PROFESSIONAL ARTICLE

INVESTOR COMPENSATION IN CROATIA: RECENT REFORMS AND POLICY CHALLENGES

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ABSTRACT: This paper explores the 2024 reform of Croatia's investor compensation scheme, which introduced important enhancements aimed at strengthening investor protection and aligning the scheme more closely with international best practice. Key innovations include the adoption of risk-weighted contributions, the option to fulfil contribution obligations through financial instruments or payment security instruments, and new responsibilities for the supervisory authority to define a target fund level and ensure greater transparency. The paper reflects on how the existing structure - particularly the long-standing accumulation of non-redeemable contributions - may shape the practical impact of risk-based funding. It further considers methodological approaches for determining an appropriate target fund size in a market with limited historical claims data. By analysing Croatia's evolving ICS model, the paper contributes to broader discussions on how investor compensation systems can balance simplicity, fairness, and risk sensitivity while maintaining market confidence.

Key words: investor compensation schemes, investor protection

JEL klasifikacija: G23, G21, G28, K22

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1 INTRODUCTION

It is widely accepted that financial regulation plays a key role in investor protection, generates positive externalities for the broader financial system (Llewellyn, 1999, p. 9), and contributes to increased social welfare (Burke, 2009). Regulatory frameworks employ a diverse range of strategies – including disclosure requirements, conduct-of-business rules, capital adequacy standards, and investor compensation schemes (ICSs) – to mitigate risks, promote market integrity and safeguard investors (Oxera, 2005, p. 111).

This paper focuses on the Croatian ICS, particularly in light of the comprehensive reforms adopted in 2024, as a case study through which to explore broader issues concerning the design and adequacy of ICSs in the EU.

The existence of ICSs is supported by both microeconomic and macroeconomic justifications, while their expansion since the late 1990s reflects increased capital market participation by less sophisticated investors and growing financial product complexity (Garcia and Prast, 2004, p. 17). At the micro level, ICSs address agency problems, since retail investors typically lack the resources or expertise to monitor financial firms (Llewellyn, 1999, p. 11). At the macro level, although investment firms may not pose systemic risks on the scale of banks, their failures can still undermine investor confidence and market functioning (European Parliament, 2011, pp. 10-11; Garcia and Prast, 2004, p. 11).

Investment firms routinely hold client assets – including funds and securities – which creates exposure to loss in the event of mismanagement or insolvency. Various legal techniques are employed to mitigate this risk. These include granting client assets preferential status in insolvency, requiring segregation of client and firm assets, using money market funds to securitise client money, and establishing ICSs (IOSCO, 1996). Among these, segregation – particularly when accompanied by reconciliation processes – serves as a key deterrent to fraud or misuse of client assets (IOSCO, 2011, p. 10). Nevertheless, segregation is not foolproof. Losses can still arise due to operational failures, fraudulent activity by the firm or third parties, or conflicts between insolvency and securities law. ICSs thus act as a residual safety net when other regulatory mechanisms fail (Moloney, 1999, p. 455).

In the European Union, ICSs were introduced not only to protect investors but also to support the functioning of the internal market. Directive 97/9/EC (the Investor Compensation Schemes Directive, or ICSD) obliges Member States to establish schemes that guarantee a minimum level of compensation to

retail investors unable to recover assets from a failed firm (Clarke, 1999; Marcacci, 2018). This measure supports the EU's passporting regime, ensuring a baseline of investor protection across borders. Interestingly, the ICSD's preamble does not emphasize financial stability or investor confidence but rather frames the ICSD as a tool to protect the internal market by harmonising minimum levels of investor protection across the EU.

Despite the relatively low number of compensation events, several investment firm failures have exposed structural weaknesses in the EU investor compensation framework (European Commission, 2005, p. 2). In response, the European Commission proposed amendments to the ICSD in 2010, arguing that excessive national discretion had undermined consistent investor protection. The proposal called for mandatory ex ante funding with a target level of 0,5% of client assets to be reached within ten years, the right for national schemes to borrow from each other, and capping compensation to EUR 50.000,00. However, these reforms were not adopted, and the proposal was formally withdrawn by the Commission in 2015. As a result, the ICSD remains one of the few minimum harmonisation directives in the EU's financial regulatory framework.

In the absence of harmonised EU reform, Croatia has moved forward with a national initiative. The reforms introduced through the 2024 amendments of the Capital Market Law (CML) represent an ambitious effort to modernise its ICS. These reforms aim to align the Croatian ICS with international best practices and address previously identified shortcomings. Key measures include the introduction of risk-weighted contributions, the option to use financial instruments or payment security instruments in lieu of cash contributions, and new mandates for the Croatian Financial Services Supervisory Agency (HANFA) to define a target fund size and public disclosure rules. These reforms seek to enhance the scheme's transparency, resilience, and alignment with risk-based regulatory principles.

This paper contributes to the broader academic literature on financial regulation. Scholars such as Burke (2009) and Schich and Kim (2011) position ICSs within a broader investor protection framework. Llewellyn (1999) connects investor compensation to three key economic rationales for regulation: the need for consumer confidence and its positive externalities; moral hazard concerns linked to financial safety nets; and investor demand for regulatory assurance to reduce transaction costs. Booysen (2021) further emphasizes the importance of tailored protection for retail investors, highlighting the complexity of designing effective investor protection regimes.

