4 July 2006

Screening report

Croatia

Chapter 4 – Free Movement of Capital

Date of screening meetings:

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I. CHAPTER CONTENT

Member States must remove, with some exceptions, all restrictions on movement of capital both within the EU and between Member States and third countries. The *acquis* is based on the EC Treaty, in particular Articles 56-60. The definition of the different types of capital movements relies on Annex I of Directive 88/361/EEC. Relevant case-law of the European Court of Justice and Commission Communications 97/C220/06 and 2005/C293/02 provide additional interpretation of the above Articles.

The *acquis* also includes rules concerning cross-border payments. Directive 97/5/EC includes provisions on requirements for customer information, performance and complaint and redress schemes for credit transfers of up to 50,000 €. Regulation 2560/2001 lays down rules on cross-border payments in euro to ensure that charges for those payments are the same as those valid within a Member State.

The directive on the fight against money laundering and terrorist financing (2005/60/EC, which repeals Directive 91/308/EEC, as amended by Directive 2001/97/EC), requires entities subject to the Directive to apply customer due diligence and to report suspicious transactions, as well as to take relevant supporting measures, such as record keeping, training and establishing internal procedures. A key requirement to combat financial crime is the creation of effective administrative and enforcement capacity, including co-operation between supervisory, law enforcement and prosecutorial authorities. The new directive aligns with and goes beyond the relevant 40 Recommendations on money laundering and nine Special Recommendations on terrorist financing of the Financial Action Task Force (FATF). The *acquis* in this area also comprises a Council of Europe (CoE) Convention (no.141)[1] and EU legislation on judicial and police cooperation (including the Joint Action 98/699/JHA of 3 December 1998, the Council Framework Decision 2001/500/JHA and the Protocol of 30 November 2000 extending Europol's competence to money laundering). In addition, Council decision 2000/642/JHA of 17 October 2000 sets out arrangements for cooperation between Financial Intelligence Units of the member states.

The acquis under this chapter is to a large extent linked to obligations under the EU-Croatia Stabilisation and Association Agreement (SAA) presently in force.

II. COUNTRY ALIGNMENT AND IMPLEMENTATION CAPACITY

This part summarises the information provided by Croatia and the discussion at the screening meeting.

Croatia indicated that it can accept the acquis regarding free movement of capital. It emphasised that, as expressed in its general negotiating position[2], and without prejudice to its future

[1] In addition, attention will need to be paid in the coming years to the recently adopted CoE convention no.198, which extends significantly the scope of Convention no.141.

[2] "In the course of substantive negotiations, certain areas will surely be of special significance, not only because of the scope of the Community legislation, but also because of the specifics of the existing Croatian legislation. As already stated, protection of the natural resources of the Republic of Croatia is one of the most important national interests, and within that framework, the issue of real-estate acquisition will be of special concern in the course of negotiations. During negotiations, transitional periods will be requested for those sectors where, at the moment of accession to the European Union, there will not be a sufficient level of preparedness for their full harmonisation and implementation. These periods will be limited in time and scope, and accompanied by a plan with clearly defined stages for full application".

negotiating position on this chapter, real estate acquisition was an issue of special concern to it; in this context, it referred to the Resolution of the Croatian Parliament of 14 October 2005 which includes acquisition of real estate among the areas where Croatia would need adequate transition periods. Croatia will define its timetable for alignment with the acquis in its forthcoming negotiating position on this chapter.

II.a. Capital movements and payments

While current payments, direct investment abroad and long-term credit transactions have been liberalised, Croatia acknowledges that it maintains restrictions on a number of capital transactions, notably through explicit provisions of the Foreign Exchange Act (FEA), most recently amended in 2005, or through subordinate regulations issued by the Croatian National Bank (CNB):

– Croatia prohibits the granting of financial loans with a maturity of less than 1 year to non-residents, and non-residents may not invest in Treasury bills of the Ministry of Finance or in the Croatian National Bank bills. Furthermore, resident physical persons investing in foreign securities are obliged to execute their investments via domestic brokerage houses and deposit the purchased securities into a domestic custodian bank. Croatia at this moment assesses that it will not have any difficulties in aligning with the acquis on these issues. It plans to lift the prohibition of investment in Treasury bills and CNB bills by non-residents by the end of 2006.

