based on valuation techniques commonly used for the corresponding assets. In subsequent periods, the fair value is updated by referent to market price or indexes of similar assets.

31 December 2006

	Individual (retail customers)					
	Overdrafts	Credit cards	Housing loans	Mortgages	Other	Total
Past due up to 30 days	-	65	1,146	709	8,056	9,976
Past due 30 - 90 days	-	-	89	23	1,055	1,167
Total	-	65	1,235	732	9,111	11,143
Fair value of collateral	-	-	153,680	61,630	25,206	240,516

	Large corporate customers	SMEs	Other	Total
Past due up to 30 days	400	19,849	-	20,249
Past due 30 - 90 days	-	7,236	-	7,236
Total	400	27,085	-	27,485
Fair value of collateral	17,429	802,439	-	819,868

Note 3 – financial risk management (continued)

3.1 Credit risk (continued)

(c) Loans and advances individually impaired
Loans and advances to customers

The individually impaired loans and advances to customers before taking into consideration the cash flows from collateral held is HRK 28,107 thousand (2006: HRK 19,819 thousand).

The breakdown of the gross amount of individually impaired loans and advances by class, along with the fair value of related collateral held by the Bank as security, are as follows:

	Individual					Corporate entities			
	Overdrafts	Credit cards	Housing loans	Mortgages	Other	Large corporate customers	SMEs	Other	Total
31 December 2007									
Individually impaired loans	2,027	94	745	113	7,193	-	17,928	6	**28,107**
Fair value of collateral	-	-	196,307	77,961	26,994	31,937	934,272	24,411	**1,291,885**
31 December 2006									
Individually impaired loans	2,020	58	178	-	7,376	-	10,186	2	**19,819**
Fair value of collateral	-	-	153,679	61,629	25,206	17,429	802,438	23,221	**1,083,606**

(d) Loans and advances renegotiated

Restructuring activities include extended payment arrangements, modification and deferral of payments. Restructuring policies and practices are based on indicators or criteria which, in the judgment of the Management Board, indicate that payment will most likely continue. These policies are kept under continuous review. Restructuring is most commonly applied to loans for corporate customers financing. Within these loans there were no renegotiated loans that would otherwise be past due or impaired either at 31 December 2007 or 2006.

3.1.6 Debt securities, treasury bills, commercial and other eligible bills

Total investments in debt securities, treasury, commercial and other bills have at least at A- credit rating.

Note 3 – financial risk management (continued)

3.1.7 Repossessed collateral

During 2006, the Bank obtained assets (business premises) by taking possession of collateral held as security in the amount of HRK 14,938 thousand. During 2007 the Bank sold business premise in the amount of HRK 13,607 thousand. As at 31 December 2007 repossessed collateral is as follows:

Nature of assets	Carrying value
Business premises	1,331

Repossessed properties are sold as soon as practicable with the proceeds used to reduce the outstanding indebtedness. Repossessed property is classified in the balance sheet within other assets available for sale.

3.1.8 Concentration of risks of financial assets with credit risk exposure

(a) Geographical sectors

The following table breaks down the Bank's main credit exposure at their carrying amounts, as categorised by geographical region as of 31 December 2007. For this table, the Bank has allocated exposures to regions based on the country of domicile of its counterparties.

	Croatia	European Union	Other countries	Total
Treasury bills and other eligible bills	60,089	-	-	60,089
Loans and advances to banks	62,700	347,550	54	410,304
Loans and advances to customers:				
Loans to individuals:				
- Overdrafts	13,723	-	-	13,723
- Housing loans	163,714	-	-	163,714
- Mortgages	25,531	-	-	25,531
- Credit cards	6,471	-	-	6,471
- Other	334,862	-	-	334,862
Loans to corporate entities:				
- Large corporate customers	68,484	-	-	68,484
- SMEs	498,166	-	-	498,166
- Other	40,128	-	-	40,128
Trading assets – debt securities	9,205	-	-	9,205
Investment securities – debt securities	81,788	-	-	81,788
Other assets	2,228	-	-	2,228
As at 31 December 2007	**1,367,089**	**347,550**	**54**	**1,714,693**
As at 31 December 2006	**1,218,964**	**276,183**	**23**	**1,495,170**

Note 3 – financial risk management (continued)

3.1 Credit risk (continued)

(b) Industry sectors

The following table breaks down the Bank's main credit exposure at their carrying amounts, as categorised by the industry sectors of our counterparties.

2007	Financial institutions	Manu-facturing	Real estate	Wholesale and retail trade	Public sector	Other industries	Individuals	Total
Treasury bills and other eligible bills	4,933	4,364	582	20,662	28,338	1,210	-	60,089
Loans and advances to banks	410,304	-	-	-	-	-	-	410,304
Loans and advances to customers:								
Loans to individuals:								
- Overdrafts	-	-	-	-	-	-	13,723	13,723
- Credit cards	-	-	-	-	-	-	6,471	6,471
- Housing loans	-	-	-	-	-	-	163,714	163,714
- Mortgages	-	-	-	-	-	-	25,531	25,531
- Other loans to individuals	-	-	-	-	-	-	334,862	334,862
Loans to corporate entities:								
- Large corporate customers	-	19,720	-	11,627	-	37,137	-	68,484
- SMEs	-	67,364	49,857	220,523	-	160,422	-	498,166
- Other	-	-	-	-	19,695	20,433	-	40,128
Trading assets – debt securities	-	4,794	958	-	3,453	-	-	9,205
Investment securities – debt securities	60,500	-	-	-	21,288	-	-	81,788
Other assets	-	-	-	-	-	2,228	-	2,228
As at 31 December 2007	475,737	96,242	51,397	252,812	72,774	221,430	544,301	1,714,693
As at 31 December 2006	337,817	129,764	43,696	212,708	201,130	82,858	487,197	1,495,170

Note 3 – financial risk management (continued)

3.2 Market risk

The Bank takes on exposure to market risks, which is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices. Market risks arise from open positions in interest rate, currency and equity products, all of which are exposed to general and specific market movements and changes in the level of volatility of market rates or prices such as interest rates, credit spreads, foreign exchange rates and equity prices. The Bank separates exposures to market risk into either trading or non-trading portfolios.

The market risks arising from trading and non-trading activities are concentrated in the Treasury and Financial Markets Division. Regular reports are submitted to the Management Board and heads of each business unit.

Trading portfolios include those positions arising from market-making transactions where the Bank acts as principal with clients or with the market.

Non-trading portfolios primarily arise from the interest rate management of the entity's retail and commercial banking assets and liabilities. Non-trading portfolios also consist of foreign exchange and equity risks arising from the Bank's held-to-maturity and available-for-sale investments.

3.2.1 Market risk measurement techniques

As part of the risk management process, the Bank operates a risk hedging strategy. The most significant measurement technique used by the Bank for measuring and controlling market risk is historical simulation. The Bank assessed the potential movement of variables of certain financial instruments by applying average monthly interest rates to all financial instruments recorded with a variable yield, movements of the EUR/USD exchange rate and the stock market index CROBEX, CROBIS in the last three years of operation.

The data on the level of the Bank's exposure to currency, interest rate and price risk by using the stated historical changes of rates, prices, exchange rates, indicators etc. directly on balance sheet items as at 31 December 2007 and 2006 are presented below:

	2007	2006
	(in thousands of HRK)	
Currency rate risk exposure	22,283	5,037
Interest rate risk exposure	10,843	21,519
Securities available for sale price risk	1,975	12
Other securities price risk	3,896	1,113

Note 3 – financial risk management (continued)

3.2.2 Foreign exchange risk

The Bank takes on exposure to the effects of fluctuations in the prevailing foreign currency exchange rates on its financial position and cash flows.

