

## 1 INTRODUCTION

The Czech National Bank is pleased to present to the public its fourth Financial Stability Report, this time for 2007. 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. The turbulence on global financial markets that emerged in summer 2007 highlights the relevance of these analyses, especially as regards the potential impacts of external developments on the Czech financial system.

Starting with this Report, the work with the risks to financial stability is shifting towards a more detailed analysis of selected risks and quantification of their impacts on the stability of the financial system. This shift allows us to enhance the consistency of the analyses and raise the Report's level towards the highest international standards. This year's Report profits from a gradually constructed modelling and analytical framework for the financial stability area based on advanced stress testing and accompanying economic models. Three alternative scenarios of adverse developments 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 take into account the current turbulence on global financial markets, developments in the Czech property market and the risks of a potential cooling of economic activity abroad. The baseline scenario from the CNB's official February 2008 macroeconomic forecast is used for comparison. The alternative scenarios – entitled "safe haven", "property market crisis" and "loss of confidence" are presented in the Report in the form of boxes in the sections that analyse the main components of the individual scenarios. A new subsection 4.2 *Assessment of the financial sector's resilience* contains a discussion of the impacts of all the scenarios.

Our efforts to strengthen the quantitative aspects of the Report necessitated a review of the interactions and transmission channels for the spread of instability across individual economic sectors. These linkages are quantified using sub-models, expert estimates and other analytical techniques. The basic analytical tool for analysing the spread of instability and assessing the impacts of shocks to financial system stability is stress testing, which the CNB has been developing for several years now. The development of the stress-testing methodology and the results derived from the various scenarios for development have been regularly disclosed by the CNB in the form of annexes and thematic articles in previous Reports. The stress tests quantify the impact of changes in key macroeconomic and financial indicators on the solvency of the most important financial institutions, i.e. banks, insurance companies and pension funds. These tests are complemented by several quantitative indicators of the stability of the financial system, such as the banking sector stability indicator presented as a thematic article in last year's Report and the non-financial corporation creditworthiness indicator described in a thematic article in this Report.

This Report is similar in structure to last year's. 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 the financial markets, the property market and the financial infrastructure. The last section, *The financial sector*, covers developments in the financial sector and newly also the aforementioned section assessing the Czech financial market's resilience to shocks from the three alternative scenarios. The Report ends with a table of key indicators relevant from the point of view of financial stability.

Like last year, the Report includes four thematic articles. *The Role of Ratings in Financial Sector Stability Assessment* discusses the ratings of financial market

participants as one of the indicators of financial stability. *Scoring as an Indicator of Financial Stability* deals with the construction of an indicator of the creditworthiness of non-financial corporations using a scoring model and is based on a microeconomic study of Czech corporations. *Competition and Efficiency in the Czech Banking Sector* offers empirical evidence on the evolution of competition in the Czech banking sector and its relationship to the cost efficiency of banks in the Czech Republic. The last article, *Operational Risk and its Impacts on Financial Stability*, describes the nature and significance of operational risk with regard to financial stability and identifies the impacts of the newly introduced capital regulation of operational risk.

This Financial Stability Report was approved by the Bank Board of the Czech National Bank on 15 May 2008. It is available in electronic form at <http://www.cnb.cz/>.