– The opening of accounts abroad by residents is generally prohibited. Cash withdrawals and deposits from bank accounts held by non-resident legal persons are restricted, though a recent CNB decision, still to enter in force, limits these restrictions to deposits in local currency. There are restrictions on cash transactions between residents and non-residents, while cash payments on the basis of capital transfers are prohibited. There are limits to personal transfers abroad of assets related to gifts and grants, of export of foreign cash by residents and of the export and import of domestic cash by both residents and non-residents. Statistical reporting to the CNB of credit transfers is a prerequisite for execution. Also, the Income Tax Act and related regulations provide that payments of receipts that are deemed income have generally to be made to taxpayers' accounts (cash payments being prohibited). Croatia assesses at this moment that it will not have any difficulties in aligning with the acquis on all these issues.

– The Insurance Act provides that, until EU membership, residents may insure property and persons only with domestic institutions.

– There are restrictions on activities of foreign or foreign-owned legal persons in some sectors, namely in air carriers and in seawater, as well as in freshwater, fisheries *(see chapters 14 – Transport, and 13-Fisheries*).

A number of restrictions are provided for in legislation concerning institutional investors:

– Companies authorised under the Securities Markets Act can only invest their customers' funds in securities traded in Croatian, EU or OECD member state markets. Croatia plans to abolish this restriction by the end of 2006 at the latest. Moreover, legislation on pension funds, insurance undertakings and savings and loan cooperatives discriminate between their right to invest in domestic and in foreign assets. Croatia plans to abolish the restrictions for savings and loan cooperatives by the end of 2006 at the latest.

– Assets in a building saving's account of a Croatian citizen can be used only in Croatia.

– There are also restrictions in the daily foreign currency position of banks: banks are obliged to ensure at the end of each workday that their total open foreign exchange position, increased by their position in gold, does not exceed 20% of their regulatory capital.

Special government rights ("golden shares" with veto rights) are foreseen in the privatisation acts of the state telecom (Hrvatske telekomunikacije -HT), electricity (Hrvatska elektroprivreda-HEP), and oil (Industrija nafte – INA) companies. Croatia has not provided a timetable for the abolition of these special rights.

A 10% limit on individual or joint shareholding in HEP is included in the respective Privatisation Act, as well as for the Central Depository Agency pursuant to the Securities' Market Act. In both cases, the State is not restricted by this ceiling.

Special rights at local government level are still being assessed by Croatia.

There are a number of restrictions on foreign ownership of real estate:

– Under Croatia's Constitution, a foreign person may acquire property under conditions prescribed by law. This issue is regulated by the Act on Ownership and Other Proprietary Rights. The acquisition of real estate by a national of a foreign country is subject to a requirement of reciprocity and, except when acquisition is by inheritance, an administrative authorisation by the Minister of Foreign Affairs and European Integration after securing the opinion of the Minister for Justice. The Minister's decision is subject to judicial review before the Administrative Court pursuant to the Act on Administrative Lawsuits.

– Acquisition of agricultural land, forests and forestland in private ownership is prohibited for foreign legal and natural persons, unless otherwise provided by international agreements. Acquisition of proprietary rights over natural resources (strict reserves, national parks, special reserves, nature parks, regional parks, significant landscape, forest parks and park architecture monuments) and excluded areas for security reasons is also prohibited.

– Croatian legislation provides that certain categories of real estate, in particular State-owned forests, State-owned forest land and the public water domain are unalienable from State ownership and may therefore not be acquired either by Croatian citizens or by aliens. Similarly, certain categories of real estate (maritime domain and seaports; public roads) are excluded from legal transactions (public goods), of which neither Croatian nationals nor aliens may acquire ownership nor other proprietary rights. The State and local self-government units have pre-emption rights on real estate in protected areas and on cultural goods.

Croatia has concluded 55 bilateral agreements on promotion and reciprocal protection of investments. Croatia does not have a bilateral investment treaty with Japan. Its bilateral investment treaties with the United States and Canada do not include regional economic integration organisation (REIO) clauses permitting EU/EEA preference in certain required areas.

II.b. Payment systems

Croatia states that its legislation, including the Foreign Exchange Act, subordinate CNB acts and the Croatian Civil Code, is only partially aligned to the provisions of Directive

97/5. It plans to harmonise with the Directive by the adoption of a new Act during the 4th Quarter of 2007 and is preparing for implementing Regulation 2560/2001.

In particular, Croatia states that a CNB Decision entering into force on 1/6/2006 fully aligns to the provisions of Directive 97/5 with respect to prior and subsequent information to a cross-border credit transfer. It only partly aligns with respect to definitions of small value cross-border transactions, time taken for execution, obligation to execute in accordance with instructions and *force majeure*. Croatia has not aligned with respect to specific undertakings by the institution, refunding obligations by institutions and settlement of disputes.

