

The Czech National Bank is pleased to present to the public its sixth Financial Stability Report (FSR). The main aim of the FSR is to identify and analyse the risks to the financial stability of the Czech Republic which may arise on the basis of previous and expected developments in the real and financial sectors.

Compared to last year, the analytical and modelling framework of the FSR has been further improved. This applies in particular to the banking sector stress tests, which have a dynamic nature and a longer (two-year) horizon. The balance-sheet liquidity tests use a larger number of liquidity shocks and better reflect the subsequent responses of the banks. The partial models applied have been re-estimated, revised and supplemented with a banking sector income model. Compared to last year, the FSR also uses new data sources, e.g. the SOLUS register and additional information from the ongoing joint stress testing project of the CNB and selected banks.

The financial sector's resilience is tested by means of alternative macroeconomic scenarios that capture the biggest risks to financial stability in the Czech Republic. The risk of W-shaped economic activity, i.e. a renewed recession characterised by a further sharp decline in GDP in 2010 and partly also in 2011, is considered in the *Return of Recession* stress test. By contrast, the *Loss of Confidence* scenario captures the potential combination of weak economic growth and adverse financial market developments. The two alternative stress scenarios are compared with a *Baseline Scenario* that corresponds with the CNB's official May forecast. The impacts of the scenarios are assessed not only from the perspective of the financial sector, but also with regard to the property market and the corporate and household sectors.

The structure of the FSR is unchanged. The report is divided into three main sections analysing the risks in individual economic sectors. The section entitled *The real economy* discusses developments in the external and domestic macroeconomic environment and in the key domestic sectors, i.e. households and corporations. The section entitled *Asset markets and the financial infrastructure* analyses in detail risks in the financial market, the property market and the financial infrastructure. The last section, *The financial sector*, sums up developments in the financial sector and assesses the Czech financial system's resilience to shocks under the alternative economic scenarios. For ease of use and clarity, the FSR for the first time contains short headlines summarising the main ideas and conclusions of individual parts of the text. The report ends with a table of key financial stability indicators.

As usual, the final part of the FSR is devoted to thematic articles that discuss in more detail some topical issues relating to financial stability. The article entitled *Stress Test Verification as Part of an Advanced Stress-testing Framework* summarises the CNB's updated stress-testing methodology and verifies that methodology with a view to identifying any inaccuracies and thus improving its quality. The article entitled *Financial Integration at Times of Financial (In)stability* assesses

the impacts of the financial crisis on the speed and level of integration of the Czech financial market with the euro area. The third article, *Procyclicality of the Financial System and Simulation of the Feedback Effect*, examines the procyclical behaviour of financial institutions and analyses the possible impacts of procyclicality on the Czech banking sector. The last article deals with the *Regulation of Alternative Funds in the Czech Republic in the Context of the Debate on their Potential Regulation in the European Union*. The article recommends some changes to the current Czech regulations.

The title of the FSR was altered slightly last year to better describe the period to which the financial stability analysis relates. As some important full-year data become available only with a lag of several months, the FSR is published in the middle of the year. Nevertheless, many of the analyses are based on current data which extend beyond the first quarter of 2010. For this reason, the time period 2009/2010 is used in the title of the Report.

This Financial Stability Report was approved by the Bank Board of the Czech National Bank on 13 May 2010 and published on 18 June 2010. It is available in electronic form at <http://www.cnb.cz/>.