

4 THE FINANCIAL SECTOR

2011 was a relatively good year for the Czech financial sector. The banking sector as a whole maintains a good starting position in terms of credit risk, capital adequacy and profitability, but the situation remains quite heterogeneous across the sector. Insurance companies have solid capitalisation this year, but their profitability decreased. The pension fund segment remains stable but will be affected by a reform of the pension system. The market shares of collective investment funds and, as in the previous year, of non-bank financial corporations engaged in lending decreased slightly.

The risks to the financial sector consist mainly in possible worse-than-expected performance of the Czech economy, which could substantially increase the credit losses of Czech banks despite their caution in providing loans. If concerns regarding the ability of governments to stabilise fiscal imbalances spread and financial market turbulence re-emerges, substantial bond revaluation could take place, affecting financial institutions' balance sheets. Another significant risk is potential contagion from the foreign banking system through the links between Czech banks and their parent companies, for example if the above-mentioned two risks were to materialise.

The depth of financial intermediation in the Czech Republic increased in 2011

The relatively favourable economic developments in 2011 and persisting confidence in the Czech financial sector were reflected in a rise in the balance-sheet total of the financial sector. The ratio of financial institutions' assets to GDP increased from 143% in 2010 to 150% in 2011.⁵³ Banks, and partly also credit unions and pension funds, strengthened their shares in the financial sector. By contrast, the shares of insurance companies, collective investment funds and non-bank financial corporations engaged in lending decreased slightly (see line FS.2 of the Table of Indicators). On aggregate, the largest growth in assets was recorded in the banking sector, owing chiefly to purchases of government bonds and the provision of new loans.

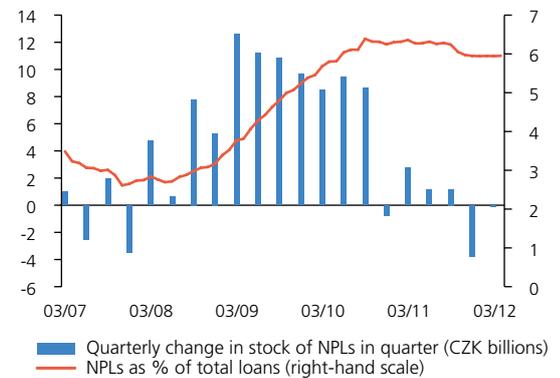
Credit risk in the banking sector improved slightly in 2011

In contrast to 2009–2010, there was no further strong growth in NPLs, and their ratio to total loans declined slightly to 6% at the end of 2011 (compared to 6.3% at the end of 2010). The ratio remained at a similar level in March 2012. This was due not only to a smaller absolute change in NPLs, which in 2011 H2 returned close to its pre-crisis levels of 2007–2008 (see Chart IV.1), but also to moderate growth (of around 6%) in the total volume of loans provided. An international comparison between selected EU countries shows that the NPL ratio in the Czech Republic is similar to that in Slovakia (5.6%), higher than in Austria (2.7%) and Belgium (2.8%), and lower than in Poland (8.2%), Slovenia (11.8%) and

CHART IV.1

NPLs in the Czech banking sector

(client loans; %, CZK billions)

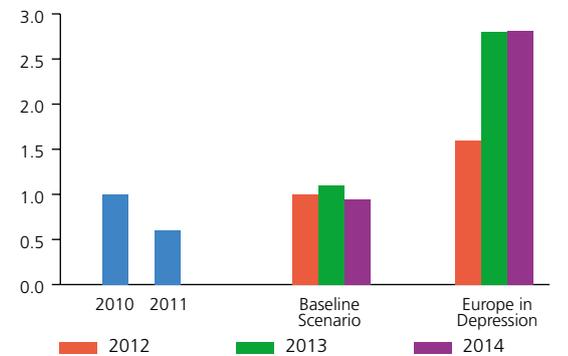


Source: CNB

CHART IV.2

Risk costs of the banking sector

(%)



Source: CNB, CNB calculation

TABLE IV.1

Shares of loans in segments restructured in the given year

(%)

	Non-financial corporations	Households (house purchase loans)	Households (consumer credit)
2008	0.4	0.2	0.1
2009	1.0	0.5	0.9
2010	1.9	0.6	1.6
2011	1.9	0.5	1.4

Source: CNB

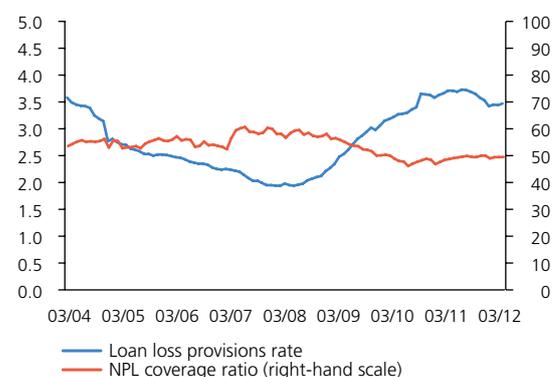
Note: Credit excluding overdrafts and card credit.

⁵³ Because of a substantial data revision, this figure is not in line with the one published in FSR 2010/2011 (see the Table of Indicators).

CHART IV.3

Provisions and coverage of NPLs by provisions

(%)



Source: CNB

TABLE IV.2

Structure of NPLs

(%)

	Sufficiently collateralised loans to households and corporations	Fully non-collateralised loans to households and corporations	Other loans	NPLs, total
2008	26.4	38.6	35.0	100.0
2009	31.0	32.5	36.5	100.0
2010	35.1	31.5	33.4	100.0
2011	36.8	30.6	32.6	100.0
	Non-standard	Doubtful	Loss	NPLs, total
2008	31.3	15.0	53.6	100.0
2009	37.8	21.0	41.2	100.0
2010	39.2	13.4	47.4	100.0
2011	32.8	14.1	53.1	100.0
	Not past due	Up to 3M past due	More than 3M past due	NPLs, total
2008	45.2	9.2	45.6	100.0
2009	52.9	8.7	38.4	100.0
2010	51.8	9.6	38.6	100.0
2011	46.0	9.3	44.8	100.0

Source: CNB, CNB calculation

Note: Sufficiently collateralised loans = loans for house purchase + loans to corporations backed by property and at least two other types of collateral (pledged receivables, movables, securities, sureties, guarantees, etc.).

Hungary (13.3%).⁵⁴ A moderate decline in credit risk is also indicated by the evolution of risk costs, defined as net provisioning relative to total loans (see Chart IV.2), and by the evolution of loan restructuring in both the household segment and the non-financial corporations segment (see Table IV.1). The risk of banks using loan restructuring to avoid admitting default by debtors and using the current low interest rate environment to reduce the burden on debtors is significantly limited by law, compliance with which is actively supervised. The legislation deems a change in the terms and conditions of a loan agreement that is motivated by the debtor's inability to repay under the original terms and conditions to be forced restructuring, and the bank is required to categorise the restructured loan as non-performing and create provisions where relevant.

The outlook for the near future represented by the *Baseline Scenario* assumes moderate growth in NPLs and risk costs owing to stagnation of the Czech economy in 2012. However, if the adverse *Europe in Depression* scenario were to materialise, risk costs would more than double (see Chart IV.2).

At the aggregate level, credit risk can be regarded as sufficiently covered by provisions, but risks remain...

NPL coverage was just below 50% throughout 2011 and stood at 49.5% in March 2012 (see Chart IV.3). This confirms that banks created sufficient provisions in the previous period to cover the stagnating volume of NPLs. However, the question remains whether coverage of around 50% will be sufficient in a stagnating economy in the period immediately ahead. On the one hand, the proportion of well secured NPLs increased further in 2011 (see Table IV.2), but on the other hand valuation of property and other types of collateral may be problematic in a situation of weak economic performance.

Other signals from the evolution of the NPL structure may indicate some risks. In 2011, the share of NPLs categorised as loss loans increased significantly.⁵⁵ The share of loss loans in total NPLs reached the level observed in 2008, when, however, the volume of NPLs was much smaller. Given the current economic situation, moreover, it is reasonable to expect continuing migration of NPLs towards loss loans and a need for additional provisions or write-offs, with an adverse knock-on effect on bank profitability.