Croatia adopted a CNB Decision on the generation and use of international bank account numbers (IBAN) in 2004 and this Decision will be applied by all banks by 1/10/2007. Croatia maintains an obligation of reporting cross-border payments of up to € 12.500 for balance-of-payment purposes.

II.c. Fight against money laundering

Croatia states that money laundering was criminalised in 1996. The Money Laundering Prevention Act, which provides *inter alia* for the establishment of a Financial Intelligence Unit (FIU), was enacted in 1997 and amended in 2004. The implementing Ordinance by the Ministry of Finance was adopted in 2003. Croatia has ratified Council of Europe Convention No.141. Provisions against money laundering are also included in other legislation (Foreign Exchange Act, Civil Obligatory Act).

Croatia acknowledges that its legislation is not aligned with a number of provisions of Directive 91/308/EEC as amended by Directive 2001/97/EC, relating notably the provision of feedback to reporting entities, reporting obligations by supervisory bodies to the FIU and identification obligations.

Croatia also acknowledges that further harmonisation with the recently adopted Directive 2005/60/EC (and CoE Convention No.198) is necessary, notably regarding the scope, customer due diligence obligations, reporting obligations, supporting measures and supervision of reporting entities. It estimates that it will have no difficulties in aligning with Directive 2005/60/EC and that it is aware that it should also take into account the 40 revised general recommendations plus 9 specific recommendations of the Financial Action Task Force (FATF).

In particular, regarding the identification obligation, Croatia states that it will amend its legislation to replace the term “more permanent business cooperation” by “establishment of business relationship”. It assesses at this moment that it will not have any difficulty in aligning with the acquis with respect to the premium threshold for client identification in relation to life insurance. It will abolish the possibility to object to FIU requests for further information. Furthermore, Croatia acknowledges its legislation does not include a regulatory basis for the reporting of suspicious transactions by supervisory bodies and feedback to reporting entities, though state bodies are obliged to send to the FIU all information necessary for the detection of money laundering. Croatia assesses it will not have any difficulty in aligning with the acquis for this provision. It intends to align its legislation with Directive 2005/60/EC requirements regarding customer due diligence by the second quarter of 2008. Croatia confirmed that new bearer passbooks in whatever form cannot be opened since 1997, and old ones have mostly been abolished. It indicated that it planned to regulate the abolition of the remaining bearer passbooks, those held by residents in domestic currency, in the third quarter of 2006 at the latest; it has the intention also to abolish bearer shares.

A Financial Intelligence Unit (FIU) was established within the Ministry of Finance in 1998. The FIU has a staff of 17. Croatia acknowledges that the FIU, supervisory bodies and law enforcement entities need to strengthen their administrative capacity, in number of personnel, in expertise and equipment. The FIU cooperates with the State Attorney's Office, the Office for the Suppression of Corruption and Organised Crime, the Police and the supervisory bodies of the Ministry of Finance.

The CNB supervises banks pursuant to the anti-money laundering Act. Croatia states that the FIU and the CNB intend to conclude a co-operation agreement providing for the issuing of guidelines and instructions for the implementation of the anti-money laundering Act in the banking sector. The Croatian Financial Services Supervisory Agency, covering the non-bank financial sector, was established as of 1/1/2006 to replace the previously existing three non-bank supervisors which covered the insurance sector, the securities markets and investment funds and pension funds.

According to statistics provided by Croatia, the vast majority (over 95% in 2004-05) of suspicious transactions are reported by banks. There is a particularly low level of reporting by non-bank financial institutions (investment funds and management companies, insurance companies), as well as by certain non-financial entities, especially lawyers and notaries.

Croatian legislation provides only for an administrative pecuniary fine to reporting entities which violate their obligations. In the case of exchange offices, the CNB can revoke their licence under certain conditions which include violation of anti-money laundering legislation. Croatia considers that the fines prescribed by its legislation, given income levels and GDP per capita, are appropriate.

On the basis of suspicious transaction reports it received, the FIU launched an average of 221 more detailed analyses of suspicious transactions per annum during the period 2000-2005, involving an average of €180 million per annum of suspect funds. These figures oscillate significantly from year to year and show no discernible trend. During the same period, an annual average of 50 cases were submitted to competent domestic authorities or to foreign FIUs for further processing or prosecution, involving an average of € 57million per annum of suspect funds. The latter number of cases has been rising, from under 30 in 2000-01 to 60-70 in 2003-05.