A related strand of literature focuses on trust and retail participation. Georgarakos and Inderst (2011) show that trust in financial advice significantly influences stock market participation among households with low financial capability, while more financially capable households are more influenced by their perception of legal protections. Similarly, Gurun, Stoffman and Yonker (2018) find that communities affected by the Madoff scandal withdrew assets from investment advisers and increased deposits at banks, highlighting the link between loss of trust and disintermediation.

Academic work that focuses specifically on ICSs remains limited. Shkolnyk, Bondarenko and Ostapenko (2017) view ICSs tools for capital market development and use a modified Markowitz model to determine optimal scheme size. Several national case studies assess ICS effectiveness and design. Kazandzhieva and Mladenov (2008) analyse the Bulgarian ICS and propose structural reforms; Bogna (2009) critiques the Polish scheme's location within the central securities depository and advocates for integrating ICS and deposit insurance management. Saad and Elsayed (2016) examine capital adequacy in Egypt's ICS and stress the need for regular reviews. More recently, Kazandzhieva and Ralinska (2024) find low public awareness of Bulgaria's ICS, suggesting a gap in retail investor engagement.

A broader but conceptually related literature examines deposit insurance schemes, which - unlike ICSs – typically cover a more uniform range of products (deposits) and institutions (banks). Nonetheless, insights from this literature can inform ICS design. Dávila and Goldstein (2023) develop a framework for setting optimal deposit insurance levels. Bernet and Walter (2009) explore how fund size interacts with credibility and moral hazard. Ognjenovic (2017) outlines key features of efficient schemes, including contribution systems and target fund setting. Garcia and Prast (2004) provide comparative overview of deposit insurance schemes globally. O'Keefe and Ufier (2017) present a model for setting funding targets based on default probabilities and expected loses. Manz (2009) finds that optimal coverage increases with lower liquidity requirements, better depositor information, and fewer large uninsured creditors. Chan, Greenbaum and Thakor (1992) argue that risk-sensitive pricing for deposit insurance is theoretically appealing but difficult to implement without strong incentive-compatible mechanisms in a deregulated environment.

Following this introduction, Section 2 outlines the key design features of ICSs, with particular emphasis on institutional arrangements, funding mechanisms, participation requirements, and the scope of covered losses. Section 3

examines the Croatian ICS model, analyses the recent 2024 reforms, and identifies areas where further clarification or enhancement may be warranted. The paper concludes with a summary of key findings and policy considerations.

2 DESIGN CHALLENGES AND INSTITUTIONAL VARIATIONS IN INVESTOR COMPENSATION SCHEMES

The ICSD requires EU Member States to establish one or more ICSs, guaranteeing a minimum level of protection of EUR 20.000,00 per investor. While the ICSD sets out a harmonised baseline for investor protection, it grants Member States significant discretion in determining the institutional architecture, financing models, and operational rules governing their schemes. As a result, implementation across the EU has diverged considerably.

According to Article 2 of the ICSD, compensation is provided for claims arising from an investment firm's inability to return money or financial instruments owed to or belonging to investors in connection to investment business, provided the failure is directly related to the firm's financial circumstances. As Oxera (2005, pp. 91-92) notes, the ICSD thus encompasses both financial and operational risks. However, operational risks – such as fraud, negligence, or errors – only lead to investor losses when the firm is unable or unwilling to rectify them, effectively converting them into financial risks. In practice, this risk is exacerbated when client assets are not properly segregated, or when third-party institutions, such as custodian banks or intermediaries, fail – scenarios that are not always covered by national ICS frameworks.

Investor risk also varies depending on the structure of national financial markets. In systems dominated by large, well-capitalised financial groups, internal controls and institutional robustness often mitigate client risk. Conversely, in jurisdictions where smaller, less-resourced firms provide most retail investment services, the role of compensation schemes becomes more critical to investor confidence and protection (Oxera, 2005, p. 105).

The 2010 Impact Assessment accompanying the European Commission's proposal to amend the ICSD identified four major shortcoming in the existing framework. These include the absence of harmonised rules on funding, leading to undercapitalisation in certain countries (e.g. Ireland, Germany, and Austria); delays in processing investor claims, often due to administrative bottlenecks or protracted insolvency proceedings; legal uncertainty regarding third-party

custodial failures not directly triggering firm insolvency; and disparities between ICSs and deposit insurance schemes that may distort investor behaviour or market competition.

These challenges underscore the importance of specific scheme design elements in shaping their effectiveness, credibility, and fairness of investor compensation. The following four subsections examine key structural components in greater detail: the institutional set-up, funding arrangements, participation requirements, any the types of losses covered by compensation schemes.

2.1 Institutional set-up

We approach the institutional set-up of ICS in the EU using two distinct criteria: the type of financial institution providing investment services, and the ownership or administration of the scheme.