The available data still indicate relatively cautious categorisation of NPLs, as a large proportion of these loans (46%) are not actually overdue. By comparison with 2010, however, the share of loans that are not past due is decreasing and the share of all loans that are more than three months past due is rising (see Table IV.2). This phenomenon, too, reflects the migration of NPLs conservatively categorised in past years into worse NPL categories and may represent a risk of additional provisioning.

⁵⁴ Figures based on IMF data (Financial Soundness Indicators) as at the end of 2011.

⁵⁵ This share increased from 52.7% to 59% in the household sector (house purchase loans from 41.2% to 45.2% and consumer credit from 58.8% to 54.8%) and from 29.6% to 33.1% in the non-financial corporations sector.

There are quite large differences in NPL coverage across domestic banks

For most banks, the coverage of NPLs by provisions is close to the sector average. However, there are banks in which this indicator is much lower. Moreover, the NPL ratios of these banks exceed 10%, which is well above the sector average and is roughly equivalent to the third quartile of the distribution of banks according to this indicator (see quadrant IV of Chart IV.4). Although the lower volume of provisions may also reflect better collateralisation of NPLs in some banks (e.g. by guarantees and pledges) or a higher repayment probability, the combination of a high NPL ratio and low coverage by provisions may represent an increased risk at least to some banks in the “problematic” quadrant IV. Similarly, an analysis of the NPL structure by default period shows that in some banks with high NPL ratios loans are categorised only after they become overdue (see quadrant II of Chart IV.5). Although these banks may categorise loans in accordance with the applicable regulation, they face a higher risk of additional provisioning, as they lack the safety buffer of “cautiously” created (and thus partly forward-looking) provisions for categorised loans that are not past due.

To assess the coverage of NPLs with provisions, an analysis of sufficiency of provisioning was performed, based on a comparison of the actual and “required” coverage levels using loss given default (LGD) values.⁵⁶ In comparison with 2010 there is a higher number of banks whose actual degree of coverage exceeds the “required” level (see Chart IV.6). Even in 2011, however, more than one-half of the monitored banks would not reach the “required” coverage in the event of an additional stress adding 10 pp to the initial LGD values.

The risks connected with government bond holdings in banks’ balance sheets are rising as their share in the banking sector balance sheet increases

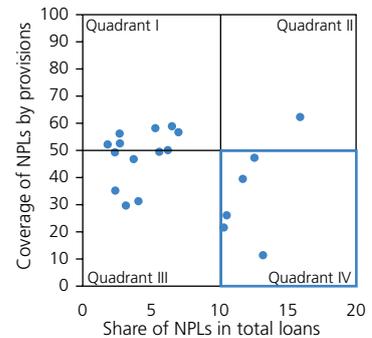
A preference for low-risk assets among domestic and foreign banks has been apparent since the onset of the financial crisis. Domestic banks increased their holdings of domestic government bonds from 11% of their balance-sheet total at the end of 2008 to 15.1% at the end of 2011. Although a flight to quality is also visible in the euro area, the share of domestic government bond holdings in the balance sheet of euro area monetary financial institutions excluding central banks has long been much lower than in the Czech Republic (see Chart IV.7), due mainly to a lower excess of client bank deposits over loans. There are several incentives for domestic banks to increase their holdings of

⁵⁶ The “required” coverage should cover NPL losses and was therefore calculated as the product of the LGD values and the volume of NPLs according to the main segments (loans to corporations, loans for house purchase, consumer credit and other loans). The baseline LGD values for the individual portfolio categories were identical to the values reported by banks in the joint stress test project. For other banks (excluding foreign bank branches) which did not participate in the project, averages for the participating banks were used. The LGD values applied in 2011 were 42% for loans to non-financial corporations, 20% for house purchase loans, 46% for consumer credit and 42% for other loans. The calculated average required coverage for the baseline LGD values was 37.9% for 2010 and 35.2% for 2011. The figures for LGD under additional stress were 47.9% for 2010 and 45.2% for 2011.

CHART IV.4

NPL coverage

(%; client loans; as of 31 December 2011; NPLs = non-performing loans)

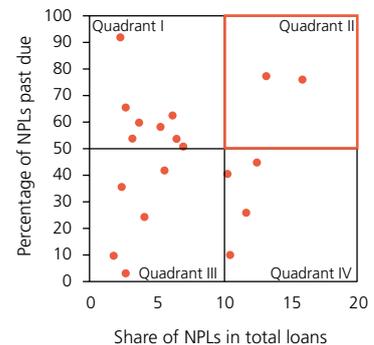


Source: CNB
Note: Banks excluding branches of foreign banks.

CHART IV.5

Credit risk in banks’ balance sheets

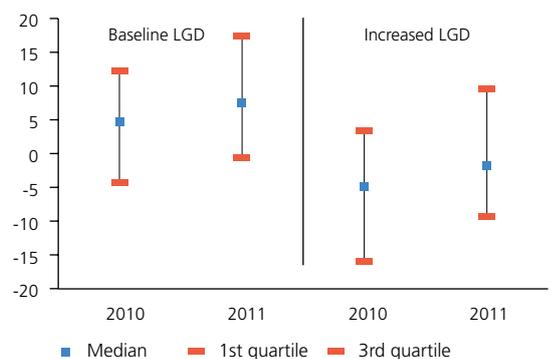
(%; client loans; as of 31 December 2011)



Source: CNB
Note: Banks excluding branches of foreign banks.

CHART IV.6

Differences between actual and required level of NPL coverage by provisions according to the LGD method
(pp; for the additional stress 10 pp was added to the LGD)

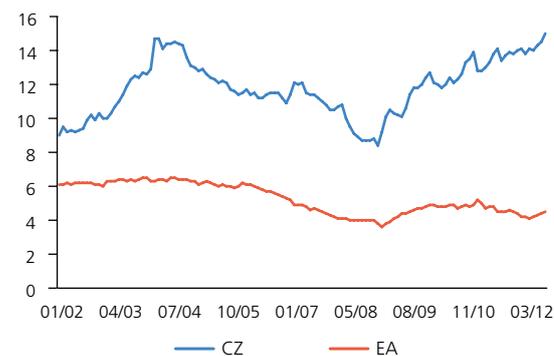


Source: CNB

CHART IV.7

Share of bonds issued by domestic governments in the balance sheet of MFIs excluding central banks

(%; MFIs excluding central banks comprise credit institutions and money market funds)

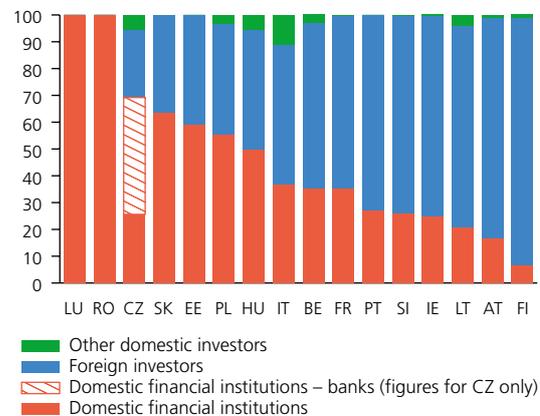


Source: ECB

CHART IV.8

Government bonds holdings by type of investor

(%; 2010; figure for CZ for 2011 Q4)



Source: Eurostat, CNB

domestic government bonds. The current applicable regulation assigns a zero risk weight to domestic government bonds in the calculation of capital adequacy. This gives banks a relatively certain yield amid a minimum cost of capital.⁵⁷ Czech government bonds are regarded as very liquid assets, also because banks can use them as collateral in the CNB's liquidity-providing repo operations, which were introduced in 2008 to support the bond market and still remain among the CNB's instruments (see Box 3 in section 3.1). Although the use of these operations is not significant given the good liquidity position of the banking sector, they provide banks with a liquidity safeguard at this time of increased uncertainty. In the medium term, however, they may foster a rise in concentration risk in the sense of asset concentration vis-à-vis a single debtor (the government).