Despite the fact that the anti-money laundering Act does not contain an obligation to provide feedback to reporting entities, the FIU currently provides feedback once a year to the banking sector. Work is currently underway in the FIU to prepare feedback for the other sectors.

Interdepartmental coordination has been established between the FIU and relevant supervisory bodies and institutions, headed by the Minister of Finance. While there is no special anti-money laundering police unit, there are units specialised in economic crime, including money laundering. Croatia provided information on procedures for coordinating police districts and prosecutorial offices in this field.

Croatia acknowledges the need to increase the number of on-site supervisions by the supervisory bodies, of improving the instructions issued by these and of introducing appropriate and standardised statistics. It also assesses there is a need to establish specialised departments within the financial investigations bodies, to improve procedures for identification of suspicious transactions, to raise the level of efficiency and coordination of all institutions and bodies involved in combating money laundering, and to raise the level of public awareness.

Croatia's relevant services have been integrated into appropriate international organisations (Moneyval, Egmont Group, GPML-UN). It also has extensive bilateral co-operation, in particular with countries of the region. It has signed 19 bilateral Memoranda of Understanding, while the signature of two more is pending. In 2004-05 it made 81 requests to foreign FIUs and responded to 250 requests from foreign FIUs.

Croatia has ratified the 12 UN anti-terrorism conventions and protocols and states that it is implementing the 9 FATF Special Recommendations related to terrorist financing.

Croatia considers that its penal sanction regime related to money laundering is fully compatible with the *acquis*. In particular, it states that it has an all-crimes approach as to the scope of predicate offences compatible with Council of Europe convention no.141. Money laundering is punished by a deprivation of liberty of up to five years. This penalty has a maximum of ten years for aggravated laundering. Croatia also states that it has recourse to detailed provisions related to freezing, seizure and confiscation, including recourse to value confiscation as an alternative to other forms of confiscation. On measures to provide guidance related to search, seizure and confiscation of the proceeds from crime, a rulebook on financial investigation was issued in 2003.

Croatia assesses that there is no firm and conclusive evidence to confirm the claim that the effectiveness of anti-money laundering defences is seriously hampered by the high level of crime and particularly by the level of corruption.

III. ASSESSMENT OF THE DEGREE OF ALIGNMENT AND IMPLEMENTING CAPACITY

Overall, Croatia has reached a reasonable level of alignment with and capacity to implement the acquis in this chapter. However, Croatia needs to make further progress in many areas, and in particular in the area of acquisition of real estate by foreigners, where it needs to comply with its obligations vis-à-vis EU nationals under the SAA, and in the area of money laundering, notably in enforcement.

As noted in the Commission's Progress Report of November 2005, Croatia can be regarded as a functioning market economy. This is an important requirement for the negotiations in this chapter.

III.a. Capital movements and payments

Croatia has on the whole achieved a reasonable level of alignment with the acquis in free movement of capital and payments, notably by aligning in the areas of current payments, direct investment and long-term credit transactions[3]. However, alignment has not been achieved in a number of areas, including acquisition of real estate by foreigners, outward portfolio investment by residents, short-term credit and cash transactions, restrictions on institutional investors, special government rights in privatised companies and bilateral investment treaties. Croatia has demonstrated a very good understanding of the acquis.

Croatia maintains significant restrictions in the area of acquisition of real estate by foreigners. These also include a prohibition in general of acquisition of agricultural land, forests and forestland and natural resources. While a number of these restrictions, namely

[3] Restrictions in the areas of air transport and fisheries are addressed under other chapters of the acquis (Chapters 14 – Transport, and 13-Fisheries).

those related to state ownership of certain types of real estate and to public goods (maritime domain, seaports, public roads, certain forests and forest land) are compatible under Article 295 of the TEC, Croatian legislation will need important amendments to achieve alignment with the acquis. Full alignment with the acquis in this area would necessitate *inter alia* an amendment of the Constitution.

Croatia should indicate that it intends to abolish special government rights in privatised companies by the date of accession.

The justification for the limits on the open foreign exchange position of banks will need to be assessed at a later stage.

Croatia should confirm its readiness to bring its bilateral investment agreements into compliance with the acquis if incompatible, or to renounce them.

Croatia complies on the whole with its obligations under the Stabilisation and Association Agreement (SAA), with the notable exception of the area of acquisition of real estate by EU nationals:

– In accordance with the Agreement, it has largely liberalised current payments, direct investment and long-term loans and credit. However, there remain restrictions to outward direct investment by some Croatian institutional investors. Croatia has committed to lift restrictions on outward investment by savings and loans cooperatives by the end of 2006.