The Bank sets principles and limits for foreign currency exposures which are monitored daily. The Bank directs its business activities trying to minimise the gap between assets and liabilities denominated in or linked to foreign currency, and maintaining the daily business activities within daily potential loss limits. The parameters are regularly reviewed in accordance with fluctuations in foreign currency rates and correlations between currencies.

The table below summarises the Bank's exposure to foreign currency exchange rate risk at 31 December. Included in the table are the Bank's financial instruments at carrying amounts, categorised by currency.

Concentrations of currency risk – on- and off-balance sheet financial instruments

(In thousands of HRK)	HRK	EUR	USD	Other currencies	Total
At 31 December 2007					
ASSETS					
Cash and balances with Central bank	201,021	141,022	1,704	6,638	350,385
Treasury bills and other eligible bills	60,089	-	-	-	60,089
Loans and advances to banks	62,640	289,879	57,779	6	410,304
Loans and advances to customers	330,138	812,009	4,777	4,155	1,151,079
Trading assets	5,240	8,194	-	-	13,434
Investment securities:					
- available for sale	63,711	12	-	-	63,723
- held to maturity	21,288	-	-	-	21,288
Other assets	3,324	9	-	-	3,333
Total financial assets	**747,451**	**1,251,125**	**64,260**	**10,799**	**2,073,635**
LIABILITIES					
Due to banks	1,137	23,528	4	-	24,669
Due to customers	607,830	1,209,674	64,401	9,642	1,891,547
Other liabilities	12,381	6,174	62	28	18,645
Total financial liabilities	**621,348**	**1,239,376**	**64,467**	**9,670**	**1,934,861**
Net on-balance sheet financial position	**126,103**	**11,749**	**(207)**	**1,129**	**138,774**
Credit commitments	**49,971**	**36,946**	**-**	**-**	**86,917**
At 31 December 2006					
Total financial assets	623,749	1,125,366	82,258	11,326	1,842,699
Total financial liabilities	535,128	1,103,871	81,043	10,931	1,730,973
Net on-balance sheet financial position	**88,621**	**21,495**	**1,215**	**395**	**111,726**
Credit commitments	**6,316**	**46,679**	**-**	**-**	**52,995**

Note 3 – financial risk management (continued)

3.2.3 Interest rate risk

Cash flow interest rate risk is the risk that the future cash flows of a financial instrument will fluctuate because of changes in market interest rates. Fair value interest rate risk is the risk that the value of a financial instrument will fluctuate because of changes in market interest rates. The Bank takes on exposure to the effects of fluctuations in the prevailing levels of market interest rates on both its fair value and cash flow risks. Interest margins may increase as a result of such changes but may reduce losses in the event that unexpected movements arise. The Board sets limits on the level of mismatch of interest rate repricing that may be undertaken, which is monitored daily by the Bank's Treasury and Financial Markets Division.

The table below summarises the Bank's exposure to interest rate risks. Included in the table are the Bank's assets and liabilities at carrying amounts, categorised by the earlier of contractual repricing or maturity dates.

(In thousands of HRK)	Up to 1 month	1-3 months	3-12 months	1-3 years	Over 3 years	Non interest bearing	Total
At 31 December 2007							
ASSETS							
Cash and balances with Central bank	278,884	-	-	-	-	71,501	350,385
Treasury bills and other eligible bills	855	18,191	41,043	-	-	-	60,089
Loans and advances to banks	410,304	-	-	-	-	-	410,304
Loans and advances to customers	1,048,881	7,613	22,231	42,475	29,879	-	1,151,079
Trading assets	-	-	-	1,102	12,332	-	13,434
Investment securities:							
- available for sale	60,500	-	-	-	3,203	20	63,723
- held to maturity	-	-	-	-	21,288	-	21,288
Other assets	-	-	-	-	-	3,333	3,333
Total financial assets	**1,799,424**	**25,804**	**63,274**	**43,577**	**66,702**	**74,854**	**2,073,635**
LIABILITIES							
Due to banks	270	197	3,305	4,751	16,146	-	24,669
Due to customers	1,861,605	7	1,839	442	4,286	23,368	1,891,547
Other liabilities	18,645	-	-	-	-	-	18,645
Total financial liabilities	**1,880,520**	**204**	**5,144**	**5,193**	**20,432**	**23,368**	**1,934,861**
Total interest repricing gap	**(81,096)**	**25,600**	**58,130**	**38,384**	**46,270**	**51,486**	**138,774**
At 31 December 2006							
Total financial assets	1,466,343	30,875	151,957	43,878	52,382	97,264	1,842,699
Total financial liabilities	1,679,106	249	4,740	4,318	22,631	19,929	1,730,973
Total interest repricing	**(212,763)**	**30,626**	**147,217**	**39,560**	**29,751**	**77,335**	**111,726**

Note 3 – financial risk management (continued)

3.3 Liquidity risk

Liquidity risk is the risk that the Bank is unable to meet its payment obligations associated with its financial liabilities when they fall due and to replace funds when they are withdrawn. The consequence may be the failure to meet obligations to repay depositors and fulfill commitments to lend.

The Bank is exposed to daily calls on its available cash resources from overnight deposits, current accounts, maturing deposits, loan draw downs, guarantees and from margin and other calls on cash settled derivatives. The Bank does not maintain cash resources to meet all of these needs as experience shows that a minimum level of reinvestment of maturing funds can be predicted with a high level of certainty. Management sets limits on the minimum proportion of maturing funds available to meet such calls and on the minimum level of inter bank and other borrowing facilities that should be in place to cover withdrawals at unexpected levels of demand. The Bank manages liquidity reserves daily, ensuring also accomplishment of all customer needs.

3.3.1 Funding approach

Sources of liquidity are regularly reviewed by the Bank's Treasury and Financial Markets Division to maintain a wide diversification by currency, geography, provider, product and term.

3.3.2 Non-derivative cash flows

The table below presents the cash flows payable by the Bank under non-derivative financial liabilities by remaining contractual maturities at the balance sheet date. The amounts disclosed in the table are the contractual undiscounted cash flows, whereas the Bank manages the inherent liquidity risk based on expected undiscounted cash inflows.

Note 3 – financial risk management (continued)

3.3 Liquidity risk (continued)

(In thousands of HRK)	Up to 1 month	1- 3 months	3-12 months	1-3 years	Over 3 years	Total
At 31 December 2007						
LIABILITIES						
Due to banks	271	199	3,421	5,250	17,841	26,981
Due to customers	982,368	362,147	507,979	28,856	30,190	1,911,539
Other liabilities	10,936	-	7,709	-	-	18,645
Total liabilities (contractual maturity dates)	**993,575**	**362,346**	**519,108**	**34,106**	**48,031**	**1,957,166**
Total assets (expected maturity dates)	**895,989**	**112,822**	**289,270**	**291,084**	**539,280**	**2,128,445**
Net liquidity gap	**(97,586)**	**(249,524)**	**(229,838)**	**256,978**	**491,249**	**171,279**

(In thousands of HRK)	Up to 1 month	1- 3 months	3-12 months	1-3 years	Over 3 years	Total
At 31 December 2006						
LIABILITIES						
Due to banks	1,098	175	2,639	3,730	20,784	28,426
Due to customers	903,123	356,346	390,566	40,477	19,013	1,709,524
Other liabilities	2,937	172	3,951	5,220	127	12,407
Total liabilities (contractual maturity dates)	**907,158**	**356,693**	**397,156**	**49,427**	**39,924**	**1,750,358**
Total assets (expected maturity dates)	**658,623**	**138,623**	**360,034**	**237,515**	**483,349**	**1,878,144**
Net liquidity gap	**(248,535)**	**(218,070)**	**(37,122)**	**188,088**	**443,425**	**127,786**

Assets available to meet all of the liabilities and to cover outstanding loan commitments include cash, central bank balances, items in the course of collection and treasury and other eligible bills; loans and advances to banks; and loans and advances to customers. In the normal course of business, a proportion of customer loans contractually repayable within one year will be extended. In addition, debt securities and treasury and other bills have been pledged to secure liabilities. The Bank would also be able to meet unexpected net cash outflows by selling securities.

