OVERALL ASSESSMENT

This summer the global economy will enter its seventh year since the crisis broke out. In Europe, however, the crisis cannot be said to be over yet, mainly because of developments in the euro area. Extreme financial market stress in late 2011 was dampened by a combination of ECB measures to provide massive amounts of long-term liquidity to banks. In summer 2012, however, the financial stability of the euro area was jeopardised again by a sharp rise in yields demanded on Spanish and Italian government bonds. It was again the ECB that calmed the situation, with its president promising to do anything to maintain the euro and being ready to make stabilising interventions on the government bond market where necessary. Although financial markets stabilised and liquidity was restored even on risky assets markets, the outlook for real economic activity worsened further. The situation therefore remains very strained, the current stability is very fragile, and a resurgence of strong tensions due to a combination of risks in bank balance sheets, falling economic activity and sovereign risk cannot be ruled out. The risks to financial stability in the euro area remain high.

The Czech financial sector remained highly resilient to external risks in 2012, with some of its parameters becoming even more robust. The return of the domestic economy to recession and the above-mentioned developments in the euro area pose a number of risks to future financial stability in the Czech Republic. The main risk scenario for the Czech economy over the next two years remains a sharp contraction of economic activity. The adverse income prospects of firms and households, related not only to falling external demand, but also to weak domestic demand, are generating potential for an increase in credit risk. So far this risk can be regarded as a short- to medium-term one. However, it cannot be ruled out that the European economy will face longer-term economic stagnation. In some countries this risk is arising as a result of macroeconomic imbalances and disruptions in the financial system stemming from the pre-crisis period. In other economies, including the Czech Republic, the indirect impacts of subdued growth in trading partner countries and structural obstacles to internal stimulation of economic activity predominate. This risk is being exacerbated by some European regulatory initiatives and certain elements of the banking union project.

DEVELOPMENTS IN 2012 AND 2013 Q1

Developments in both the global and Czech economy in 2012 were disappointing

The optimistic expectations of a recovery in advanced countries failed to materialise in 2012. The decline in euro area economic activity was also intensified by reduced availability of loans to the private sector in some countries. The German economy continued to grow, but also recorded signs of a slowdown in early 2013. In 2012 the Czech economy returned to recession, which still persists according to preliminary GDP data for 2013 Q1.

Monetary policies remained easy and major central banks are continuing their unconventional support measures

Given the absence of demand-pull inflation pressures, the world's major central banks kept their monetary policy rates at historically low levels.

In addition to standard instruments, they continued to pursue quantitative easing policies and introduced specific instruments to support the functioning of financial market segments and the real economy. Besides their indubitable stabilising effects, however, these policies may encourage excessive risk-taking in some financial market segments and have adverse cross-border consequences. A flattening of the yield curve and a related reduction in market opportunities led to a further decline in money market activity. CNB monetary policy rates have been at "technical zero" since November 2012. The situation on the Czech interbank market remained calm, as evidenced by zero take-up of the CNB's liquidity-providing repo operations.

The performance and financial position of the corporate sector deteriorated

The decline in economic activity had an adverse effect on the performance of the corporate sector, especially margins and profitability. This is true not only of construction and services, which had been under pressure from worsening financial conditions in previous years, but also of sectors which had previously been growing (including manufacturing), where negative signals are also beginning to emerge. The economy's high sensitivity to demand in the automotive industry, which is strongly affected by the business cycle in the EU, appears to be risky. The evolution of corporate credit risk was relatively favourable in 2012, with the NPL ratio recording a further decline, although some leading indicators point at renewed growth and slight signals of forbearance can even be observed. However, the total debt of the corporate sector is stable over time and seems sustainable, thanks among other things to lower interest expenses.

The worsened income situation of households has affected credit risk only slightly so far, but low-income households have become very vulnerable

In 2012 the household sector faced a worse situation primarily on the labour market, where the unemployment rate rose, the number of vacancies decreased and real wages declined. The NPL ratio in the household sector stabilised, partly because of falling interest rates. The exception was the consumer credit segment. However, the impacts on total credit risk are limited owing to the relatively low and falling share of this type of credit in total loans in the private sector. The financial situation of young households in and around Prague and Brno, which have the largest amount of loans, will be crucial to the further evolution of credit risk. Stress tests of the household sector indicate substantially higher vulnerability and a rising degree of overindebtedness among low-income households in all the tested scenarios.

Property prices and the number of property transactions continued to fall

The downward trend in residential property prices recorded in previous years continued into 2012. The decreases were in line with the trend in the real economy. The decline in prices was accompanied by a fall in the number and volume of property transactions. The commercial property segment did not record any improvement either. At the same time, indicators of residential property price sustainability improved, indicating, together with other estimates, that prices are most likely close to their fundamental levels. However, regional differences in the evolution of prices and the number of transactions are apparent within the overall downward trend in activity on the Czech property market, with Prague recording more moderate declines than the rest of the Czech Republic, or even slight increases.

Financial sector developments in 2012 were positive despite the unfavourable economic situation…

Developments in 2012 were positive from the perspective of the Czech financial sector, but annual growth in its total assets slowed owing to the decline in economic activity. The banking sector recorded increases in capital adequacy, profitability and household client deposits, with small banks recording the largest absolute increases given the higher average interest rates offered by these banks. The situation regarding the links between Czech banks and their parent groups has been generally favourable in recent months and the total exposures of domestic banks to their parent groups have shrunk, partly due to a change in the regulatory limits set by the CNB.