– On the basis of available information, Croatia is not fully complying with its obligation under the SAA to authorise, by making full and expedient use of its existing procedures, the acquisition of real estate by EU nationals, except in agricultural land and natural resources. In particular, applications for authorisation for acquisition are not being treated expediently, as testified by lengthy delays in the application process and a backlog of over 5000 pending requests. Also, when applying its existing procedures concerning reciprocity, Croatia has not taken full account in all relevant cases of the possibilities for Croatian non-resident nationals to purchase real estate in EU Member States. Under the SAA, Croatia also has to progressively adjust its legislation relating to acquisition of real estate by February 2009, except in agricultural land and natural resources.

– Croatia assesses it will not have any difficulty in aligning with the acquis in the areas where, in accordance with the Agreement, it has to liberalise movements of capital by February 2008, notably those relating to portfolio investments and short-term financial loans and credits. In both these areas, remaining restrictions are numerous and include, most importantly, restrictions in investment by resident physical persons and institutional investors in foreign securities and prohibition of granting short-term loans to non-residents. Croatia has committed to abolish existing restrictions in some of these cases (companies and saving and loans cooperatives investment in securities abroad, investment by non-residents in Treasury and CNB bills) by the end of 2006.

– Areas not mentioned above (i.e. special government rights in privatised companies, restrictions on cash transactions, general prohibition to open bank accounts abroad for residents), are covered by the SAA provision stipulating that during the first four years of its application, measures will be taken to permit the creation of the necessary conditions for the further gradual application of Community rules on free movement of capital, and that by the end of the fourth year after its entry into force (i.e. 1/2/2009), the

SA Council will determine the modalities for the full application of the acquis. For most of these areas, Croatia assesses it will not have any difficulty in aligning with the acquis.

III.b. Payment systems

Croatia has achieved a good level of alignment with the acquis in the area of payment systems. Its very good knowledge of the acquis and the administrative capacity of relevant government bodies and the banking system, render credible its commitment for full alignment by the end of 2007.

III.c. Fight against money laundering

Croatia's system for the prevention of money laundering and terrorist financing is partially in line with the *acquis* in this chapter. Full alignment of Croatia's legislation with Directive 91/308/EEC, as amended by Directive 2001/97/EC, has yet not been achieved in respect of such requirements as the money laundering definition, the way lawyers, notaries, accountants and tax advisors are included in the law, customer due diligence obligations, the principle that reporting in good faith will not incur any liability, feedback and reporting obligations by supervisory bodies to the FIU in several aspects. Outside the banking sector secondary legislation needs still to be issued and implemented. Furthermore, legislation remains to be amended to achieve alignment with the Third Directive and the FATF standard, among others, in respect of: the scope, the customer due diligence obligations, in particular the concept of beneficial ownership, the reporting obligation and supporting obligations in this respect. Supervisory aspects need also to be upgraded, *inter alia*, licensing/registration and a fit and proper test of management and beneficial owners of casinos, money transfer agencies and company service providers.

The effective enforcement of anti-money laundering and terrorist financing requirements in Croatia gives rise to concerns. There are weaknesses affecting most institutions in the maintenance chain, including supervisory authorities, law enforcement agencies, prosecutors and the judiciary. There are specific concerns about the low level of reporting of suspicious transactions by non-bank financial institutions (even taking into account the dominant role of banks within the Croatian financial sector) and the effectiveness of the corresponding supervisory authorities, now merged into the Croatian Financial Services Supervisory Agency, in monitoring the implementation of anti-money laundering and terrorist financing obligations. Similar concerns apply for other non-financial reporting entities covered by the Money Laundering Prevention Act, such as lawyers and notaries.

Improvements are also needed in sanctions and the level of fines would need to reflect the international character of money laundering and terrorist financing. Access by the FIU to law enforcement information is insufficient. Law enforcement (including prosecution and judiciary) seems to be the bottleneck in the maintenance chain, as indicated by the very limited number of convictions and confiscations. In the period 2001-04, there were only two *res judicata* convictions out of 30-40 cases prosecuted annually. Coordination is in the process of strengthening, but enhancing effective cooperation within Croatia between the entities of the maintenance chain and with other countries is needed. Moreover, this lack of effectiveness of Croatia’s defences is further aggravated by general surrounding factors: high level of crime and corruption, size of informal economy, limited resources, expertise and inadequate statistics.