Note 3 – financial risk management (continued)

3.3.3 Off-balance sheet items (continued)

(a) Loan commitments

The dates of the contractual amounts of the Bank's off-balance sheet financial instruments that commit it to extend credit to customers and other facilities (Note 32), are summarised in the table below.

(b) Other financial facilities

Other financial facilities (Note 32), are also included below based on the earliest contractual maturity date.

	No later than 1 year	1-3 years	Over 3 years	Total
At 31 December 2007				
Loan commitments	111,596	-	10,905	122,501
Guarantees, acceptances and other financial facilities	31,715	598	1,565	33,878
Total	**143,311**	**598**	**12,470**	**156,379**
At 31 December 20076				
Loan commitments	77,736	-	-	77,736
Guarantees, acceptances and other financial facilities	23,767	12,034	100	35,901
Total	**101,503**	**12,034**	**100**	**113,637**

The matching and controlled mismatching of the maturities and interest rates of assets and liabilities is fundamental to the management of the Bank. It is unusual for banks ever to be completely matched since business transacted is often of uncertain term and of different types. An unmatched position potentially enhances profitability, but can also increase the risk of losses.

The maturities of assets and liabilities and the ability to replace, at an acceptable cost, interest–bearing liabilities as they mature, are important factors in assessing the liquidity of the Bank and its exposure to changes in interest rates and exchange rates.

Liquidity requirements to support calls under guarantees and standby letters of credit are considerably less than the amount of the commitment because the Bank does not generally expect the third party to draw funds under the agreement. The total outstanding contractual amount of commitments to extend credit does not necessarily represent future cash requirements, since many of these commitments will expire or terminate without being funded.

3.4 Fair values of financial assets and liabilities

Fair value represents the amount for which an asset can be exchanged or a liability settled between knowledgeable and willing parties at usual market conditions. Financial instruments which are assessed at fair value through profit and loss account and those which are available for sale are assessed at fair value.

Note 3 – financial risk management (continued)

3.4 Fair values of financial assets and liabilities (continued)

(a) Financial instruments measured at fair value using a valuation technique

The total amount of the change in fair value estimated using a valuation technique that was recognised in profit or loss during the period is HRK 504 thousand (2006: HRK 3.329 thousand).

(b) Financial instruments not measured at fair value

The table below summarises the carrying amounts and fair values of those financial assets and liabilities not presented on the bank's balance sheet at their fair value.

	Carrying value		Fair value	
	2007	2006	2007	2006
Financial assets				
Loans and advances to banks	410,304	290,278	408,697	288,854
Loans and advances to customers				
- Retail customers (individual)	544,301	487,197	542,459	485,797
- Large corporate customers	68,484	33,036	68,056	32,716
- SMEs	498,166	406,531	496,608	404,564
- Other	40,128	36,411	39,877	36,059
Trading assets	13,435	37,489	13,435	37,489
Investment securities available for sale	63,723	47,616	63,723	47,616
Investment securities (held-to-maturity)	21,288	20,108	21,288	20,108
Total financial assets	**1,659,829**	**1,358,666**	**1,654,143**	**1,353,203**
Financial liabilities				
Due to banks	24,669	26,003	24,444	25,785
Due to customers	1,891,547	1,692,447	1,886,417	1,687,956
Total financial liabilities	**1,916,216**	**1,718,450**	**1,910,861**	**1,713,741**
Off-balance sheet financial instruments				
Loan commitments	122,501	77,736	122,067	77,410
Guarantees, acceptances and other financial facilities	33,878	35,901	33,772	35,814

/i/ Due from other banks

Due from other banks includes inter-bank placements and items in the course of collection. The fair value of floating rate placements and overnight deposits is their carrying amount.

Note 3 – financial risk management (continued)

3.4 Fair values of financial assets and liabilities (continued)

/ii/ Loans and advances to customers

Fair value of loans and advances is calculated based on discounted expected future principal and interest cash flows. For loans that do not have fixed repayment dates repayments are estimated based on experience in previous periods when interest rates were at levels similar to current levels, adjusted for any differences in interest rate outlook. Expected future cash flows are estimated considering credit risk and any indication of impairment. Expected future cash flows for homogeneous categories of loans are estimated on a portfolio basis and discounted at current rates offered for similar loans to new borrowers with similar credit profiles. The estimated fair values of loans reflect changes in credit status since the loans were made and changes in interest rates in the case of fixed rate loans. As the Bank has a very limited portfolio of loans and advances with fixed rate and longer-term maturity, the fair value of loans and advances is not significantly different from their carrying value.

/iii/ Bank and customer deposits

For demand deposits and deposits with no defined maturities, fair value is taken to be the amount payable on demand at the balance sheet date. The estimated fair value of fixed-maturity deposits is based on discounted cash flows using rates currently offered for deposits of similar remaining maturities. The value of long-term relationships with depositors is not taken into account in estimating fair values. As most of the Bank's deposits are given with variable rate, there is no significant difference between the fair value of these deposits and their carrying value.

/iv/ Borrowings

As the majority of the Bank's borrowings bear interest at variable rates, which are paid regularly, there is no significant difference between their carrying and fair value.

/v/ Investment securities

Investment securities include only interest-bearing assets held to maturity, as assets available-for-sale are measured at fair value. Fair value for held to maturity asset is based on market prices or broker/dealer price quotations. Where this information is not available, fair value has been estimated using quoted market prices for securities with similar credit, maturity and yield characteristics.

/vi/ Debt securities in issue

The aggregate fair values are calculated based on quoted market prices. For those notes where quoted market prices are not available, a discounted cash flow model is used based on a current yield curve appropriate for the remaining term to maturity. There is no significant difference between their carrying and fair value.

/vii/ Off-balance sheet financial instruments

The estimated fair values of the off-balance sheet financial instruments are based on markets prices for similar facilities. When this information is not available, fair value is estimated using discounted cash flow analysis.

Note 3 – financial risk management (continued)

3.5 Capital management

The Bank's objectives when managing capital, which is a broader concept than the 'equity' on the face of balance sheets, are:

- to comply with the capital requirements set by the regulators of the banking markets where the entities within the Bank operate;
- To safeguard the Bank's ability to continue as a going concern so that it can continue to provide returns for shareholders and benefits for other stakeholders; and
- To maintain a strong capital base to support the development of its business.

Capital adequacy and the use of regulatory capital are monitored daily by the Bank's management, employing techniques based on the regulatory requirements of the Croatian National Bank (the Authority), for supervisory purposes. The required information is filed with the Authority on a quarterly basis.

The Authority requires each bank or banking group to: (a) hold the minimum level of the regulatory capital, and (b) maintain a ratio of total regulatory capital to the risk-weighted asset at the minimum of 10%.

The Bank's regulatory capital as managed by its Treasury and Financial Markets Division is divided into two tiers:.