Two main models are observed based on the type of financial institution. The first, implemented in Austria, Cyprus, Denmark, Germany, Greece, and Spain, features separate ICS for credit institutions and non-bank investment firms. In these countries, deposit insurance schemes have been extended to cover investment services provided by credit institutions, while non-bank investment firms participate in distinct schemes. Uniquely, in Denmark, both schemes are managed by the same entity. The second model, applied in the remaining Member States, involves a single compensation scheme covering the investment activities of both credit institutions and non-bank investment firms. Under this model, deposit-taking credit institutions engaged in investment services must participate in both the ICS and the deposit insurance scheme. Although the funds are not pooled, the ICS may be managed by the same entity as the deposit insurance scheme.

Regarding ownership or administration, ICS may be managed by public or private entities. Private schemes are sometimes structured as limited companies, where participating firms act as shareholders and elect a governing board. Alternatively, management may be delegated to a trade association representing the member firms. Public schemes are organised in various ways. Some are operated within the financial services supervisory authority, as in Cyprus (banking scheme), Latvia, the Netherlands, Luxembourg, and Slovenia. In the Netherlands, Latvia and Cyprus, the central bank manages the ICS, while in Luxembourg it is the responsibility of an integrated financial markets supervisor independent from the central bank. These schemes are typically managed within a dedicated organizational unit responsible for resolution and protection schemes. Latvia and

Luxembourg operate ex post schemes, while the others use ex-ante funding. Slovenia is unique in appointing a specialized capital markets regulator for its ICS. In other cases, public ICS are managed by independent, single-purpose entities involving representatives from public bodies such as securities regulators, governments, or central banks. In some instances, these entities also include representatives from member firms. This model is found in Bulgaria, Cyprus (non-banking scheme), Czechia, Greece (non-banking scheme), Hungary, Ireland, Malta, Portugal, Romania, Slovakia, and Spain (banking scheme). In some countries, a single public entity manages the deposit insurance scheme, the ICS, and the resolution scheme. This multi-purpose model is used in Belgium, Denmark, Estonia, France, Greece (banking scheme), Lithuania, and Sweden.

Additionally, some countries assign the management of ICSs to other entities. In Croatia and Poland, the central securities depository assumes this role, while in Germany, KfW manages the non-banking scheme. However, such models require strict separation of liabilities, which may not always be feasible. Specifically, liabilities arising from the management of the ICS may spill over to the managing entity, making this model potentially less attractive than others.

As illustrated above, there is no predominant model for the ICSs in the EU. The choice of institutional set-up is largely shaped by historical context, market size, and financial sector structure. With the blurring of boundaries between financial sectors and the emergence of innovative financial products, financial services have become increasingly complex. To address these developments, some jurisdictions have moved toward integrated financial supervision and are gradually adopting integrated consumer protection schemes (IADI, 2015, p. 11; Garcia and Prast, 2004, p. 7). The potential benefits of such integration include enhanced operational efficiency through economies of scale and scope, improved coordination among industry stakeholders and safety-net participants, access to specialized expertise, and stronger crisis response capacity (IADI, 2015, p. 41). Increased consumer awareness of available protection mechanisms is also cited as an advantage (IADI, 2015, p. 35). Nonetheless, integrated compensation models can face significant drawbacks. These include governance complexities, the risk of cross-subsidization in the absence of clear sectoral segregation, and the potential dilution of sector-specific knowledge and oversight focus (IADI, 2015, p. 37). In particular, combining the roles of central bank, supervisor, lender of last resort, resolution and compensation schemes operator within a single institution may give rise to conflicts of interest and weakened accountability (Garcia and Prast, 2004, p. 66).

2.2 Funding arrangements

ICSs in the EU are primarily financed through contributions from participating firms. However, substantial variation exists across Member States in terms of the timing of contributions, sources of funding, pooling practices, and the methods used to calculate contributions.

The academic and policy literature typically categorises funding models into three types: ex-ante, ex-post, and hybrid approaches (O'Keefe and Ufier, 2017, p. 5). Ex-ante funding involves collecting contributions in advance to build a reserve, while ex-post funding entails levying contributions only after a failure occurs. In practice, many schemes adopt a hybrid model, whereby administrative costs are pre-funded under an ex-post structure, while ex-ante schemes retain the ability to raise additional contributions in case reserves prove insufficient to cover the costs of a large failure.

Ex-ante funding offers several advantages. It ensures the immediate availability of funds for timely payouts, enhances public confidence, and allows for the implementation of risk-weighted contribution models. It also reduces the risk of cross-subsidization by ensuring that firms contribute prior to their failure and helps smooth contributions over time. However, maintaining a prefunded reserve incurs opportunity costs and may be inefficient where failures are rare. In smaller markets, high contributions from a limited number of participants may represent an important financial burden. Moreover, large ex ante funds may introduce moral hazards if participants perceive the scheme as an unconditional safety net. Contributions may also be misaligned with actual losses, potentially creating surpluses or deficits (Oxera, 2005, p. 88; O'Keefe and Ufier, 2017, p. 5). If the objective is to cover isolated firm failures rather than systemic crises, a well-designed ex-post scheme may be sufficient (Oxera, 2005, p. 88).

A second critical design issue is the availability of backup funding. Since major failures may exceed available reserves, most ex-ante schemes are authorised to impose supplementary levies. Many also have borrowing powers to manage liquidity shortfalls. In some jurisdictions ICSs and deposit insurance schemes are permitted to borrow from each other. While insurance policies are permitted in some jurisdictions, insurance coverage for ICSs is not used in practice due to high premiums (European Parliament, 2012, p. 9), and state guarantees or direct budgetary contributions are also an exception.