However, the zero regulatory risk weight motivating banks to hold domestic government bonds may also lead to a higher tolerance of banks to Czech government debt and therefore to less cautious assessments of sovereign risk. This may, in turn, support further expansion of government debt. As the Czech banking sector currently holds about 44% of the total volume of government bonds (see Chart IV.8), a significant rise in credit risk and a loss of confidence in the government's ability to maintain fiscal stability might lead to significant sales of bonds from banks' balance sheets, either at the decision of the banks themselves or at the behest of their foreign owners. This would lead to a sharp decrease in the Czech Republic's ability to refinance its debt in the market and to a slump in the market value of these securities, which would also have a secondary effect on other holders, e.g. pension funds and insurance companies.⁵⁸ This scenario represents a medium-term risk in the event of continuing expansion of Czech government debt.

The off-balance-sheet activities of banks remain significant, despite decreasing since the start of the crisis

Banks' off-balance-sheet activities are closely correlated with the business cycle, with economic growth supporting growth in the off-balance-sheet total until 2008. By contrast, the crisis period saw a decline in irrevocable loan commitments given (of almost 20% between 2008 and 2011), owing to subdued credit growth, and in derivative contracts (of 41% between 2008 and 2011). On the other hand, a rising trend was recorded by guarantees given for clients (up by 6% between 2008 and 2011) and pledges received by banks (up by 24% between 2008 and 2011) owing to the higher economic uncertainty and the related need for both clients and banks to hedge against risks (see Table IV.3). At the end of 2011, total off-balance-sheet assets were CZK 6.7 trillion (i.e. around 150% of the banking sector's balance-sheet total) and off-balance-sheet liabilities were CZK 10.1 trillion (225% of the banking

⁵⁷ Some banks applying the IRB approach to the calculation of capital adequacy use slightly positive risk weights for government bonds.

⁵⁸ While banks may hold any amount of Czech government bonds as held-to-maturity receivables, which are not revalued to fair value, in the case of pension funds and insurance companies the volume of government bonds not revalued to fair value is limited by regulation. Moreover, the new Solvency II regulatory framework should completely rule out this possibility.

sector's balance-sheet total). However, the overwhelming majority of the off-balance sheet (almost 90% of all off-balance-sheet assets and almost 60% of off-balance-sheet liabilities) consists of derivatives transactions, which are recognised in off-balance-sheet assets and liabilities at the value of the underlying instrument. The fair value entering the balance sheet is much lower than that of the underlying instrument.⁵⁹

However, the considerable decrease in banks' off-balance-sheet activities due to the crisis does not necessarily correspond to a decline in the risks arising from the off-balance sheet, which for some items, conversely, can increase in bad times. First, higher drawings on irrevocable credit facilities and payments under guarantees provided may represent a liquidity risk for banks (see the liquidity stress tests in section 5). Second, the fact that these items are potential receivables also gives rise to credit risk, which may not be negligible in a period of weak economic performance. The ratio of irrevocable facilities and guarantees to banks' balance-sheet total is a sizeable 16.3%, exceeding the figure for the EU in 2008 by approximately 5 pp.⁶⁰

Banks regularly assess credit risk from contingent receivables in the form of commitments and guarantees given and create reserves for these potentially risky exposures. Commitments and guarantees are also subject to capital regulations and enter the calculation of the capital requirements for credit risk.

The decline in economic activity increases the probability of payments under guarantees and associated risks

The provision of guarantees to legal entities and natural persons who are entrepreneurs fell moderately between the start of the crisis and late 2010. The volume of "risky" guarantees, defined as guarantees given by a bank for clients who are in default, rose in line with the NPL ratio between 2008 and 2010 (see Chart IV.9). Besides the probability of having to honour a guarantee to a third party, the bank's expected loss from the resulting balance-sheet claim on the client also increases in the case of such guarantees.⁶¹ The volume of "risky" guarantees varied over time depending on the economic situation, reaching almost CZK 9 billion in 2010 but falling considerably to CZK 4 billion in 2011 in connection with the moderate post-crisis recovery. If this risk were to materialise in full, the NPL ratio in the non-financial corporations sector would rise by around 0.5 pp.

⁵⁹ At the end of 2011, for example, the positive fair value of derivatives totalled CZK 162 billion, i.e. only 2.8% of the value of the underlying instruments recorded in off-balance-sheet assets.

⁶⁰ The ratio of loan commitments and guarantees given to assets in the EU was 11% in 2008 (ECB, EU Banking Sector Stability 2009) as compared to 16.3% and 20.6% in 2011 and 2008 respectively for the Czech Republic.

⁶¹ The bank will first make good on the guarantee, i.e. pay the agreed amount for the client to a third party, but it will then record a claim on the client equal to the amount paid under the guarantee. If the payment under the guarantee was due to the client's bankruptcy, it can directly classify the claim as an NPL with a usually high loss given default.

TABLE IV.3

Off-balance-sheet items (CZK billions)

	31 Dec. 2008		31 Dec. 2011	
Receivables (liabilities) from derivatives	9,832	(9,826)	5,829	(5,834)
Commitments given (received)	609	(108)	491	(26)
Guarantees given (received)	225	(385)	238	(410)
Pledges given (received)	2	(1,475)	13	(1,822)
Receivables (liabilities) from spot transactions	44	(44)	48	(52)
Write-off receivables	29	(" ")	39	(" ")
Values given (received) to custody and asset management	50	(1,398)	35	(1,907)
Off-balance-sheet assets (liabilities), total	10,791	(13,236)	6,694	(10,051)
Share of value of off-balance-sheet assets and liabilities in banking sector balance sheet (%)	267	(327)	150	(225)

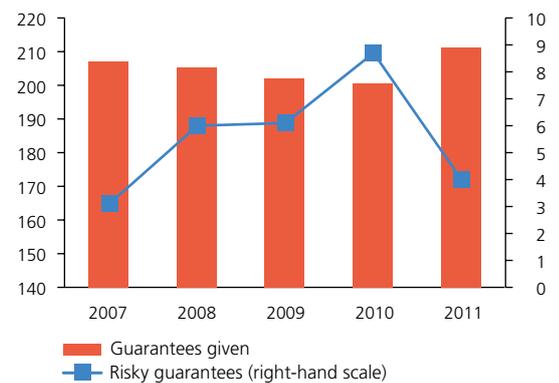
Source: CNB

Note: In terms of notional value derivatives are made up mainly of interest rate derivatives (68% at the end of 2011) and currency derivatives (31% at the end of 2011). The share of interest rate swaps (IRS) in total interest rate derivatives is 90%.

CHART IV.9

Risky guarantees

(CZK billions; legal entities and individual entrepreneurs)

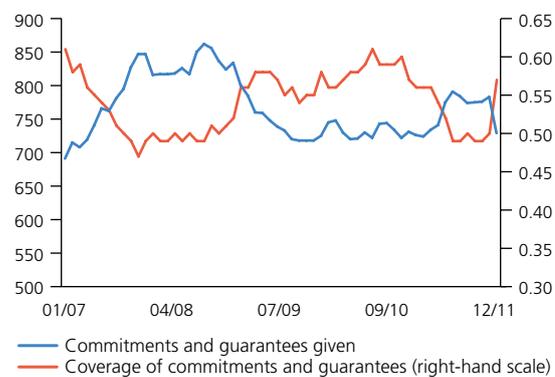


Source: CNB

Note: Risky guarantees = Volume of guarantees given to clients who have a non-performing loan with the given bank or another bank.

CHART IV.10

Coverage of commitments and guarantees by reserves (CZK billions; %)

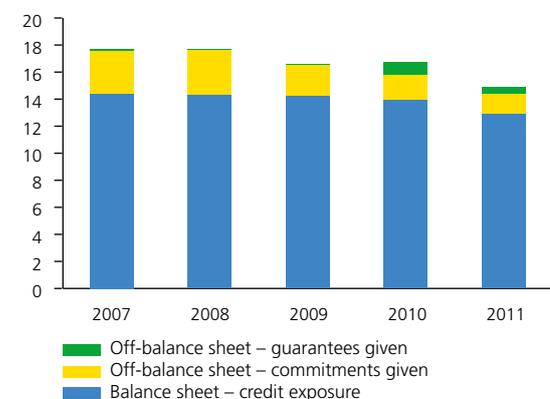


Source: CNB

CHART IV.11

Concentration of corporate portfolios, including the effect of the off-balance sheet

(%; share of three largest client credit exposures in corporate portfolio, including off-balance-sheet items)



Source: CNB

Note: The corporate portfolio represents credit exposures to all legal entities. Concentration is calculated as a weighted average of the concentrations of the portfolios of individual banks, where the weights used were the market shares of the banks in the total portfolio of loans to legal entities.