- Tier 1 capital: share capital (net of any book values of the treasury shares), retained earnings and reserves created by appropriations of retained earnings. The book value of goodwill is deducted in arriving at Tier 1 capital; and
- Tier 2 capital: qualifying subordinated loan capital, collective impairment allowances and unrealised gains arising on the fair valuation of equity instruments held as available for sale.

Investments in associates are deducted from Tier 1 and Tier 2 capital to arrive at the regulatory capital. The risk-weighted assets are measured by means of a hierarchy of five risk weights classified according to the nature of – and reflecting an estimate of credit, market and other risks associated with – each asset and counterparty, taking into account any eligible collateral or guarantees. A similar treatment is adopted for off-balance sheet exposure, with some adjustments to reflect the more contingent nature of the potential losses.

The table below summarises the composition of regulatory capital and the ratios of the Bank for the years ended 31 December. During those two years, the individual entities within the Bank and the Bank complied with all of the externally imposed capital requirements to which they are subject.

Note 3 – financial risk management (continued)

3.5 Capital management (continued)

	2007	2006
Tier 1 capital		
Paid-up ordinary shares	63,236	63,236
Paid-up preference shares (other than cumulative preference shares)	1,664	1,664
Reserves from profit after taxations	54,752	45,421
Retained earnings (including previous years' earnings)	26,673	26,659
Profit for the current year	17,232	9,344
Capital gains	180	180
Gross Tier 1 capital	**163,737**	**146,504**
Less:		
Intangible assets and positive consolidated reserves	50	50
Acquired treasury shares	26	26
Undue repayments of loans extended to finance the Bank's own shares purchase	-	112
Total deductions from Tier 1 capital	**76**	**188**
Total qualifying Tier 1 capital (Tier 1 less deductions)	**163,661**	**146,316**
Tier 2 capital		
Collective impairment allowance	18,740	15,918
Gross Tier 2 capital	**18,740**	**15,918**
Less:		**-**
Unidentified loan loss allowance not included in Tier 2	11,232	2,896
Total deductions from Tier 2 capital	**11,232**	**2,896**
Total qualifying Tier 2 capital	**7,508**	**13,021**
Total regulatory capital	**171,169**	**159,338**
Risk-weighted assets:		
On-balance sheet	1,431,755	1,251,691
Off-balance sheet	75,643	57,849
Total risk-weighted assets	**1,507,398**	**1,309,540**

The increase of the regulatory capital in the year of 2007 is mainly due to the contribution of the current-year profit. The increase of the risk-weighted assets reflects the expansion of the business in SMEs in 2007.

Note 4 – critical accounting estimates

The Bank makes estimates and assumptions that affect the reported amounts of assets and liabilities within the next financial year. Estimates and judgments are continually evaluated and are based on historical experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances.

(a) Impairment losses on loans and advances

The Bank reviews its loan portfolios to assess impairment at least on a quarterly basis. In determining whether an impairment loss should be recorded in the income statement, the Bank makes judgments as to whether there is any observable data indicating that there is a measurable decrease in the estimated future cash flows from a portfolio of loans before the decrease can be identified with an individual loan in that portfolio. This evidence may include observable data indicating that there has been an adverse change in the payment status of borrowers in a group, or national or local economic conditions that correlate with defaults on assets in the group. Management uses estimates based on historical loss experience for assets with credit risk characteristics and objective evidence of impairment similar to those in the portfolio when scheduling its future cash flows. The methodology and assumptions used for estimating both the amount and timing of future cash flows are reviewed regularly to reduce any differences between loss estimates and actual loss experience.

To the extent that the net present value of estimated cash flows were to be higher by +2%, the provision would be estimated HRK 552 thousand lower.

(b) Impairment of available for-sale equity investments

The Bank determines that available-for-sale equity investments are impaired when there has been a significant or prolonged decline in the fair value below its cost. This determination of what is significant or prolonged requires judgment. In making this judgment, the Bank evaluates among other factors, the normal volatility in share price. In addition, impairment may be appropriate when there is evidence of a deterioration in the financial health of the investee, industry and sector performance, changes in technology, and operational and financing cash flows.

The changes in fair value of securities within the available for sale portfolio are not considered material and do not have an impact on the Bank's financial result.

Note 5 – segment analysis

(a) By business segment

The Bank is divided into two main business segments:

- Retail banking – incorporating private customer current accounts, savings, deposits, credit and debit cards, consumer loans and mortgages;
- Corporate banking – incorporating direct debit facilities, current accounts, deposits, overdrafts, loan and other credit facilities, foreign currency and derivative products;

Other Bank operations comprise financial instruments trading and fund management, none of which constitutes a separately reportable segment.

(In thousands of HRK)	Retail banking	Corporate banking	Other	Total
At 31 December 2007				
Revenues	51,271	85,405	10,668	147,344
Segment result	10,095	79,071	5,832	94,998
Unallocated costs	-	-	-	(59,977)
Operating profit	-	-	-	35,021
Income tax expense	-	-	-	7,759
Net profit	-	-	-	27,262
Segment assets	357,153	1,237,632	202,765	1,797,550
Unallocated assets	-	-	-	313,014
Total assets	-	-	-	2,110,564
Segment liabilities	1,708,046	105,209	88,182	1,901,437
Unallocated liabilities	-	-	-	35,387
Total liabilities	-	-	-	1,936,824
Other segment items				
Capital expenditure	5,368	49	2,771	8,188
Depreciation	2,614	1,758	116	4,488
Impairment charge - loans	1,843	4,017	-	5,860
Other non-cash expenses	-	9,552	-	9,552

Note 5 – segment analysis (continued)

(a) By business segment (continued)

(In thousands of HRK)	Retail banking	Corporate banking	Other	Total
At 31 December 2006				
Revenues	48,264	75,289	7,190	130,743
Segment result	12,337	66,185	3,716	82,238
Unallocated costs	-	-	-	(54,919)
Operating profit	-	-	-	27,319
Income tax expense	-	-	-	5,823
Net profit	-	-	-	21,496
Segment assets	310,910	1,008,490	247,408	1,566,808
Unallocated assets	-	-	-	322,795
Total assets	-	-	-	1,889,603
Segment liabilities	1,531,195	85,131	91,279	1,707,605
Unallocated liabilities	-	-	-	23,368
Total liabilities	-	-	-	1,730,973
Other segment items				
Capital expenditure	850	60	2,846	3,756
Depreciation	3,354	2,139	36	5,529
Impairment charge - loans	(978)	1,373	-	395
Other non-cash expenses	4,199	1,564	301	6,064

The matching of assets and liabilities by segments with the Bank's assets and liabilities is summarized as follows:

(In thousands of HRK)	2007		2006	
	Assets	Liabilities	Assets	Liabilities
Assets / Liabilities by segments	**1,797,550**	**1,901,437**	**1,566,808**	**1,707,605**
Unallocated:	**313,014**	**35,387**	**322,795**	**23,368**
Cash and balances with the Croatian National Bank	288,795	-	279,860	-
Provisions	(16,092)	-	(7,448)	-
Property and equipment	32,736	-	28,965	-
Intangible assets	2,861	-	3,001	-
Non-current assets held for sale	1,331	-	14,938	-
Other assets	3,363	-	3,459	-
Investment securities available for sale	20	-	20	-
Income tax liability	-	1,963	-	116
Due to customers	-	15,050	-	11,081
Other liabilities	-	18,374	-	12,171
Total	**2,110,564**	**1,936,824**	**1,889,603**	**1,730,973**

(b) The geographical segment is disclosed in Note 3.1.8

Revenue from external customers realised over 91% in Croatia.