Empirical evidence does not clearly favour one funding model over another. The European Parliament (2011, pp. 12-13) found no compelling

justification for the superiority of ex-ante schemes over ex-post models. For instance, the Italian and British ICSs, which use ex-post systems, have performed effectively, while some ex-ante schemes have struggled to provide compensation. Thus, both funding models have proven workable in practice, and any blanket preference for one over the other is difficult to justify.

In conclusion, ICSs are not expected to cover all investor losses. A scheme is not considered underfunded simply because it lacks sufficient reserves for an extreme event; rather, adequacy depends on maintaining an acceptably low probability of funding shortfall. The effectiveness of a compensation scheme is less dependent on whether it uses an ex-ante or ex-post structure than on its overall flexibility and access to diverse, reliable funding sources. Best practice calls for regular assessment of potential exposures, estimation of loss likelihoods, and the establishment of robust mechanisms to ensure timely access to additional funds when needed.

2.3 Participation requirements for investment firms

A key issue in the design of ICSs is whether all investment firms should be required to participate, even if their business models are unlikely to give rise to compensation claims. Two main questions are commonly raised in this context: first, should firms that are not authorised to hold client money or financial instruments be obliged to join the scheme? Second, must firms that exclusively serve ineligible clients - such as those engaging only in wholesale investment business - also be included?

The rationale for exempting such firms is that they generally do not create compensation risk. However, exceptions may arise - for instance, when a firm holds client assets without the necessary authorisation. Moreover, a policy argument supports broader mandatory participation on the basis that it fosters market confidence, justifying contributions from firms that may not directly expose investors to risk.

Implementation of the ICSD across Member States reflects significant variation. In most jurisdictions, all investment firms are required to participate in the ICS, regardless of whether they are authorised to hold client assets. France provides a notable exception: "portfolio management companies" are excluded from participation, as they are legally prohibited from holding client assets.

Firms without eligible clients are also generally required to participate, although they often pay reduced contributions. In the Netherlands, market

makers - firms that operate solely on a proprietary trading basis - successfully challenged mandatory ICS participation in court and have been exempt since 2003. In contrast, a German court rejected a similar request, reasoning that all firms benefit from the market confidence engendered by the ICS and should therefore be obliged to contribute (Oxera, 2005, pp. 18-19).

2.4 Types of losses covered

When considering the types of investor losses covered by ICSs, four key issues emerge: asset segregation, third-party losses, loss of money, and unauthorised business.

Article 2, Paragraph 2 of the ICSD mandates protection for claims resulting from an investment firm's inability to repay money or return instruments held on behalf of investors. Segregation of assets is intended to ensure that, in the event of insolvency, client funds and instruments are insulated from claims by the firm's creditors. However, despite regulatory safeguards, improper segregation – whether due to negligence, error, or fraud – remains a risk. In addition, even with rules requiring timely segregation (e.g., within one business days), an overnight failure could expose client assets. National insolvency laws further complicate matters: in some jurisdictions, even segregated assets can be drawn into bankruptcy proceedings, undermining investor protection (Oxera, 2005, pp. 91-92).

Directive 2014/65/EU (MiFID 2) introduces the requirement for investment firms to adopt "adequate arrangements" to safeguard client assets (Art. 16, paras. 6, 8-10), yet it stops short of defining what those arrangements must entail. This leaves room for variation across Member States. In some, non-bank investment firms are prohibited from holding client assets directly and must use custodians, reducing the risk of misappropriation but introducing exposure to custodian failure. Others allow "book segregation", where assets are separated via internal records alone – leaving clients vulnerable if controls fail, or if segregation is not properly maintained during short periods, such as overnight (Oxera, 2005, pp. 112-113).

Third-party risk is inextricably linked to segregation practices. When client assets are held at custodians or passed through intermediaries for order execution, a failure at the third-party level may result in investor losses. While most Member States provide compensation when such failure also leads to the investment firm's default, coverage is less consistent where the firm remains solvent.

Some schemes rule out compensation, stating that it is only provided if the third-party default triggered default of the investment firm itself. Conversely, some investor compensation rules may still allow compensation in such cases. For example, in Luxembourg the ICS covers omnibus accounts if sufficient transparency about the underlying clients existed before the third party's failure. On the other hand, other jurisdictions relieve firms of liability if they demonstrate proper care in selecting the custodian (Oxera, 2005, pp. 16-18). This divergence raises questions about the consistency of investor protection across the EU. However, it must be said that the legal basis for the use of the custodian can be very different as well. The third party custodian is usually selected by the firm, but it can also be selected by the client (EC, 2010, p. 17).