Reserves for off-balance-sheet items may be too low

As in the case of loans provided, from the point of view of the banking sector the risks arising from guarantees provided must be discussed in the context of the sufficiency of their coverage (see Chart IV.10). The reserves created for off-balance-sheet items, i.e. for irrevocable loan commitments and guarantees, are virtually constant over time (between the start of the crisis and the end of 2011 the reserves averaged CZK 4.2 billion), in contrast to the more volatile amount of commitments and guarantees given. Together with the long-standing relatively low coverage of off-balance-sheet items (below 1% of the volume of off-balance-sheet items), this raises the question of sufficient and flexible creation of reserves to cover expected losses from the off-balance-sheet activities of banks.

Loan portfolio concentration is falling steadily...

The average (weighted) concentration of client loan exposures, as measured by the share of the three largest exposures in the portfolio of loans to legal entities, is around 13%, but has been recording a moderate downward trend in recent years (see Chart IV.11).⁶² If the definition of the three largest exposures were to include loan commitments and guarantees, the average concentration rate would be higher (15% in 2011), but it would also be falling slightly over time. Some concentration in bank portfolios is unavoidable given the size of some corporations operating in the Czech Republic and their financing needs. However, the observed greater involvement of banks in syndicated loans and other measures taken by individual banks to increase their portfolio "granularity" (diversification) may foster a gradual decrease in concentration.

...but the collateralisation of the largest loans is declining

The available evidence continues to suggest low collateralisation of large exposures. At the end of 2011, the share of completely uncollateralised claims in the volume of loans to the three largest clients of each bank was 47% (42% for loans to the five largest clients). This represents a rise of almost 7 pp (or 4 pp for the five largest debtors) since 2008. If any large debtors were to get into trouble owing to worse-than-expected economic developments, the credit losses could be quite high given the low collateral. Concentration stress tests are described in section 5.

The profitability of the banking sector remains above average by international comparison...

On an unconsolidated basis, return on equity was 19.4% at the end of 2011, a slight decrease from 21.9% in 2010. The slight annual decline in the net profit of the banking sector of CZK 2.14 billion to CZK 53.5 billion in 2011 was due mainly to recognition of the impairment of Greek bonds in some banks. By contrast, profit from fees and commissions, and especially interest profit, increased year on year. However, the breakdown of the key components of profit from financial activities was broadly unchanged from 2010 (see Chart IV.12).

⁶² A similar trend is visible for the share of the five largest debtors, which stood at 17% at the end of 2011.

...but from the short-term perspective it may be jeopardised by financial market developments...

Gains and losses from financial market operations are one of the areas that can affect banks' operating profit. Although banks in the Czech Republic tend to focus on the conservative banking model of accepting deposits, providing client loans and investing in domestic government bonds, they are relatively active in the area of currency and interest rate derivatives held for trading. Insofar as banks use derivative transactions to hedge market risks and recognise them as hedging derivatives in their books, the volatility of their profits decreases. However, hedging derivatives account for only 14% of the notional value of all derivatives, while the rest is recognised as derivatives held for trading, which are revalued to fair value against profit and loss.

However, derivatives held for trading may in fact also be used for hedging, especially with regard to currency risk and interest rate risk. In the case of currency derivatives with domestic exporters, which are used to eliminate risks stemming from the currency mismatch between the claims and liabilities of exporting corporations, a bank usually opens the opposite position with its parent bank or another foreign bank, so its sensitivity to exchange rate movements is kept to a minimum. Interest rate derivatives are generally used to manage the interest rate risk of the assets and liabilities of the entire balance sheet, including deposits and loans, and to convert fixed interest rates into floating ones or vice versa. While this approach might ensure matched cash flows, it may cause one-off losses due to the revaluation of interest rate derivatives to fair value if interest rates change sharply, thereby adversely affecting the profit and loss account depending on the derivative position of a bank.

...and from the long-term perspective it may be reduced by structural changes

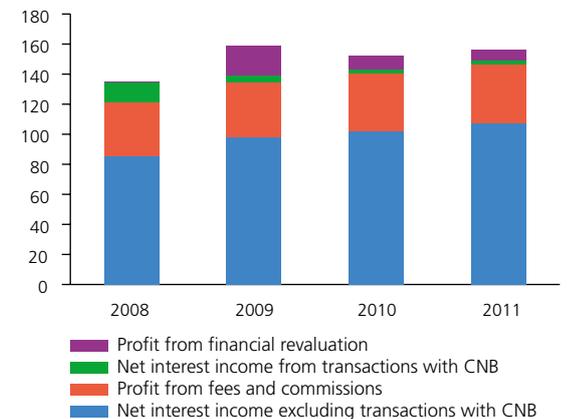
Analyses of the profitability of the Czech banking sector confirm that the ability to generate stable operating profit (especially interest rate profit), even in a period of less favourable economic conditions is to a large extent a structural characteristic of the Czech banking sector. Downward pressures on profits can therefore be caused primarily by structural changes, which are already partly visible, for example stronger competition in both the deposit and loan segments due to the entry of new players into the Czech banking market, mortgage refinancing at lower rates (with a subsequent drop in interest rate margins – see section 2.3) and reorientation of depositors to non-bank investment products, for example in connection with the pension reform (see Box 5).

The banking sector has sufficient capital adequacy and high-quality capital

As in the previous period, the Czech banking sector maintains relatively high overall capital adequacy and Tier 1 capital adequacy ratios (15.3% and 14.2% respectively at the end of 2011). Regulatory capital was strengthened above all by retained earnings. The Tier 1 capital adequacy ratio, which for the Czech banking sector equals the common equity Tier 1 ratio proposed in Basel III, is well above 9% for the banking sector

CHART IV.12

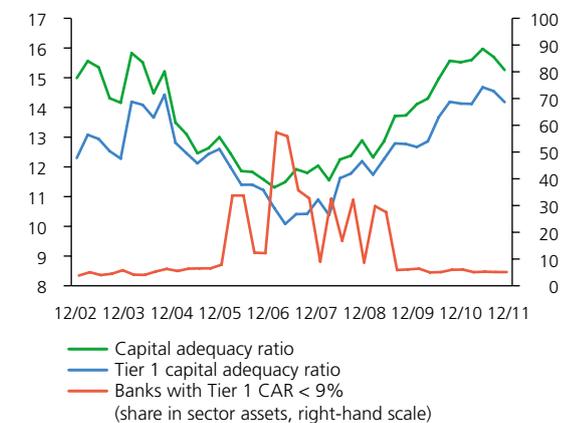
Key components of profit from financial activities
(CZK billions)



Source: CNB

CHART IV.13

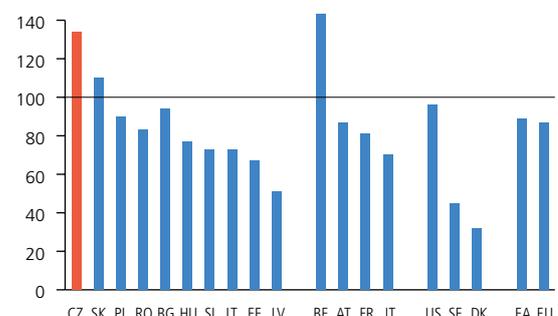
Capital adequacy
(%)



Source: CNB

Note: Assets of sector = assets of banks excluding branches of foreign banks.

CHART IV.14

Ratio of deposits to loans granted in selected EU countries
 (%; end of 2011; deposits/loans to residents)


Source: ECB

Note: EA = euro area; EU = average for all EU countries.