Note 6 – net interest income

Interest income

	2007	2006
	(in thousands of HRK)	
Loans and advances to :		
- to customers	85,515	74,063
- to banks	3,401	782
Cash and short-term funds	15,371	13,772
Securities	8,265	8,105
Other	14	-
	112,566	**96,722**

Interest expense

	2007	2006
	(in thousands of HRK)	
Customers deposits	40,982	35,219
Other borrowed funds	483	446
Other	-	106
	41,465	**35,771**

Interest income accrued on impaired financial assets is HRK 2,399 thousand (2006: HRK 3,657 thousand).

Note 7 – net fee and commission income

Fee and commission income

	2007	2006
	(in thousands of HRK)	
Domestic and foreign currency transactions	15,614	15,945
Guarantees and letter of credits given	1,116	1,362
Other	4,316	3,667
	21,046	**20,974**

Fee and commission expense

	2007.	2006.
	(in thousands of HRK)	
Domestic and foreign currency transactions	5,099	8,075
Other	186	184
	5,285	**8,259**

NOTE 8 – FOREIGN EXCHANGE DIFFERENCES - NET

	2007	2006
	(in thousands of HRK)	
Net foreign exchange differences from operations	13,756	12,560
Gains on translation of foreign currency assets and liabilities	786	180
	14,542	**12,740**

NOTE 9 – RESULT ON TRADING ASSETS

	2007.	2006.
	(in thousands of HRK)	
Change in fair value of trading assets	(504)	(3,329)
Net gains from trading assets	811	643
	307	**(2,686)**

NOTE 10 – OTHER OPERATING INCOME

	2007	2006
	(in thousands of HRK)	
Write off 'dead accounts'	774	-
Rental income	376	282
Sickness expenses refund	337	372
Other	298	180
	1,785	**834**

Note 11 – administrative expenses

	2007	2006
	(in thousands of HRK)	
Staff costs		
Wages and salaries	16,818	15,570
Pension contributions	5,027	4,607
Social security contributions	3,773	3,458
Other contributions and taxes on wages and salaries	3,802	3,349
Termination benefits	62	159
Other staff benefits	2,480	2,399
	31,962	29,542
Other administrative expenses	18,568	15,959
Depreciation and amortisation (Note 22 and 23)	4,488	5,529
	55,018	**51,030**

As at 31 December 2007 the Bank had 212 employees (2006: 202 employees).

Note 12 – other operating expenses

	2007	2006
	(in thousands of HRK)	
Saving deposits insurance charge	3,856	3,639
Rental cost	1,952	1,844
Software development costs	404	369
Taxes and contributions on income	687	656
Other	1,091	390
	7,990	**6,898**

Note 13 – impairment charge for credit losses-net

	2007	2006
	(in thousands of HRK)	
Loans and advances to banks (Note 18)	1,183	(2,104)
Loans and advances to customers (Note 19)	4,170	1,379
Other assets (Note 24)	143	98
Provisions for off-balance items (Note 27)	364	232
	5,860	**(395)**

NOTE 14 – INCOME TAX EXPENSE

	2007	2006
	(in thousands of HRK)	
Profits before tax	35,021	27,319
Non-taxable income	(159)	(293)
Deferred fee income	3,426	1,538
Non-deductible expenses	508	553
Income tax base	38,796	29,117
Income tax rate 20%	7,759	5,823
Tax pre-paid	(5,796)	(5,707)
Income tax liability	1,963	116

Temporary differences giving rise to deferred taxation are immaterial and accordingly, no provision for deferred taxation is considered necessary.

NOTE 15 – EARNINGS PER SHARE

Basic

Basic earnings per share are calculated by dividing the profit for the year by the weighted average number of existing shares (ordinary and preference) for the period, excluding own shares.

	2007	2006
	(in thousands of HRK)	
Profit after tax	27,262	21,496
Weighted average number of shares excluding own shares	58,988	58,988
Basic earnings per share –ordinary and preference (in kuna)	**462,16**	**364,41**

In 2007 and 2006 the dividend declared on ordinary and preference shares was equal (Note 30).

Diluted

Diluted earnings per share for 2007 and 2006 is equal to basic earnings per share, since the Bank did not have any convertible instruments and share options during both years.

Note 16 – cash and balances with central bank

	2007	2006
	(in thousands of HRK)	
Cash in hand	25,638	27,952
Giro account	40,733	61,019
Other money market placements	35,858	33,296
Funds included in cash and cash equivalents	102,229	122,267
Obligatory minimum reserves:		
- In HRK	147,641	132,731
- In foreign currency	100,515	86,195
	248,156	218,926
	350,385	**341,193**

The obligatory reserve represents amounts required to be deposited with the Croatian National Bank ('CNB').

The Obligatory reserve requirements consist of two parts, HRK and foreign exchange calculated on a monthly basis.

Note 17 – treasury bills and other eligible bills

	2007	2006
	(in thousands of HRK)	
Ministry of Finance bills	28,338	106,995
Commercial bills	7,896	16,923
Bills of exchange	23,855	15,712
	60,089	**139,630**

Treasury bills and bills of exchange are debt securities. Treasury bills are issued by Ministry of Finance of the Republic of Croatia for terms of three and nine months. Commercial bills and bills of exchanges are issued by several enterprises for terms of six months or nine months.

Note 18 – loans and advances to banks

	2007	2006
	(in thousands of HRK)	
Deposits in banks	347,604	276,233
Loans to banks	69,076	19,003
Items in course of collection from other banks	241	476
Less: Allowance for impairment	(6,617)	(5,434)
	410,304	**290,278**
Current	**410,304**	**290,278**

Reconciliation of allowance account for losses on loans and advances to other banks:

	2007.	2006.
	(in thousands of HRK)	
Balance at 1 January	**5,434**	**7,538**
Provision for loan impairment	1,183	-
Amounts recovered during the year	-	(2,104)
Balance at 31 December	**6,617**	**5,434**

Note 19 – loans and advances to customers

	2007	2006
	(in thousands of HRK)	
Retail customers:		
Overdrafts	13,723	12,052
Housing loans	162,903	128,124
Mortgages	25,402	20,058
Credit cards	6,526	5,195
Other loans and advances	354,981	333,216
	563,535	498,645
Corporate entities:		
- Large corporate customers	68,007	33,241
- SMEs	505,343	421,041
	573,350	454,282
Other	39,844	31,728
Gross loans and advances	1,176,729	984,655
Less: Allowance for impairment	(25,650)	(21,480)
Net	**1,151,079**	**963,175**
Current	**239,701**	**286,807**
Non-current	**911,378**	**676,368**

Reconciliation of allowance account for losses on loans and advances to customers:

	2007	2006
	(in thousands of HRK)	
Balance at 1 January	**21,480**	**19,997**
Provision for loan impairment	4,143	1,474
Foreign exchange differences	27	9
Balance at 31 December	**25,650**	**21,480**

Note 20 – trading assets

	2007	2006
	(in thousands of HRK)	
Debt securities - listed	9,205	35,333
Equity securities - listed	4,230	2,156
	13,435	**37,489**

Note 21 – investment securities

Securities available for sale

	2007	2006
	(in thousands of HRK)	
Debt securities at fair value - unlisted	60,500	45,000
Equity securities at fair value - unlisted	3,223	2,616
Total securities available for sale	**63,723**	**47,616**
Securities held to maturity		
Reconstruction bonds	21,288	20,108
Total securities held to maturity	**21,288**	**20,108**
Total investment securities	**85,011**	**67,724**
Current	**60,500**	**45,000**
Non-current	**24,511**	**22,724**

The reconstruction bonds of the Republic of Croatia were accepted in lieu of repayments from certain borrowers in 1991 and were non-transferable. The bonds were issued with 20 years maturity period and were revalued by applying the industrial product price index. No market exists for such instruments nor were there any publicly traded instruments with similar characteristics. On 6 April 2000, the Croatian Government made a Decision on replacing these Reconstruction Bonds with bonds bearing an interest rate of 5% as of 1 July 2000. These bonds are revalued in conformity to the rise in prices of industrial products. Given that the bonds are of high credit quality and the return approximates current market rates, management believes that the fair value is not materially different from their carrying value.