The treatment of client money deposited with credit institutions also varies. Some Member States differentiate money held by clients in connection with investment business from other deposits. In other countries, all money, including investment monies, are treated as claims against the deposit insurance scheme. In jurisdictions where investment monies held by credit institutions are treated as any other deposit, an investor holding both money and securities with a defaulting institution may qualify for compensation under two separate limits. In contrast, countries that classify such monies as investment claims apply a single compensation limit, covering the total of both monies and securities up to that limit (Oxera, 2005, p. 15). The treatment of investment monies is particularly relevant when considering that deposit insurance schemes generally provide a much higher amount of protection than ICSs. This substantial gap in protection level has the potential to undermine the competitiveness of non-bank investment firms compared to credit institutions offering investment services. This disparity is further exacerbated when considering the challenges related to the coverage of funds held by third-parties. In some Member States, rules surrounding the segregation of client money held by investment firms in credit institutions do not offer protection for clients. Other Member States have implemented rules offering a satisfactory level of protection. For instance, in Luxembourg, losses in "omnibus" accounts opened at a bank in the name of the investment firm for the benefit of its clients are covered by the deposit insurance scheme for each client, provided the bank is a member of the Luxembourg deposit insurance scheme and has been informed prior to its failure about the number and shares of the underlying clients.

The issue of the non-compensation for investors unable to recover their assets due to the default of a depositary or third party was notably highlighted in

the EC 2010 proposal to amend the ICSD. Interestingly, the proposal extends compensation to investors for claims related to a firm's inability to return financial instruments as a result of a third-party custodian failure. However, it does not amend the ICSD to include cases where a credit institution with whom an investment firm has deposited monies fails. The rationale for this differential treatment is that MiFID 2 provides a very strict list of institutions where client funds may be deposited, whereas unregulated entities can be appointed for the deposit of client financial instruments.

Finally, another important issue is losses from dealings with unauthorised investment firms. There have been numerous cases across various countries where poorly informed investors placed their trust in rogue traders, only to suffer losses as a result. In all Member States, since these firms operate outside the regulatory perimeter, clients have no recourse to compensation under ICS frameworks.

3 REDESIGNING INVESTOR COMPENSATION IN CROATIA

3.1 Overview of the current model

The legal framework for the Croatian ICS was first established in the Capital Markets Law (CML) of 2008 (HANFA, 2008, p. 13.). Based on Article 254, Paragraph 3 of the CML, in 2009 HANFA authorized the central securities depositary – SKDD – as the scheme operator (HANFA, 2009, p. 9). It should be noted that the law did not preclude other legal entities from applying for this role. Nevertheless, Croatia, alongside Poland, remains one of the only two EU Member States to have designated the central securities depository as the ICS operator.

The Croatian ICS is structured as an ex-ante funded scheme, financed through contributions from its members (CML, Art. 263). To mitigate the risk of insufficient assets, the scheme can access a credit line opened with a credit institution, which, if drawn upon, must be repaid by the Fund Members (CML, Art. 283). Regular contributions are based partly on revenues generated from reception, transmission and execution of orders, portfolio management, underwriting and placing of financial instruments, and safekeeping and administration of financial instruments. Contribution rates vary between 1% to 2% depending

on the service, with an additional fixed contribution of EUR 0,66 per active client per quarter. Notably, the contribution basis includes revenues and client number regardless of whether the clients are eligible for ICS protection (HANFA, 2019, Art. 4-5).

The ICS covers all financial instruments, all investment services, and the ancillary service of safekeeping and administration (CML, Art. 258). It builds upon a strong investor protection framework grounded in strict organisational and conduct-of-business rules, supervised and enforced by HANFA. Crucially, asset segregation rules stipulate that clients' assets do not form part of an investment firm's property, liquidation estate, or bankruptcy estate, and cannot be subject to enforcement for the firm's debts (CML, Art. 80, Para. 8). Importantly, the CML explicitly extends the same protection to client money held by investment firms at credit institutions (Art. 81, Para. 9). This provides a higher level of protection compared to prevailing models in other EU jurisdictions, as discussed in Section 2.4. Indeed, it could be argued that clients of investment firms enjoy stronger protection than clients of credit institutions, whose money is protected only up to the deposit insurance limit.

The ICS covers all clients - whether natural or legal persons – unless explicitly excluded under Article 262, Paragraph 2 of the CML. Consequently, retail clients who have opted for professional client status still fall under the scheme's protection. Conversely, professional clients listed among the excluded categories remain outside the scheme's coverage, even if they request to be treated as retail clients.

To mitigate spillover risks, the CML mandates that scheme assets be segregated from the assets and liabilities of the scheme operator (CML, Art. 280, Para. 3). Additionally, ICS funds must be held in a special account opened with the Croatian National Bank (CML, Art. 280, Para. 1), thus protecting the assets from potential commercial bank failures.

3.2 Discussion of reforms of the Croatian ICS

The legal framework supporting the Croatian ICS has evolved only moderately over the years. The absence of major reforms can be attributed to two main factors. First, reforms to the ICSD at the EU level have stalled, reducing pressure for national changes. Second, since its establishment in 2009, Croatia's ICS has seen only one compensation event. On 13 January 2011, HANFA determined that the investment firm Prva generacija d.o.o. had failed to segregate

and safeguard client funds and was unable to meet its obligations to investors (Official Gazette No 8/2011). According to media reports, Prva generacija d.o.o. had approximately 1.600 clients.[1]

However, the 2024 amendments to the CML (Official Gazette No. 85/2024) introduced substantial reforms to the ICS, reflecting an ambitious plan to align the scheme with best practices. Key changes include:

- The possibility for members to meet their contribution obligations using financial or payment security instruments, instead of cash alone (Art. 273, Para. 1).
- Introduction of risk-weighted contributions (Art. 273, Para. 4).
- HANFA's obligation to determine a target level for the ICS (Art. 280, Para. 8).
- HANFA's obligation to set rules on public disclosure regarding ICS management(Art. 280, Para. 8).