TABLE IV.4

Situation of the parent groups of Czech banks
 (data as of 31 December 2011; consolidated figures)

	Erste Group	KBC Group	Société Générale	UniCredit Group
Total assets (EUR bn)				
2011	210	285	1,181	927
2010	206	321	1,132	929
Net profit (% of assets)				
2011	-0.3	0.0	0.2	-1.0
2010	0.5	0.6	0.3	0.1
Impairment losses (% of assets)				
2011	1.1	0.5	0.4	0.6
2010	1.0	0.5	0.4	0.7
NPLs (%)				
2011	8.5	4.9	5.7	7.1
2010	7.6	5.2	5.4	6.6
NPL coverage ratio (%)				
2011	61.0	69.0	76.0	57.1
2010	60.0	79.0	72.0	58.8
Risk costs				
2011	168 bp	82 bp	67 bp	108 bp
2010	155 bp	91 bp	77 bp	123 bp
Capital adequacy (Core Tier 1 ratio, %)				
2011	9.4	10.6	9.0	8.4
2010	9.2	10.9	8.5	8.6
Exposures to indebted economies* (EUR billions)				
2011	0.6	4.8	4.5	40.9
2010	2.1	10.0	9.3	50.1

Source: Bank websites and results of EBA stress tests

Note: Risk costs are generally defined as the ratio of provisions to total loans provided. However, non-uniform calculation methodology prevents a closer comparison between banks. * Portugal, Ireland, Italy, Greece and Spain.

as a whole; only a small proportion of individual banks, representing 5.1% of the sector's total assets, do not exceed this level. Even higher dividends paid this year would not pose a significant threat to the aggregate level of regulatory capital (see Chart IV.13).

The Czech banking sector remains independent of external sources of funding

Although the Czech banking sector is almost exclusively owned by foreign investors,⁶³ it has long maintained a positive net external position. This reduces its dependence on foreign entities and supports its stability. The net external position (foreign assets minus foreign liabilities) stabilised at around 5% of GDP during 2011 despite a slight decrease (see line BS.47 of the Table of Indicators). The positive position is due to a long-standing high ratio of client deposits to loans, which reached 134% at the end of 2011 and is falling only very slowly over time (for example, in 2005 it was 160%). An international comparison reveals that the ratio of deposits accepted to loans provided in the Czech banking sector is well above average (see Chart IV.14).

Exposures to parent groups are stable over time and are being closely monitored by the CNB

Thanks to the good liquidity position of the banking sector, concerns arose at the start of the crisis about whether the domestic resources of banks would be used to fund their parent groups. These concerns intensified during 2011 in connection with the unclear situation of many large European banks and the need of parent groups to increase their capital by June 2012 as a result of an EBA measure.⁶⁴ In year-on-year comparison, the profitability of the parent groups of the four largest domestic banks is declining, with Erste Bank and UniCredit Group even recording a net loss associated with a rise in the NPL ratio (see Table IV.4).

In view of the uncertainty about the future of the economy and the continuing debt problems of some euro area countries to which parent groups have exposures, the situation of parent groups and their relations with domestic subsidiaries must continue to be monitored. The total gross exposure of the investment and trading portfolios of the five largest domestic banks to their parent groups has been fluctuating around CZK 120 billion over the last three years, representing about 60% of their regulatory capital (see Chart IV.15). In 2011, 71% of this exposure consisted of exposure to the parent bank itself, while 13% was exposure to domestic entities in the group and 16% was exposure to foreign entities in the group. Adjusted exposure, i.e. gross exposure net of liabilities in the form of loans and deposits accepted from foreign parent banks,⁶⁵ describes the relationship between domestic banks and their parent companies better than gross exposure. At the end of 2011, adjusted exposure was around CZK 74 billion (36.4% of regulatory capital).

63 Almost 97% of the banking sector's balance-sheet assets are controlled (directly or indirectly) by foreign owners.

64 Selected European banks have to increase their core Tier 1 capital to 9% by the end of June 2012.

65 Gross exposure and adjusted exposure are defined in the footnote to Chart IV.15.

The market share of building societies is shrinking

In 2011, the building society segment was partly affected by uncertainty surrounding the future parameters of the building savings product and its state support. Although building societies managed to stop the decline in deposits amid low interest rates and continuing, albeit reduced, state support, on the lending side they were unable to offer competitive pricing compared to the growing segment of mortgage loans, recording a drop in their share in house purchase loans of 2.5 pp. This drop was due not only to lower provision of new loans, but also to clients migrating to competing mortgage banks when refinancing their house purchase loans (see section 2.3).

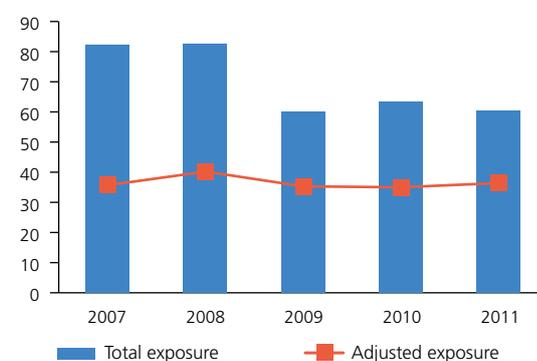
Although the building society segment is comparable to other banks in terms of credit risk, capital adequacy and profitability, a significant difference stemming from the specific business model of building societies is visible in the area of liquidity. The share of quick assets in total assets fell further to roughly 15% in 2011 and remains much lower than in other banks (see Table IV.5). If the loss of attractiveness of building savings schemes were to lead to an outflow of deposits after the binding period (such deposits account for more than two-thirds of total deposits), it could have a significant impact on the liquidity position of this sector, as the maturity mismatch between loans and deposits is larger than in the rest of the banking sector. This is particularly true for long-term claims with maturity of over five years, which significantly exceed long-term liabilities in the building society sector and are thus basically financed by short-term deposits (see Chart IV.16).

The riskiness of the credit union segment decreased from the previous year, but remains elevated

The credit union segment saw mixed trends in 2011. Improvements were recorded in compliance with prudential rules and in risk management, especially in terms of credit risk, owing partly to intensive CNB supervision. Provisioning increased compared to the previous year and the coverage of NPLs edged up from 12.8% in December 2010 to 13.5% in December 2011. However, this figure is still very low by comparison with the banking sector, where the coverage is almost 50% (see Table IV.6). The interest margin increased further, owing mainly to a rise in client interest on loans amid flat interest on deposits, resulting in relatively high profitability in the credit union segment. At the same time, however, the segment's capital adequacy ratio declined. Owing to continuing depositor interest, the share of deposits with credit unions in total deposits with credit institutions increased from 0.7% to 0.9%. The share of credit unions in total loans provided by credit institutions also increased slightly, but remained below 1% (see Table IV.6).

CHART IV.15

Total and adjusted exposure to parent groups
(%; exposure in relation to regulatory capital)



Source: CNB

Note: The chart shows the aggregate exposure of the five largest banks in the Czech Republic, which have foreign parents in the euro area. Gross exposure consists mainly of claims in the form of loans provided to the parent group and claims arising from derivatives transactions and other off-balance-sheet items in the investment and trading portfolios. Adjusted exposure = gross exposure minus liabilities in the form of deposits accepted and loans from foreign parent banks.

TABLE IV.5

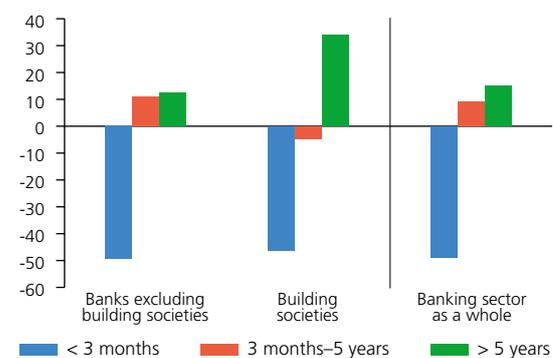
Selected indicators of building societies as compared to banks
(%; end-2010 and 2011 data)

	2010		2011	
	Building societies	Banks excl. building societies	Building societies	Banks excl. building societies
Average interest rate on client loans for house purchase (1)	5.1	5.4	5.1	5.1
Average interest rate on household deposits (2)	2.3	1.0	2.2	0.9
Interest margin (1)–(2)	2.8	4.4	2.8	4.2
Client deposits/loans	146.4	114.2	147.8	111.8
Client NPL ratio	2.5	7.1	2.6	6.7
Quick assets/total assets	16.3	27.3	15.2	28.3
Coverage of NPLs with provisions	41.8	47.1	45.1	49.2
Tier 1 capital adequacy ratio	13.9	14.1	14.1	14.2
RoE	26.1	20.7	23.1	18.6
RoA	1.1	1.4	1.1	1.2
Share of sector in loans for house purchase	37.9	62.1	35.1	64.9
Share of sector in household deposits	28.7	71.3	27.6	72.4

Source: CNB

CHART IV.16

Loan and deposit maturity mismatch: net balance-sheet position of banks and building societies
(as % of balance sheet; March 2012)



Source: CNB

Note: Banks including branches of foreign banks.

