

The Czech National Bank is pleased to present its eighth Financial Stability Report (FSR) to the public. The aim is to analyse and identify the risks to the financial stability of the Czech Republic. This year's Report focuses mainly on the risks that may arise in connection with the possible renewal of recession and the difficult situation in euro area countries.

The Report is based on an advanced analytical and modelling framework and contains stress tests of the key segments of the financial sector (i.e. banks, insurance companies and pension funds) as well as a stress test of households. The testing methodology was further refined compared to the previous Report. In the case of the banking sector, the horizon was extended to three years and the potential risks now include domestic banks' exposures to their parent companies. The stress tests of insurance companies and pension funds make increasing use of individual data for individual tested institutions. The main improvement to the household stress test is more detailed monitoring of the labour market position of households.

The financial sector's resilience is tested by means of an alternative macroeconomic scenario. The *Europe in Depression* scenario assumes a longer-term downturn in economic activity accompanied by a sizeable fall in real household income and a concurrent rise in commodity prices. The alternative stress scenario is compared with the *Baseline Scenario*, which is based on the CNB's official May forecast. The impacts of both scenarios are assessed not only from the perspective of the financial sector, but also with regard to the property market and the non-financial corporations and household sectors.

The Report is newly divided into four main sections followed by thematic articles. The *Real economy* section deals with the external and domestic macroeconomic environment and analyses the financial situation of households and non-financial corporations. The section entitled *Asset markets* analyses risks in the financial markets and the property market in more detail. The section called *The financial sector* describes key trends in the financial sector and the main sources of potential risks. The final section contains an overall evaluation of financial stability indicators and presents the results of stress tests of banks, insurance companies and pension funds. The Report now contains macroprudential recommendations relating to the risks identified.

The thematic articles react to selected topical financial stability issues. The article *How to Identify Systemically Important Financial Institutions* draws attention to the risks associated with the existence of systemically important financial institutions and discusses methods for identifying them. The article *Early Warning Indicators of Economic Crises* sets out to find a set of indicators to identify financial crises with regard to both their timing and the intensity of their adverse impact on the economy. The article *Impacts of the Sovereign Default Crisis on the Czech Financial Sector* discusses the channels of contagion of sovereign default risk to the financial system and analyses the significance of these channels in the Czech economy. The article *Contingent Claims Analysis and the*

*Inter-sector Transmission of Credit Risk* maps the network of financial linkages in the Czech economy and studies to what extent mutual financial exposures contribute to the spread of credit risk across the financial system.

This Financial Stability Report was approved by the CNB Bank Board at its regular meeting on financial stability issues on 10 May 2012 and was published on 19 June 2012. It is available in electronic form at <http://www.cnb.cz/>.