Investment in subsidiary is included among securities available-for-sale:

(in thousands of HRK)	Principal activity	Country of incorporation	Proportion of ownership interest	2007 Investment Cost	2006 Investment Cost
Fiducia d.o.o.	Wholesale trade	Croatia	100%	20	20

The Bank has one wholly owned subsidiary – FIDUCIA d.o.o., Umag, which was dormant during 2007 and 2006 and has not been consolidated in these financial statements due to its immaterial nature.

Note 21 – investment securities (continued)

Movements in investment securities may be summarised as follows:

(in thousands of HRK)	Available for sale	Held to maturity	Total
Balance at 1 January 2007	47,616	20,108	67,724
Additions	61,431	1,180	62,611
Sales	(45,324)	-	(45,324)
Balance at 31 December 2007	**63,723**	**21,288**	**85,011**
Balance at 1 January 2006	2,226	19,730	21,956
Additions	45,450	693	46,143
Sales	(60)	(315)	(375)
Balance at 31 December 2006	**47,616**	**20,108**	**67,724**

Gains from investment securities:

	2007	2006
	(in thousands of HRK)	
Sale of available-for-sale financial assets	393	298
	393	**298**

Notes 22 – intangible assets

	Software
	(in thousands of HRK)
At 31 December 2005	
Cost	7,334
Accumulated amortisation	(5,073)
Net book amount	**2,261**
Year ended 31 December 2006	
Opening net book amount	2,261
Additions	1,591
Amortisation charge (Note 11)	(851)
Closing net book amount	3,001
At 31 December 2006	
Cost	8,925
Accumulated amortisation	(5,924)
Net book amount	**3,001**
Year ended 31 December 2007	
Opening net book amount	3,001
Additions	769
Amortisation charge (Note 11)	(909)
Closing net book amount	2,861
At 31 December 2007	
Cost	9,553
Accumulated amortisation	(6,692)
Net book amount	**2,861**

Note 23 – property and equipment

(in thousands of HRK)	Land and buildings	Computer equipment	Furniture and equipment	Vehicles	Leasehold improvements	Construction in progress	Total
At 31 December 2005							
Cost	26,264	14,578	12,801	1,680	4,143	2,151	61,617
Accumulated depreciation	(8,985)	(10,736)	(7,721)	(1,091)	(1,606)	-	(30,139)
Net book amount	**17,279**	**3,842**	**5,080**	**589**	**2,537**	**2,151**	**31,478**
Year ended December 2006							
Opening net book amount	17,279	3,842	5,080	589	2,537	2,151	31,478
Additions	-	341	223	-	-	1,601	2,165
Depreciation charge (Note 11)	(754)	(1,645)	(1,025)	(218)	(1,036)	-	(4,678)
Closing net book amount	**16,525**	**2,538**	**4,278**	**371**	**1,501**	**3,752**	**28,965**
At 31 December 2006							
Cost	26,264	14,838	12,716	1,680	4,143	3,752	63,393
Accumulated depreciation	(9,739)	(12,300)	(8,438)	(1,309)	(2,642)	-	(34,428)
Net book amount	**16,525**	**2,538**	**4,278**	**371**	**1,501**	**3,752**	**28,965**
Year ended December 2007							
Opening net book amount	16,525	2,538	4,278	371	1,501	3,752	28,965
Additions	5,905	848	2,362	-	-	(1,696)	7,419
Disposals	-	-	-	-	(69)	-	(69)
Depreciation charge (Note 11)	(805)	(1,209)	(915)	(201)	(449)	-	(3,579)
Closing net book amount	**21,625**	**2,177**	**5,725**	**170**	**983**	**2,056**	**32,736**
At 31 December 2007							
Cost	32,169	15,212	14,813	1,679	3,739	2,056	69,668
Accumulated depreciation	(10,544)	(13,035)	(9,088)	(1,509)	(2,756)	-	(36,932)
Net book amount	**21,625**	**2,177**	**5,725**	**170**	**983**	**2,056**	**32,736**

As of 31 December 2007 and 2006, the Bank had no contracted capital commitments for any projects.

Note 24 – other assets

	2007	2006
	(in thousands of HRK)	
Non-current assets held for sale	1,331	14,938
Pre-payments	552	483
Fees receivable	1,281	1,197
Small inventory	556	1,081
Other	1,494	856
Less: Allowance for impairment losses on other assets	(550)	(407)
	4,664	**18,148**
Current	**4,664**	**17,856**
Non-current	**-**	**292**

The movement in the allowance for impairment losses on other assets is as follows:

	2007	2006
	(in thousands of HRK)	
Balance at 1 January	407	309
Increase in impairment loss	143	98
Balance at 31 December	**550**	**407**

Note 25 – due to banks

	2007	2006
	(in thousands of HRK)	
Deposits of banks	161	831
Borrowings from HBOR	24,508	25,172
	24,669	**26,003**
Current	**3,772**	**3,818**
Non-current	**20,897**	**22,185**

NOTE 25 – DUE TO BANKS (CONTINUED)

All deposits from banks carry variable rates.

	2007	2006
	(in thousands of HRK)	
Borrowings comprise:		
Current portion of long-term borrowings	2,811	3,071
Long-term borrowings	21,697	22,101
	24,508	**25,172**

NOTE 26 – DUE TO CUSTOMERS

	2007	2006
	(in thousands of HRK)	
Large corporate enterprises		
- current accounts	337	381
SMEs		
- current accounts	277,890	200,909
- time deposits	96,396	107,643
Citizens		
- current /demand accounts	455,385	455,735
- time deposits	1,061,539	927,779
	1,891,547	**1,692,447**
Current	**1,460,021**	**1,362,935**
Non-current	**431,526**	**329,512**

All customer deposits carry variable rates.

NOTE 27 – OTHER LIABILITIES

	2007	2006
	(in thousands of HRK)	
Sundry creditors	1,265	1,266
Employee payables	3,394	2,212
Items in transfer	10,865	5,744
Saving deposits insurance payable	987	947
Dividends payable	802	710
Other	-	560
Provisions for off-balance sheet items (Note 32)	1,332	968
	18,645	**12,407**

The movement in provisions for off-balance sheet items was as follows:

	2007	2006
	(in thousands of HRK)	
Balance at 1 January	**968**	**736**
Increase in provision	364	232
Balance at 31 December	**1,332**	**968**

NOTE 28 – SHARE CAPITAL

(in thousands of HRK)	Number of shares	Ordinary shares	Preference shares	Share premium	Treasury shares	Total
At 1 January 2006	59,000	63,236	1,664	180	-	65,080
Purchase of treasury shares	-	-	-	(13)	(13)	(26)
At 31 December 2006 / 2007	59,000	63,236	1,664	167	(13)	65,054

As at 31 December 2007 and 2006 the nominal registered, subscribed and fully paid capital comprises 57,487 ordinary shares and 1,513 preference shares with a nominal value of HRK 1,100.00 per share. Preference shares have no voting rights and the related dividend is at least at the level of the interest rate that the Bank calculates and pays on 36-month term deposits from citizens plus 1%. However a preference dividend is only payable if a dividend on ordinary shares is also approved by the Annual General Meeting of Shareholders and does not exceed the amount of dividend per ordinary share for the current year. Preference shares obtain voting rights for the period until the next Annual General Meeting of Shareholders if no ordinary dividend is declared. Preference dividends are not cumulative if not paid for a given year.