TABLE IV.6

Selected indicators of credit unions as compared to banks
(%; end-2010 and 2011 data)

	2010		2011	
	Credit unions	Banks	Credit unions	Banks
Average interest rate on client loans (1)	7.2	5.2	8.1	5.1
Average interest rate on client deposits (2)	3.3	1.1	3.1	1.1
Interest margin (1)-(2)	3.9	4.1	4.9	4.0
Client deposits/loans	138.5	118.7	127.1	116.5
Client NPL ratio	11.5	6.5	15.9	6.2
Quick assets/total assets	17.6	26.1	13.1	26.9
Coverage of NPLs with provisions	12.8	46.8	13.5	48.9
Tier 1 capital adequacy ratio	12.2	14.1	11.3	14.2
RoE	-2.5	21.1	5.5	19.0
RoA	-0.2	1.3	0.5	1.2
Share of sector in client loans	0.6	99.4	0.9	99.2
Share of sector in client deposits	0.7	99.3	0.9	99.1

Source: CNB

The credit union sector cannot be regarded as resilient to increased risks

Despite some positive signs in the credit union segment, the NPL ratio increased substantially from 11.5% in 2010 to almost 16% at the end of 2011. The adverse trend in the sub-sector peaked in March 2012, when the licence of the credit union Unibon was withdrawn. Although some aggregate indicators for the credit union sub-sector are considerably more favourable without Unibon, this fact cannot be assessed as a decline in the overall risk. This is also evidenced by a simple stress test of credit unions performed jointly by the IMF and the CNB as part of the FSAP mission (see section 5 for information on the FSAP mission). This test indicated relatively low resilience of the credit union sub-sector to potential adverse developments. From this point of view, therefore, a fundamental reorganisation of the credit union sub-sector would be desirable.

The current results of domestic insurance companies indicate stagnation

The insurance sector recorded a drop in profitability in 2011, not only in the non-life insurance area, where profitability has been broadly flat in recent years, but above all in the life insurance segment.⁶⁶ The long-running growth in gross premiums written in life insurance slowed considerably in 2011, mainly as a result of weaker growth in single premium payments (see Chart IV.17). In addition to the adverse trend in premiums written, the deteriorating economic results are explained by a continuing upward trend in gross claims paid.

In the longer term, the economic performance of life insurance companies may be adversely affected by low interest rates, as some life insurance policies concluded at a time of higher interest rates guarantee a return close to or even above the current return on less risky instruments. Upon maturity of a security held to cover life insurance, the insurer is forced to reinvest the funds at a lower return or to choose a riskier portfolio structure. The importance of this effect rises with the degree of maturity mismatch between life insurance investments and liabilities.

Competition is increasing in the non-life insurance market, leading to a drop in profitability

The falling profitability in the non-life insurance segment is largely due to competitive pressures, as the total number of non-life insurance policies has long been rising while gross premiums written have been broadly flat since 2009 (see Chart IV.17). The volume of premiums written in liability insurance and vehicle insurance is decreasing in particular. Stronger price competition will have the biggest impact on the profitability of smaller insurance companies, which cannot compensate for their results in these areas with other insurance products in the

⁶⁶ The following text pertains to domestic insurance companies unless stated otherwise. Measured by the share of gross premiums written in 2011, domestic insurance companies represent 97% of the non-life insurance market and 92% of the life insurance market.

long run. The efficiency of this segment can be expressed using the combined ratio, which is the sum of losses and operating costs divided by total premiums written. Net of reinsurers' share, this indicator rose towards 95% in 2008–2011.

The structure of financial placements of insurance companies in the Czech Republic is rather conservative

By international comparison, the financial placement of assets is dominated by bonds and other fixed-income securities. By contrast, loans and deposits with credit institutions account for only a small share (see Chart IV.18). Czech government bonds represent a significant proportion (roughly 50% of assets covering technical provisions excluding investment life insurance). The Czech government bond market is therefore systemically important for most insurance companies, even more so than in the case of Czech banks. If prices were to fall rapidly on this market, the insurance sector would be severely affected.

Investment risk is being partly transferred to policyholders

Back in 2004 the value of financial placement of unit-linked insurance had been 1.5% of total financial placement, but by the end of 2011 the figure had reached 14%. This rise was due chiefly to the growing importance of investment life insurance (ILI). The structure of financial placement of assets (investments) used to cover investment life insurance provisions is characterised by a higher share of equity securities, especially those issued by collective investment funds, and therefore higher investment risk compared to assets used to cover capital life insurance provisions and higher volatility of the pricing of such investments (see Chart IV.19).

The pension fund sector is strengthening its position in the allocation of household savings

The pension fund sector saw several changes in 2011. Stronger growth was recorded for contributions received (see Chart IV.20), pushing up the sector's balance-sheet total to CZK 248 billion. Further growth can be expected in the years ahead, due among other things to the pension reform and the changes it introduces in the third pillar (see Box 5).⁶⁷ In addition, an upswing can be seen in migrations of planholders between funds, which halted in 2009 owing to the introduction of migration fees. It can be assumed that planholders decided to change funds in response to the approved reform, with different rates of return in past years being one of the possible reasons.⁶⁸ A record increase in benefits, due chiefly to the retirement of the large post-war generation, was another change compared to the previous year. In view of demographic trends, this tendency can be expected to continue in the years ahead. Lump-sum settlements still account for the largest share of benefits (74.6%, similar to the previous year's figure of 73.5%).

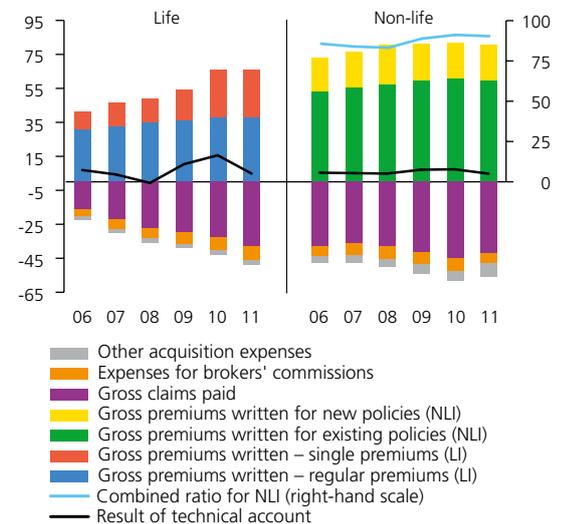
⁶⁷ In the reform of the third pension pillar, the minimum monthly planholder contribution for which a state contribution is paid will increase from CZK 100 to CZK 300 on 1 January 2013. Tax deductions will apply only to monthly planholder contributions of between CZK 1,000 and CZK 1,500, as against the current range of CZK 500 to CZK 1,000.

⁶⁸ Current planholders could change pension funds until 28 February 2012.

CHART IV.17

Key financial indicators for the insurance sector

(CZK billions; right-hand scale in %)

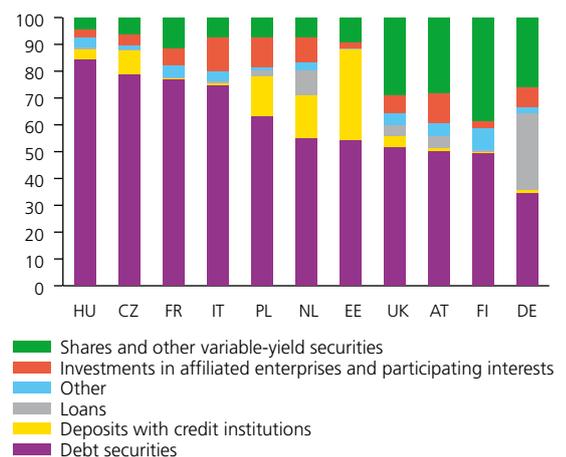


Source: CNB

CHART IV.18

Financial placement of assets of insurance companies in selected EU countries

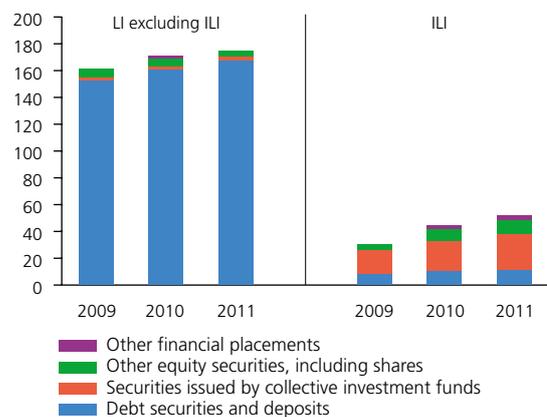
(% of total assets)