These reforms require further elaboration in secondary legislation and practical implementation. This paper seeks to contribute to the academic debate on their design and application, focusing particularly on risk-based contribution models and the determination of the ICS target level.

As Oxera (2005, pp. 64-65) notes, the basis for calculating contributions varies significantly among EU Member States and includes factors such as the value of protected assets, number of clients, revenues, number of employees, capital, and (for banks) deposit levels. Most schemes do not incorporate default probabilities. Among those that do, two main models have emerged. France, for instance, applies a model based on Common Equity Tier 1 Coverage Ratio and Return on Assets to weight the value of client financial instruments (ACPR, 2023, Art. 7). Germany, by contrast, implicitly accounts for risk by applying higher contribution rates to firms authorised to hold client assets and trade for their own account.

In Croatia, the current system does not explicitly incorporate risk indicators but applies differentiated rates on revenues depending on the nature of the service: 1% on revenues from reception, transmission and execution of orders; 1,5% on portfolio management; and 2% on safekeeping and administration (HANFA, 2019, Art. 4). Although the rationale behind these rates is not explicitly stated, it could be argued that they reflect perceived risk levels, in a manner similar to the approach adopted in the German model.

[1] See Večernji list, 24.12.2010, author Lidija Kiseljak, available at https://www.vecernji.hr/vijesti/prvi-broker-u-hrvatskoj-pred-kaznenom-prijavom-231783 (accessed 28 April 2025)

Risk-weighted contributions offer several potential benefits: They may discourage excessive risk-taking (thus reducing moral hazard) and promote fairness by requiring higher contributions from firms more likely to draw on ICS resources. However, they also present challenges: they are administratively complex, require substantial data and supervisory input, and may disproportionately burden weaker institutions, potentially destabilising them (Oxera, 2005, p. 66).

Further complexities arise when applying risk-weighted contributions to the investment services sector, which is highly heterogenous. It includes investment firms, credit institutions, and fund managers with varied business models, capital requirements, and risk profiles. Moreover, unlike deposit insurance schemes, ICSs primarily cover operational risks – such as fraud and errors – that lead to client losses only if the firm becomes unable to return client assets. Thus, conventional default risk metrics, such as capital ratios, are not directly correlated with ICS payout risk. Varying asset segregation rules across Member States further complicate the applicability of uniform risk models. In contrast to deposits, client assets in investment firms are typically segregated, making the case for risk-weighted contributions theoretically stronger in the context of deposit insurance schemes.

Setting the target fund size is closely linked to contribution levels, as contribution rates depend on the time horizon over which the target is to be reached. Under Croatia's current framework, with annual contributions and no fixed cap, the ICS fund could theoretically grow indefinitely. To prevent this, many countries adopt formal or informal target levels and suspend contributions once the target is met (Oxera, 2005, p. 73). In 2005, most ex-ante funded schemes relied on ad hoc methods or simple rules of thumb to define target sizes (Oxera, 2005, pp. 82-83). Given that Croatia's ICS has not been utilised for over a decade, it is plausible that the fund has already reached or exceeded a suitable target level – though this cannot be confirmed, as current fund balances and contributions are not publicly disclosed.

Determining an optimal target fund size poses similar theoretical challenges as setting risk-weighted contributions. A basic method is to define the target as a ratio of protected assets (Oxera, 2005, p. 83) and set the target fund size arbitrarily. More advanced approaches used in deposit insurance literature include:

- Indicator-based methods using qualitative and quantitative risk metrics.
- Market-based methods, relying on market indicators like CDS spreads or interbank interest rates.
- Rating-based methods, deriving credit ratings from indicator-based methods, ideally applied by independent agencies (Bernet and Walter, 2009, pp. 49-50).

In order to determine the target fund level. Having in mind the risks of failure, one must assess the potential losses for the ICS, which are expressed as the sum of products of exposures at default, probabilities of default and losses given default (Ognjenovic, 2017, p. 166).

These approaches are difficult to apply to most EU investment firms, which often lack market-based data or reliable ratings. Moreover, the probability of loss depends not only on firm default but also on the extent of asset segregation. This suggests that practicality, rather than theoretical precision, should guide the choice of methodology for ICS target setting.

In the context of the Croatian ICS, the current and proposed models raise concerns about fairness and moral hazard - particularly once the target fund level has been reached, which is presumably already the case or close to being so. Under the model of non-redeemable contributions (CML, Art. 273, Para. 1), past contributions, including contributions made by firms no longer active in the market, may effectively finance future defaults. Conversely, newly established firms entering the market after the target has been met may never be required to contribute yet could still benefit from the scheme if they default later. Additionally, significant changes in market share or risk levels among participants may lead to a misalignment between historical contributions and the current distribution of risk. In this context, the practical value of newly introduced risk-based contributions becomes uncertain, particularly if contributions are no longer actively collected or adjusted after the target level has been met. Furthermore, the recent introduction of the option to meet contribution obligations through payment security instruments (e.g., guarantees) also appears conceptually inconsistent with the principle of non-redeemable contributions. A more theoretically robust approach would involve redeemable contributions - especially for firms exiting the market - and ongoing recalibration of contribution levels based on business volume or risk profile. However, such a model would be more administratively demanding. These design tensions underscore the importance of detailed secondary legislation to ensure coherence and fairness in the implementation of the reformed Croatian ICS.