Note 28 – share capital (continued)

The Bank buys and sells its own shares in the normal course of its equity trading and market activities. These shares are treated as a deduction from the shareholders' equity. Gains and losses on sales or redemption of own shares are credited or charged to share premium. The total number of treasury shares at the end of 2007 was 12 (2006: 12).

The Bank's main shareholders as of 31 December can be shown as follows:

	2007			2006		
Shareholder	**Number of shares**	**% in share capital**	**% in voting rights**	**Number of shares**	**% in share capital**	**% in voting rights**
Intercommerce Umag	9,947	16.86	17.30	9,947	16.86	17.30
Tvornica cementa Umag	8,874	15.04	15.44	8,874	15.04	15.44
Hempel Umag	8,851	15.00	15.40	8,851	15.00	15.40
Serfin d.o.o.	5,701	9.66	9.92	5,701	9.66	9.92
Assicurazioni Generali s.p.a.	4,500	7.63	7.83	3,000	5.08	5.22
Plava laguna Poreč	2,106	3.57	3.66	2,106	3.57	3.66
KB 1909 s.p.a.	-	-	-	1,500	2.54	2.61
Knapić Aldo	1,420	2.41	2.47	-	-	-
Treasury shares	12	0.02	-	12	0.02	-
Other	17,589	29.81	27.98	19,009	32.23	30.45
Total	**59,000**	**100.00**	**100.00**	**59,000**	**100.00**	**100.00**

Note 29 –reserves and retained earnings

	2007	2006
	(in thousands of HRK)	
Statutory reserves	22,764	22,764
Other reserves	31,987	22,657
Retained earnings	53,935	48,155
	108,686	**93,576**
Movements in reserves:		
Statutory reserve		
At beginning of the year	22,764	17,264
Transfer from other reserves	-	5,500
At end of the year	**22,764**	**22,764**
Other reserves		
At beginning of the year	22,657	28,157
Transfer to statutory reserves	-	(5,500)
Transfer from retained earnings	9,330	-
At end of the year	**31,987**	**22,657**
Retained earnings		
At beginning of the year	48,155	42,000
Net profit for the year	27,262	21,496
Dividend for the previous year	(12,152)	(15,341)
Transfer to general banking reserves	(9,330)	-
At the end of the year	**53,935**	**48,155**

In accordance with national legislation, a portion of the net profit of the Bank is required to be transferred to a non-distributable statutory reserve until this reserve represents 5% of the share capital of the Bank.

Other reserves can only be distributed upon approval at the Annual General Meeting.

Note 30 – dividends per shares

Dividends payable are not accounted for until they have been ratified at the Annual General Meeting.

At the General Meeting that will be held on 4 April 2008, a dividend for 2007 of HRK 170.00 will be proposed (2006: HRK 206.00). The financial statements for the year ending 31 December 2007 do not reflect this resolution, which will be accounted for in shareholder' equity as an appropriation at retained earnings in the year ending 31 December 2007.

Note 31 – cash and cash equivalents

For the purposes of the cash flow statement, cash and cash equivalents comprise the following balances with less than 90 days maturity:

	Notes	2007	2006
		(in thousands of HRK)	
Cash and current accounts with banks	16	102,016	122,267
Treasury bills and other eligible bills	17	19,046	46,118
Due from other banks	18	403,699	290,278
Investment securities available-for-sale	21	60,500	45,000
		585,261	**503,663**

Note 32 – contingent liabilities and commitments

a) Legal proceedings. At 31 December 2006, there were no legal proceedings outstanding against the Bank. At 31 December 2007 there were legal proceedings outstanding against the Bank, however the Management considers these actions groundless and believes that no provisions are necessary for these legal proceedings outstanding against the Bank.

b) Capital commitments. At 31 December 2007 and 2006, the Bank had no capital commitments in respect of buildings and equipment purchases.

c) Loan commitments, guarantees and other financial facilities
The following table indicates the contractual amounts of the Bank's off-balance sheet financial instruments:

	2007	2006
	(in thousands of HRK)	
Guarantees	25,889	25,860
Letters of credit	7,989	10,040
Undrawn portion of loans on approved overdrafts	35,584	24,742
Commitments to lend	86,917	52,995
Less: Provision for off-balance sheet items (Note 27)	(1,329)	(968)
Total	**155,050**	**112,669**

The primary purpose for commitments to lend from guarantees and letters of credit is to ensure that funds are available to a customer as required. Guarantees and standby letters of credit, which represent irrevocable assurances that the Bank will make payments in the event that a customer cannot meet its obligations to third parties, carry the same credit risks as loans.

NOTE 32 – CONTINGENT LIABILITIES AND COMMITMENTS (CONTINUED)

Commitments to lend represent unused portions of authorisations to lend in the form of loans, guarantees or letters of credit. With respect to credit risk on commitments to lend, the Bank is potentially exposed to loss in an amount equal to the total unused commitments. However, the likely amount of loss is less than the total unused commitments since most commitments to lend are contingent upon customers maintaining specific credit standards.

Guarantees, irrevocable letters of credit and undrawn loan commitments are subject to similar credit risk monitoring and credit policies as utilised in the extension of loans. The management of the Bank believes the market risk associated with guarantees, irrevocable letters of credit and undrawn loan commitments to be minimal.

NOTE 33 – RELATED-PARTY TRANSACTIONS

Parties are considered to be related if one party has the ability to control the other party or exercise significant influence over the other party in making financial or operational decisions. A number of banking transactions are entered into with related parties in the normal course of business. These transactions were carried out under commercial terms and conditions and at market rates.

The volumes of related party transactions outstanding balances at the year-end are:

	Directors and other key personal		Others*	
	2007	2006	2007	2006
	(in thousands of HRK)		*(in thousands of HRK)*	
Loans				
At beginning of the year	906	172	8,866	7,794
Increase	475	879	12,795	11,061
Decrease	(513)	(145)	(7,753)	(9,989)
At 31 December	**868**	**906**	**13,908**	**8,866**
Interest income	30	10	444	378
Deposits				
At beginning of the year	1,187	471	43,841	46,496
Increase	62	716	545	46,473
Decrease	-	-	(545)	(49,128)
At 31 December	**1,249**	**1,187**	**43,841**	**43,841**
Interest expense	34	16	2	1,185

Directors and other key personnel

	2007	2006
Gross salaries and other short-term benefits	2,363	2,215

*Under 'Other' are disclosed entities which have representatives in the Bank's Supervisory Board.

Note 34 – managed funds - agency business

The Bank manages funds on behalf of individuals and other institutions. The risk and rewards associated with these assets remain with those third parties and accordingly the assets are not included in the balance sheet of the Bank.