Source: EIOPA

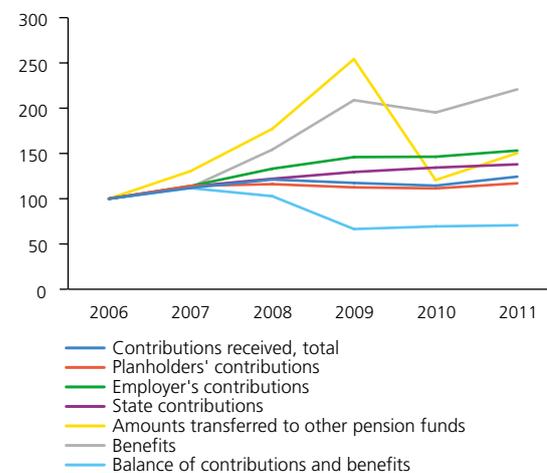
Note: Data as of 31 December 2010; domestic insurance companies and branches of foreign insurance companies are both included.

CHART IV.19

Financial placement of assets from technical reserves
 (CZK billions)


Source: CNB

CHART IV.20

Pension fund contributions and benefits
 (index, 2006 = 100)


Source: CNB

Assets are invested mostly in debt securities

By law, pension funds must invest at least 50% of the fund's assets in the currency in which the fund's liabilities to planholders are denominated. Therefore, Czech government bonds and other Czech debt securities are clearly the predominant assets. This makes the sector sensitive to movements in domestic government bond prices (see Chart IV.21). The long-standing situation of low interest rates is limiting the ability of pension funds to achieve higher returns on their assets. However, the risk of searching for yield, which could lead to mispricing and excessive purchases of risky assets, is not as significant in the pension fund sector as in other European countries thanks to relatively strict legislative rules for managed portfolios. Moreover, pension funds reduced the share of equity securities in total assets in 2011 – shares fell to 0.4% and fund units to 2.5% compared to the previous year.

**BOX 5:
THE PENSION REFORM**

The structure of the Czech pension system will change on 1 January 2013.⁶⁹ In addition to the existing pay-as-you-go (PAYG) state system (the first pillar), which has been complemented by voluntary pension insurance (the third pillar), a new second pillar allowing fund saving will be introduced. For economically active citizens, participation in this pillar is voluntary but irreversible, and the decision to participate must be taken before 35 years of age.⁷⁰ Participation involves transferring 3% of the social security assessment base in the PAYG state system to a personal pension account. Participants must add 2% from their own funds in the form of a deduction from their gross wage. The savings will be managed by pension management companies (PMCs) through four retirement funds with different investment strategies for the managed portfolio and different related risks.

Retirement savings participants choose the saving strategy (i.e. the allocation of savings between the individual funds) themselves and are allowed to make any changes.⁷¹ The PMC is entitled to charge a fee for managing the assets and receive remuneration for gains in asset value. If asset value declines in bad times, remuneration for gains in asset value will be paid to the PMC only after the fund's value reaches the level of the amount initially invested (the "high-water mark"). The role of PMCs is solely to manage retirement savings. At the end of the saving phase, the money saved will be transferred to a life insurance company, which will be responsible for paying out the benefits.

69 The pension reform is a response to adverse demographic trends in the Czech Republic and the related unsustainability of the current pension insurance system – see the *Final Report of the Expert Advisory Forum* (2010), Ministry of Labour and Social Affairs (the "Bezdek Commission").

70 Economically active citizens above 35 years of age must decide whether to participate by the end of June 2013.

71 PMCs are obliged to offer participants a life-long saving strategy, with the distribution of savings between funds changing depending on the participant's age.

A CNB forecast on the level of participation in the fund pillar indicates that as much as CZK 25 billion could be deposited in PMCs during 2013.⁷² This amount is composed of two parts. The first part consists of the 3% transferred from the original first pillar. These transferred funds will become a new source of savings for those participating in the new fund pillar, because so far they have been used for PAYG pension payments. The second part is made up of the additional 2% from participants' own funds, which may consist largely of money they previously held in other assets before joining the second pillar.

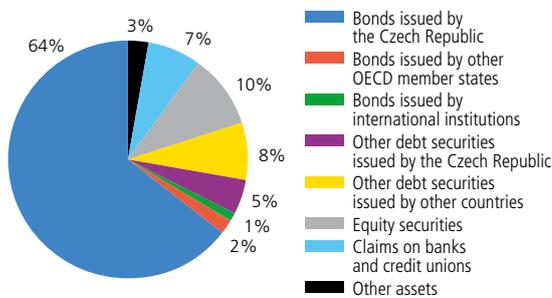
The introduction of fund pension saving will affect not only the amount and structure of households' assets, but also the financial sector as a whole, as a new type of institutional investor will come into existence. This could lead to a rise in demand for securities. In the case of the more conservative funds, there will be an increase in demand primarily for government bonds. For the government as debtor, this will mean a larger number of potential creditors and a decrease in refinancing risk, the possibility of issuing bonds with longer maturities, and subsequently better stabilisation and smoothing of the government debt maturity profile over time. However, the creation of such a close relationship between PMCs' balance sheets and the state budget requires prudent public finance policy, as PMCs will be heavily exposed to sovereign risk through the purchase of large volumes of government bonds.

The less conservative fund types may also invest part of their funds in riskier and more volatile securities such as long-term government bonds, corporate bonds and shares. As the current offer of Czech shares is limited, a rise in demand for foreign shares is likely. In the long term, provided that the PMCs are established and operate successfully and are regulated and supervised effectively, this financial market segment can be expected to have a positive impact on the overall development of the capital market.⁷³ In addition to the effect of PMCs on demand for securities, their effect on security prices must be taken into account. In normal, good times, demand from PMCs reduces yields on securities, as their size – affecting portfolio diversification, purchased volumes and economies of scale in gathering information – is reflected in a lower demanded risk

⁷² The forecast assumes that those who will achieve higher returns from fund saving and whose pension as a ratio to contributions paid is low will be interested in participating in the second pillar.

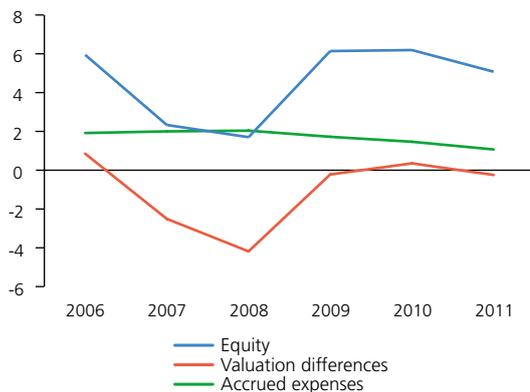
⁷³ For example, Davis (2005) finds a positive effect of the PMC sector on the size of the equity market (as measured by market capitalisation). The correlation coefficient between the total assets of PMCs and the equity market is 0.73 in advanced economies and 0.55 in emerging markets. See Davis, E. P. (2005): *The Role of Pension Funds as Institutional Investors in Emerging Markets*, Economics and Finance Discussion Papers 05–18, School of Social Sciences, Brunel University, London.

CHART IV.21

Pension fund asset allocation
 (%)


Source: CNB

CHART IV.22

Pension fund capitalisation, valuation differences and accrued expenses
 (% of assets)


Source: CNB

premium.⁷⁴ At the same time, thanks to lower transaction costs and high-quality information, PMCs have a positive effect on the pricing of assets in line with their fundamental value. At times of uncertainty, however, PMCs – like other institutional investors – have a tendency towards herd behaviour. Given the volumes traded, such behaviour may have a visible impact on asset prices.

