The Czech National Bank is pleased to present its fifth Financial Stability Report to the public. This report analyses the risks to the financial stability of the Czech Republic in the near future on the basis of previous and expected developments in the real and financial sectors.

This year's Report profits from a modelling and analytical framework for the financial stability area based on advanced stress testing, liquidity testing and accompanying economic models. This year, this framework, which is constantly being refined, has been expanded to include a comprehensive test of banks' balance-sheet liquidity. The bank stress testing methodology has also undergone quite a major revision, including the creation of a pilot methodology for capturing the impacts of individual shocks over time. Three alternative adverse scenarios were constructed on the basis of an analysis of trends and weak spots in the domestic and external economy and financial sector, and their impact on the financial sector was tested. The alternative scenarios, drawn up with the aid of the CNB's macroeconomic model, take into account the current situation on global financial markets, developments in the Czech property market and the risks of a decline in the external and domestic economies. The alternative scenarios – entitled "Europe in recession", "market nervousness" and "economic depression" – are presented in the Report one by one in the form of boxes in the sections that analyse the main features of each scenario. Section 4.2 *Assessment of the financial sector's resilience* discusses the impacts of all the scenarios. The stress tests of banks, insurance companies and pension funds are complemented by several quantitative indicators of financial system stability, such as a banking sector stability indicator, a non-financial corporation creditworthiness indicator and a newly constructed financial stability map.

The structure of the Report follows the logic of the approach to the analyses, i.e. the risks in each sector are first identified and the size of stress that the financial sector is able to withstand is then examined. The section entitled *The real economy* discusses developments in the external and domestic macroeconomic environment and in key domestic sectors, i.e. households and corporations. The section entitled *Asset markets and the financial infrastructure* analyses developments and risks in the financial market, the property market and the financial infrastructure. The last section of the main part of the Report, *The financial sector*, covers developments in the financial sector and includes a section assessing the Czech financial system's resilience to shocks under the three alternative scenarios. The Report ends with a table of key indicators relevant to financial stability and an annex analysing the situation of overindebted households.

The Report includes four thematic articles. The article *Instruments for Curbing Fluctuations in Lending over the Business Cycle* discusses instruments for reducing procyclical bank lending behaviour and reveals that Czech banks are among those that provision in a procyclical manner. The article *Property Price Determinants in the Czech Regions* discusses factors affecting property prices and, among other things, identifies overvalued property prices in 2002/2003 and 2007/2008. The Article *Models of Bank Financing of Czech Corporations and Credit Risk* shows that the level of credit risk at bank level decreases significantly in line with the extent to which firms applying single relationship banking occur in the bank's portfolio. The last article *Estimating Expected Loss Given Default* discusses the estimation of a key credit risk parameter – loss given default (LGD) – and reveals that the average LGD of the sample of firms analysed varies over time from 20% to 50%.

In the current situation, where the economic and financial outlook is changing dynamically, it is very important for the Report to be up-to-date and forward-looking. For this reason, the Report has been re-named the 2008/2009 Financial Stability Report. The new name reflects the fact that because some important full-year data do not become available until March of the following year, the Financial Stability Report is published practically in the middle of the year, and so its data coverage in some other areas can be extended to January–May of the current year.

This Financial Stability Report was approved by the Bank Board of the Czech National Bank on 14 May 2009 and published on 16 June 2009. It is available in electronic form at *http://www.cnb.cz/*.