Regarding the requirement for rules on public disclosure, increased transparency may enhance public trust in the ICS. However, revealing short-term funding needs could also undermine confidence and introduce procyclical effects. These concerns are relevant only if clients actually respond to such information – something that remains uncertain.

3.3 Possible further improvements

In addition to the major reform elements discussed in the previous Section, several aspects of the Croatian ICS legal framework remain unclear or insufficiently developed.

One such issue concerns the scope of mandatory membership in the ICS. Article 36 of the CML establishes a general rule that entities authorised to hold client financial instruments or funds must participate in the ICS. However, Article 255 appears to depart from this principle by applying the "asset-holding" criterion exclusively to investment firms. At the same time, it mandates participation for all credit institutions and all fund management companies authorised to provide portfolio management services, regardless of whether they hold client assets. This divergence creates ambiguity, particularly in relation to fund management companies. Although they do not, in practice, hold client assets - since client money is typically held in bank accounts and financial instruments are kept with custodians - they nonetheless participate in the ICS. As a result, investment firms offering only portfolio management services may be subject to different treatment than fund management companies providing the same service. To ensure consistency and legal clarity, it would be advisable to align the membership provisions of Articles 36 and 255.

A second area requiring attention is the treatment of branches of third-country investment firms. These branches are not explicitly included in the list of entities subject to mandatory ICS membership under articles 36, 255 and 256 of the CML. Nonetheless, such branches are required to participate in the ICS where no equivalence exists in the level of investor protection between Croatia and the firm's home jurisdiction ICS. While this assessment is conducted by HANFA during the branch's authorisation process, making the participation requirement explicit in the CML would enhance transparency and legal certainty.

Another gap in the current legal framework concerns losses resulting from the failure of third-parties, such as custodians or banks. Neither the CML nor HANFA's implementing regulations explicitly address these situations. It appears that such losses would be covered by the ICS only if they directly result in the default of the investment firm itself. Otherwise, in cases where the investment firm refuses to compensate its clients for third-party losses, investors may be forced to pursue claims through litigation. This introduces uncertainty and the risk of significant delays in compensation. The absence of explicit provisions also suggests that neither investors nor the investment firm, acting on behalf of

its clients, would be entitled to claim compensation from the ICS in such cases. While Article 81 of the CML requires investment firms to exercise due care and diligence in selecting third parties, and the Rulebook on organisational requirements and business conduct (HANFA, 2018, Arts. 9–22) imposes additional safeguards to mitigate these risks, the lack of a clearly defined compensation pathway remains a significant shortcoming of the current framework.

Another important limitation of the Croatian ICS is that it does not have the authority to levy extraordinary contributions. Instead, it may only access additional funds through a pre-arranged credit line with a credit institution (CML, Art. 283). While this may offer some degree of liquidity, it could prove impractical—particularly in the case of modest shortfalls, where drawing on a credit line may be disproportionate or administratively burdensome.

A further point of ambiguity concerns the payment of interest on compensation amounts. An amendment to the CML in 2013 introduced a provision for interest to be paid from the date of the compensation event (Art. 261, Para. 3), whereas the earlier version of the law explicitly excluded such payments. However, the current legal framework does not define what is meant by "interest." It remains unclear whether this refers to accrued interest on client-held financial instruments or to additional compensatory interest. In the absence of clarification, disputes over interpretation could arise in the event of a compensation event.

The treatment of client assets involved in specific transactions - such as margin calls for derivatives, pledges, encumbrances, re-hypothecation, margin lending, and securities lending - also remains undefined under the current framework. Neither the CML, HANFA's implementing regulations, nor the rules of the ICS operator (SKDD, 2022) address how such transactions and related assets would be treated in the event of an investment firm's default. As noted by IOSCO (2011, pp. 3–4), jurisdictions differ significantly in their approaches to these complex arrangements. In the Croatian context, the absence of detailed provisions, coupled with a lack of case law or administrative practice, leaves investors without clear guidance on whether such assets fall within the scope of ICS protection.

Another point of uncertainty concerns structured deposits. Articles 7, Paragraph 5, and 36, Paragraph 2 of the CML require credit institutions and investment firms distributing structured deposits to join the ICS. However, it is not clearly established whether or to what extent such instruments are actually covered by the ICS, particularly as structured deposits fall under the deposit insurance framework. Combining the definition of a deposit from Article 4,

Paragraph 1, of the Law on the Deposit Insurance System with the definition of a structured deposit under the CML, it can be inferred that the deposit insurance scheme covers only the principal, while any market-linked gains may fall under the scope of the ICS. In any case, the current framework would benefit from a clearer set of provisions.

