1 INTRODUCTION

The Czech National Bank is pleased to present to the public its Financial Stability Report for 2005. In so doing it is fulfilling its new task stipulated by law – to analyse the financial system and contribute to the stability of the financial system as a whole.

An important change ensuing from an amendment to the Act on the CNB (effective from 1 April 2006) is the integration of financial market supervision into the CNB. The integration was aimed at improving the efficiency of supervision and simplifying communication between regulated entities and supervisors. The Financial Stability Report does not deal with this topic in detail, since it focuses on the developments in 2005. The integration should help to further strengthen financial stability in the Czech economy in the medium term.

Financial stability can be understood as a situation where the financial sector operates with no serious failures or undesirable impacts on the present and future development of the economy as a whole, yet shows a high degree of resilience to shocks. Factors, which may (but will not necessarily) have a substantial effect on financial stability are referred to as risks in this Report. These risks may arise *inter alia* from the external environment, domestic macroeconomic developments, economic policies, changes in the institutional environment or processes within the financial sector. Financial stability may be disturbed should these risks materialise, i.e. if the financial sector is hit by a shock.

The structure of this Report is similar to that of the first Report for 2004. The financial sector operates in an environment shaped by external and domestic macroeconomic developments and foreign and domestic financial markets. These topics are addressed in section 2. Section 3 analyses developments in the domestic corporate sector and households. These are the main debtors and creditors of financial institutions and represent the primary source of credit risk for them. Attention is also paid to developments in the real estate market. Section 4 focuses on financial institutions themselves, analysing the financial sector's structure, profitability, efficiency, loan portfolio quality and compliance with prudential criteria. All these factors can affect the performance and capital strength of financial institutions and consequently also their ability to cope with potential shocks. The last section discusses the development of the financial infrastructure, i.e. the interbank payment system and the short-term bond system, whose smooth operation is a key prerequisite for financial stability.

The Report newly includes four thematic articles relating to financial stability issues. The first article presents stress testing of the banking sector. In addition to updating the stress tests conducted in the previous Financial Stability Report, we have widened the range of stress tests to include testing of the impacts of alternative macroeconomic scenarios and an analysis of the risk of interbank contagion. The stress testing uses outputs from a credit risk model, which is described in the second thematic article. The model predicts the share of bad loans in the overall loan portfolio in response to the evolution of key macroeconomic indicators. The third article addresses the issue of insolvency law, including past and present changes thereto, in relation to financial stability. The last article analyses the cost efficiency of banks in order to examine the hypothesis of whether falling cost efficiency can signal the risk of bank failure. The Report ends with a list of all abbreviations used in the Report.

The Report analyses the evolution of relevant indicators, focusing on 2005. Where 2005 data were not available, data for the previous period were used.

This Financial Stability Report was approved by the Bank Board of the Czech National Bank on 11 May 2006. It is available in electronic form at www.cnb.cz