The net assets and liabilities managed on behalf of third parties may be summarized as follows:

	2007	2006
	(in thousands of HRK)	
Assets		
- Loans to citizens	2,377	2,396
- Loans to companies	5	6
- Cash	-	162
- Other	629	592
Total assets	**3,011**	**3,156**
Liabilities		
- Companies	5	7
- Financial institutions	2,377	2,396
- Other	629	753
Total liabilities	**3,011**	**3,156**

Correspondent banks

Austria		
Adria Bank AG	Vienna	ABAG AT WW
Bank Austria-Creditanstalt AG	Vienna	BKAU AT WW
Bank Styria AG	Graz	STSP AT 2G
Zveza Bank RZZOJ	Klagenfurt	VSGK AT 2K
Belgium		
Fortis Bank S.A.	Brussels	GEBA BE BB 36A
Bosnia and Herzegovina		
Unicredit Zagrebačka banka dd	Mostar	ZABA BA 22
Denmark		
Danske Bank A/S	Copenhagen	DABA DK KK
France		
Société Générale	Paris	SOGE FR PP
Germany		
Bayerische Hypo-und Vereinsbank AG	Munich	HYVE DE MM
Bayerische Landesbank Girozentrale	Munich	BYLA DE MM
Commerzbank AG	Frankfurt a/M	COBA DE FF
LHB Internationale Handelsbank AG	Frankfurt a/M	LHBI DE FF
Italy		
Banca Antonveneta SpA	Padova	ANTB IT 2P 480
Banca di Cividale SpA	Cividale	CIVI IT 2C
Intesa SpA	Milan	BCIT IT MM
Nova Ljubljanska banka Trieste	Trieste	LJBA IT 2T
UniCredito Italiano	Milan	UNCR IT MM
Netherlands		
ING Bank NV	Amsterdam	INGB NL 2A
Slovenia		
Banka Koper dd	Koper	BAKO SI 2X
Nova Ljubljanska banka dd	Ljubljana	LJBA SI 2X
Sweden		
Svenska Handelsbanken AB	Stockholm	HAND SE SS
Switzerland		
UBS AG	Zurich	UBSW CH ZH
United States		
The Bank of New York	New York	IRVT US 3N

Contacts

	country code	+385
HEAD OFFICE	switchboard	52/702 300
Ernesta Miloša 1	facsimile	52/702 388
P.O.Box 103		52/741 396
52470 UMAG		52/741 275
Croatia		
	SWIFT	ISKB HR 2X
	telex	24745 ikb rh
	e-mail	marketing@ikb.hr
	internet	www.ikb.hr
Management board	phone	52/702 307
	fax	52/702 388
Office of the management board	phone	52/702 307
	fax	52/702 388
Legal Affairs	phone	52/702 380
Human Resources, Public Affairs and General Administration	phone	52/702 310
Internal audit and internal control department	phone	52/702 390
	fax	52/702 388
Risk management and loan recovery department	phone	52/702 305
	fax	52/702 388
Financial controlling department	phone	52/392 194
	fax	52/392 195
Information security department	phone	52/702 371
	fax	52/702 388
Treasury And Financial Markets Division	phone	52/702 340
	fax	52/702 388
Domestic Payment Operations	phone	52/702 376
	fax	52/702 309
International Payment Operations	phone	52/702 347
	fax	52/741 396
Domestic Treasury	phone	52/702 343
Foreign Exchange Treasury	phone	52/702 385
Marketing, product support and development division	phone	52/702 350
	fax	52/702 388
Market Research and Advertising	phone	52/702 359
Credit Products Support and Development	phone	52/702 317
Retail Deposit and Payment Products Support and Development	phone	52/702 351
Card Business Department	phone	52/702 352
Accounting and logistics division	phone	52/702 330
	fax	52/702 387
Accounting Department	phone	52/702 333
Supply and Technical Services Department	phone	52/702 329
Information technology department	phone	52/702 320
	fax	52/702 388
Central and Network Information Systems Department	phone	52/702 325
Informatics Engineering Department	phone	52/702 319

Business network

country code +385

BUSINESS CENTRE UMAG – BUJE – NOVIGRAD

BRANCH UMAG – HEAD OFFICE	phone	52/702 300
Ernesta Miloša 1, 52470 Umag	fax	52/702 353
Corporate and Retail Finance Department	phone	52/702 361
Retail Operations Department	phone	52/702 366
BRANCH-OFFICE **UMAG** - Department Store	phone/fax	52/741 082
1. svibnja bb, 52470 Umag		
BRANCH-OFFICE **SAVUDRIJA**	phone/fax	52/759 547
Bašanija bb, 52475 Savudrija		
BRANCH-OFFICE **BRTONIGLA**	phone/fax	52/774 430
Trg. Sv. Zenone 4, 52474 Brtonigla		
BRANCH-OFFICE BUJE	phone	52/772 271
Trg J.B.Tita 1, 52460 Buje	fax	52/772 431
BRANCH-OFFICE NOVIGRAD	phone	52/757 414
Murvi 15, 52466 Novigrad	fax	52/757 145

BUSINESS CENTRE POREČ – PAZIN

BRANCH POREČ	phone	52/429 050
Partizansko šetalište 5c, 52440 Poreč	fax	52/451 453
Corporate and Retail Finance Department	phone	52/429 051
Retail Operations Department	phone	52/429 057
BRANCH-OFFICE **POREČ**	phone	52/427 383
Aldo Negri 2, 52440 Poreč	fax	52/431 832
BRANCH-OFFICE **POREČ**	phone/fax	52/453 259
Partizansko šetalište bb, 52440 Poreč		
BRANCH-OFFICE **VRSAR**	phone	52/441 130
Obala J.B.Tita 27, 52450 Vrsar	fax	52/442 074
BRANCH-OFFICE **VIŠNJAN**	phone	52/449 420
Istarska 1, 52463 Višnjan	fax	52/449 369
BRANCH-OFFICE **TAR**	phone	52/443 757
Borgo bb, 52465 Tar	fax	52/443 767
BRANCH-OFFICE PAZIN	phone	52/624 557
Trg slobode 2, 52000 Pazin	fax	52/621 160
BRANCH-OFFICE **ŽMINJ**	phone	52/846 270
Pazinska bb, 52431 Žminj	fax	52/846 490

BUSINESS CENTRE PULA – ROVINJ – LABIN

BRANCH PULA	phone	52/215 977
Dalmatinova 3, 52100 Pula	fax	52/215 973
Corporate and Retail Finance Department	phone	52/215 977
Retail Operations Department	phone	52/217 422
BRANCH-OFFICE **PULA (VERUDA)**	phone	52/392 193
Tomassinijeva 32, 52100 Pula	fax	52/392 195
BRANCH-OFFICE ROVINJ	phone	52/845 070
S.Radića 9, 52210 Rovinj	fax	52/845 079
BRANCH-OFFICE LABIN	phone	52/881 051
Zelenice 10, 52220 Labin	fax	52/881 053

BUSINESS CENTRE RIJEKA – BUZET

BRANCH RIJEKA	phone	51/213 360
Jadranski trg 2c, 51000 Rijeka	fax	51/213 106
Corporate and Retail Finance Department	phone	51/332 484
Retail Operations Department	phone	51/213 360
BRANCH-OFFICE **OPATIJA**	phone	51/271 841
Maršala Tita 140/3, 51410 Opatija	fax	51/271 681
BRANCH-OFFICE **VIŠKOVO**	phone	51/504 320
Viškovo 2, 51216 Viškovo	fax	51/504 325
BRANCH-OFFICE BUZET	phone	52/663 417
Trg Fontana 2, 52420 Buzet	fax	52/663 393


SAVUDRIJA
UMAG
BUJE
BUZET
BRTONIGLA
VIŠKOVO
NOVIGRAD
RIJEKA
OPATIJA
TAR
PAZIN
POREČ
VIŠNJAN
VRSAR
ŽMINJ
LABIN
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PULA