In addition, the current ICS compensation limit of EUR 20.000,00 remains low relative to typical portfolio and transaction values and may offer only limited protection in the event of a firm's default. This level was originally aligned with the minimum threshold for deposit insurance coverage, which has since been substantially increased due to the systemic importance of banking institutions. While investor compensation is not systemically significant in the same way, the low coverage limit may still undermine investor confidence and merits reconsideration.

Finally, the institutional structure of ICS management may also warrant reconsideration. It could be advisable to transfer management responsibilities to the Croatian Deposit Insurance Agency, which also manages the deposit insurance scheme and the resolution fund for credit institutions. Consolidating oversight under a single body could improve efficiency, reduce duplication, and enhance coherence across Croatia's financial safety net mechanisms.

4 CONCLUSION

ICSs serve an important function within the broader financial regulatory framework, offering a last-resort protection mechanism for retail investors and thereby contributing to confidence in financial markets. While their role may not carry the systemic implications of deposit insurance schemes, ICSs are a critical component in safeguarding individual investors, particularly in markets with high retail participation. This paper has reviewed the legal design and recent reform of Croatia's ICS, placing it in the context of European regulatory developments and best practice.

The 2024 amendments to the Croatian CML represent the most significant reform of the ICS since its establishment in 2009. They signal a strategic shift toward a more structured, transparent, and risk-sensitive approach to investor protection. At the core of the reform is the introduction of risk-weighted contributions, the possibility to meet contribution obligations through payment security instruments, and the requirement for HANFA to determine both a target fund level and rules for public disclosure on the fund's management.

These changes demonstrate clear intent to align the Croatian ICS with international best practice. The move toward risk-weighted contributions is theoretically sound, offering a more equitable and incentive-compatible mechanism that links firm behaviour and risk exposure to contribution obligations. The current revenue-based model, which already applies differentiated rates across investment services, may serve as a useful foundation for further refinement. However, the practical application of risk-weighted contributions in Croatia will depend on the availability of reliable firm-level risk metrics, supervisory capacity, and appropriate calibration of the model. As the experience of other EU Member States shows, implementing such models can be administratively demanding and politically sensitive.

Another key challenge arises from the interaction between risk-weighted contributions and the non-redeemable nature of contributions under Croatian law. Over the past decade, the ICS has accumulated assets through flat-rate contributions from all members. Once the target fund size is reached, newly licensed firms - or those whose market share has grown significantly - may never be required to contribute, while former or smaller firms may have borne disproportionate costs. Introducing risk-weighted contributions in this context may therefore raise questions of fairness, since existing contributions cannot be adjusted retroactively, and the scheme lacks a mechanism to periodically rebalance contribution burdens. Without a model for redeemability or dynamic recalibration, risk-weighted contributions may have limited impact in practice.

The introduction of a target fund level is nonetheless a welcome step, aligning Croatia's ICS with recommendations from both EU policy discussions and academic literature. A defined target enhances predictability and helps ensure proportionality in contribution demands. However, questions remain about how this target will be determined. Theoretical models developed for deposit insurance—such as indicator-based or rating-based methods—may not translate directly to ICSs, given the differences in risk transmission and asset segregation practices. In the Croatian context, where no major compensation event has occurred since 2011, reliance on historical data is limited. A pragmatic approach that considers both risk exposure and operational feasibility will be essential.

While the 2024 reform addresses key aspects of ICS design, other elements of the Croatian framework – in particular the low coverage limit, the absence of extraordinary levy powers, and the treatment of third party losses – remain areas for future legislative improvement.

In sum, the 2024 reform of the Croatian ICS constitutes a meaningful step toward a more robust and modern compensation framework. Its success will ultimately depend on the implementation of risk-weighted funding, the operationalisation of the target level, and the regulatory guidance that follows. The Croatian experience offers valuable insights for other jurisdictions seeking to enhance investor protection while balancing fairness, feasibility, and market confidence.

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NAKNADA ŠTETE INVESTITORIMA U HRVATSKOJ: NEDAVNE REFORME I IZAZOVI POLITIKA

Sažetak: Ovaj rad istražuje reformu hrvatskog sustava naknada štete investitorima iz 2024. godine, kojom su uvedena važna poboljšanja usmjerena na jačanje zaštite investitora i usklađivanje sustava s najboljom međunarodnom praksom. Ključne inovacije uključuju usvajanje doprinosa ponderiranih rizikom, mogućnost ispunjavanja obveza doprinosa putem financijskih instrumenata ili instrumenata osiguranja plaćanja te nove odgovornosti nadzornog tijela za definiranje ciljane razine fonda i osiguranje veće transparentnosti. Rad razmatra kako postojeća struktura - posebno dugogodišnje akumuliranje neotkupljivih doprinosa - može oblikovati praktični utjecaj financiranja temeljenog na riziku. Nadalje, rad razmatra metodološke pristupe za određivanje odgovarajuće veličine ciljanog fonda na tržištu s ograničenim povijesnim podacima o zahtjevima. Analizom razvoja hrvatskog modela naknada štete investitorima, rad doprinosi širim raspravama o tome kako sustavi naknade za investitore mogu uravnotežiti jednostavnost, pravednost i osjetljivost na rizik, a istovremeno održati povjerenje tržišta.

Ključne riječi: sustavi naknada štete investitorima, zaštita investitora