The introduction of a second pillar into the pension system may also have implications for the banking sector. PMCs will become new financial intermediaries and will generate a change in the competitive environment in the financial system. This may cause a slowdown in the growth of bank deposits of households and foster a relative drop in the currently high deposit base of banks, especially in the longer run. The possibility of managing one's own savings could lead to greater interest of households in investing in other non-bank investment products and a lower willingness to deposit funds in low-interest deposit accounts. This change in household behaviour could increase the financing costs of the banking sector and reduce its profitability. On the other hand, PMCs may be a source of bank financing as part of a strategy of purchasing debt securities issued by banks (e.g. mortgage bonds) or depositing some of their funds on term accounts.

All this implies that the addition of the fund pillar to the PAYG pension system may bring about a number of significant changes in the functioning of the financial sector. Although the experience of other countries suggests that the changes may be profound, the possibility of voluntary participation in the second pillar may moderate these effects of the fund pension system. However, it will not be possible to determine how much the pension reform will affect the structure of the financial sector until the level of participation in fund saving, for which estimates currently differ, is known.⁷⁵

As regards financial stability, macroeconomic stability is of particular importance for the effective functioning of PMCs, as it is for any other financial system segment. The introduction of fund financing may have a positive effect on the development of the financial sector, provided that regulation and supervision is effective.

74 Experience from the UK shows that demand of PMCs for long-term debt securities smoothed the yield curve, resulting in a more favourable interest rate environment for the business sector. See Catalan, M., Impavido, G., Musalem, A. (2000): *Contractual Savings or Stock Market Development: Which Leads?* Journal of Applied Social Science Studies 120(3).

75 See *Inflation Report IV/2011*, Box 1.

The capitalisation of pension funds was stable in 2011, but the sector must continue to prepare for the pension reform

The capitalisation of pension funds remained around 5% of assets in 2011 (see Chart IV.22). Consequently, no pension fund was forced to activate the prudential mechanism introduced jointly by the CNB and the Association of Pension Funds, or to increase its equity capital. The valuation changes item, where sizeable losses were recorded in 2007–2009, has been falling slightly in connection with the recent financial market developments. The sector's stability is still aided by the option allowing pension funds to value selected securities at amortised cost. In 2011, however, only a modest decline was recorded in accrued expenses, which stood at CZK 2.7 billion at the end of 2011. This item is mostly related to expenses on new planholders, specifically the gradual amortisation of commissions paid, which funds are gradually writing off. As funds are trying to amortise these expenses by the end of 2012, this may have a significant effect on the revenues generated by some funds this year.⁷⁶

Collective investment funds generally stagnated in 2011...

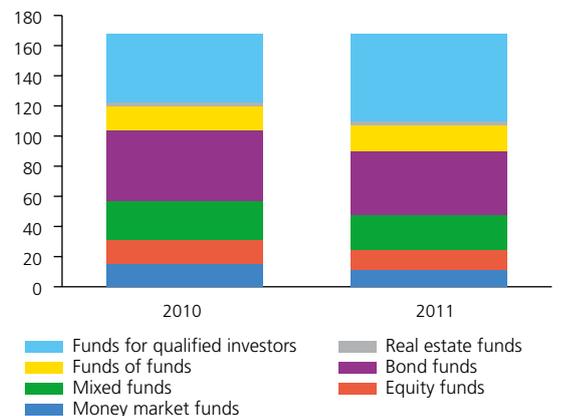
The total value of assets held by households and institutional investors in collective investment funds (CIFs) was little changed from the previous year, reaching almost CZK 170 billion (see Chart IV.23). In 2011, a slight decline in asset value was recorded by most funds except real estate funds, which saw no change, and funds of funds and funds for qualified investors, which recorded an inflow of investment. As in previous years, funds for qualified investors saw buoyant growth in 2011. The value of the assets they manage increased by almost CZK 13 billion, taking their share in total CIF assets up to 35% (a rise of 8 pp). This rise demonstrates the expected attractiveness of funds for qualified investors compared to other CIFs. This is due mainly to favourable tax conditions, but is also linked with the absence of investment policy constraints.⁷⁷ Owing to the pension reform, funds invested in CIFs might increase in the years ahead, with the specific amount depending on financial market developments, which are the key factor in the CIF segment.

...and their equity fell as a result of higher unit redemptions

Given the low asset prices around the world in 2011, most CIFs intended for the public recorded higher unit redemptions than unit sales. This was reflected in a decline their equity (see Chart IV.24). Only funds of funds and equity funds recorded an inflow of investment. In the case of equity funds, this might have been linked with renewed investor interest in investment in these funds at the end of 2011 on expectations of growth in shares following the sharp falls seen in 2011 H2 (see section 3).

CHART IV.23

Collective investment fund structure
(CZK billions; assets at the end of 2010 and 2011)

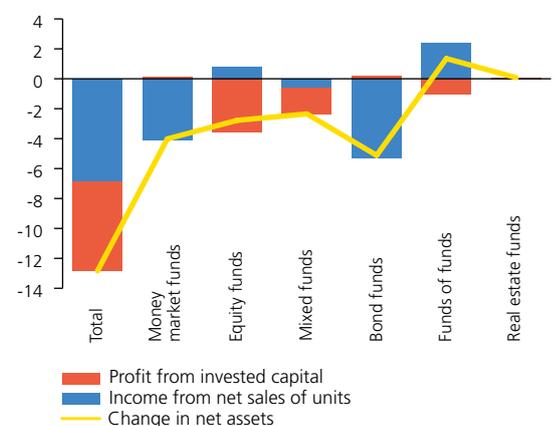


Source: CNB

Note: As a result of a change to the European regulation, some funds were moved from the money market funds category to the bond funds category in 2011.

CHART IV.24

Decomposition of changes in the net assets of open-ended mutual funds intended for the public
(CZK billions; for 2011 as a whole)



Source: CNB

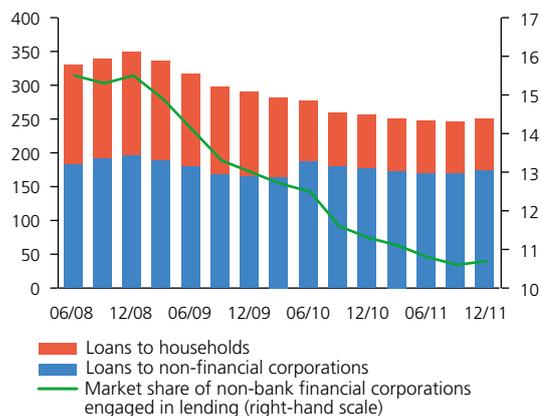
⁷⁶ In the third pillar, the pension reform assumes separation of managed planholder assets from shareholders' assets. Planholder assets will be transferred to transformed third-pillar funds and the pension fund's remaining assets will be transferred to the new PMCs.

⁷⁷ Funds for qualified investors, which are classified as closed-end mutual funds, started to be established on the basis of an amendment to the Collective Investment Act adopted in 2006. The favourable tax conditions result from a corporate income tax rate of 5%.

CHART IV.25

Loans of non-bank financial corporations engaged in lending

(CZK billions; right-hand scale in %)



Source: CNB
 Note: Market share in total loans provided to residents by banks and non-bank financial corporations engaged in lending.

The situation of non-bank financial corporations engaged in lending stabilised

The decline in loans provided by non-bank financial corporations engaged in lending halted during 2011. These loans totalled CZK 258 billion at the end of 2011. By contrast, a slight increase was recorded in 2011 Q4 despite the negative impact of a year-on-year fall in demand for financing of photovoltaic equipment. In 2009–2010 the decline in lending had been due chiefly to a decline in the household sector, but in 2011 the overall dynamics were affected by households and non-financial corporations in equal measure (see Chart IV.25).

The total market share of non-bank financial corporations engaged in lending stabilised just below 11% during 2011. However, this share does not include all of the activity of the corporations monitored. According to data from the Czech Leasing and Finance Association, the long-running shift in the method of leasing financing, used mainly by non-financial corporations, from financial to operational leasing⁷⁸ continued. Its share rose to 33% in 2011, from 26% in 2010.

⁷⁸ Operational leasing allows a movable or immovable item to be used, but unlike in the case of financial leasing there is no transfer of the substantial risks and benefits associated with ownership of the asset. Operational leasing is therefore de facto renting and is not included in the CNB's financial intermediation statistics.