… almost all segments of the financial market recorded a rise in assets, but the credit union segment remains highly risky

Despite its riskier profile, the credit union segment also recorded a rise in customer numbers accompanied by a significant rise in total assets. Building societies saw a continued decrease in market share in loans for house purchase, primarily due to higher price competitiveness of loans for house purchase provided by banks. Insurance companies continue to show solid capitalisation and profitability. The pension fund sector has been affected by changes related to the pension reform but remains highly stable. Following previous losses, collective investment funds posted profits in 2012, while non-bank financial corporations engaged in lending recorded a slight decrease in loans provided, but also a slight decrease in credit risk.

RISKS TO FINANCIAL STABILITY AND ASSESSMENT OF THE FINANCIAL SECTOR'S RESILIENCE

The composition of external risks is unchanged, but the view of their relative importance has shifted: risks connected with the decline in economic activity have come to the fore

A high degree of uncertainty about further developments in the real economy, especially the horizon of a return to economic growth, persists in advanced countries and especially in the euro area. Consequently, the situation in spring 2013 is much the same as it was year ago. However, the perception of the importance of individual risks has partly changed. Risks linked with weak economic activity are being stressed more. By contrast, the perception of the importance of sovereign risk has diminished and a need to slow or even postpone fiscal consolidation is beginning to be accepted. At the same time, concerns about euro area banks' balance sheets and resilience to existing risks are increasing. Distrust of reported asset quality is deepening here, doubts surrounding the sufficiency of provisioning against non-performing loans are increasing and concerns about systematic forbearance are rising. These concerns are being reflected in calls for strict stress tests and coordinated asset quality reviews and subsequent recapitalisation or restructuring of banks that fail the tests and reviews.

High private sector and government debt in advanced countries is preventing a renewal of investor and consumer confidence

Slow progress is being made in reducing the imbalances that arose in many European countries before the crisis broke out. The rate and manner of correction of these imbalances differs significantly from country to country. Some countries are still characterised by high private sector debt, which is preventing a renewal of investor and consumer confidence. In some cases this is being exacerbated by rising public sector debt, which the countries concerned are failing to halt, let alone reduce, amid subdued economic growth. If the refinancing needs of the highly indebted states start to increase again, concerns about the impacts of

sovereign risk could resurface and a general rise in interest rates could prevent a return to economic growth.

The Czech economy will remain in recession in 2013, and recovery in 2014 is uncertain

The CNB's May forecast expects a further moderate fall in real GDP of 0.5% this year, but a relatively robust recovery is predicted for 2014, with GDP rising by 1.8%. Given the recent developments in the euro area, however, the risk that the Czech economy will stay in recession for longer must be taken into account. The difficult labour market situation and pessimistic expectations of the private sector will be obstacles to a faster recovery in domestic demand in the near future.

The probability of a balance-sheet recession remains very low

Some advanced countries are showing signs of a balance-sheet recession stemming from an increase supply of savings for which there is insufficient demand. In the Czech Republic, the potential for a balance-sheet recession is arising in the household sector, which has considerably increased its financial surpluses. However, these surpluses are for now being used by the corporate and especially the government sector. The relatively favourable evolution of the credit conditions, especially their interest rate component, also speaks against the materialisation of this scenario.

Rising budget deficit financing from abroad leading to growth in net external government debt could become a risk to Czech public finance

The external balance of the Czech Republic developed quite well in 2012. The exception was net external government debt, which followed an upward trend for the fourth consecutive year. Although both the level and speed of increase of government debt in the Czech Republic are currently favourable by comparison with advanced European countries, efforts to raise much more funds in the future to finance government debt on foreign markets could become a risk to financial stability.

Shortening mortgage rate fixation periods are making households more sensitive to the interest rate environment

As regards loans for house purchase, the share of mortgage loans with short rate fixation periods increased last year as a result of very low short-term interest rates. This is making households more sensitive to the interest rate conditions. However, it should not turn into a significant risk, as it implies a fall in mortgage loan servicing costs. As long as the rise in interest rates is gradual, banks and their customers should have time to adjust to the new situation. Growth in interest rates would pose a significant risk only if short refixation periods or floating rates were used mostly by low-income households.

The risks to property prices remain tilted to the downside

In the residential property sector, given the outlook for the real economy and demographic factors, apartment prices are expected to be flat or falling slightly in the near future. Prices could start to rise again in mid-2014. However, the risks to property prices are sizeable and are tilted towards lower price growth. A widening difference between the rental return and interest rates on house purchase loans is opening up the possibility of property purchases as financial investment. If this occurs on a large scale, prices in some regions could become overvalued in the medium term. Such overvaluation could even take the form of a bubble "from below", with property prices rising at a modest pace but their fundamentals (labour market stance, demographic developments, etc.) worsening at the same time and prices therefore becoming unsustainable in the long term.

The focus of financial investors on quality and liquidity is generating a risk of fundamental overvaluation of some government and corporate bonds

Flight-to-quality and flight-to-liquidity effects can emerge in bond markets at times of financial market stress. As a result, prices of high-quality government and corporate bonds can record excessive upward deviations. Besides market losses, a jump in long-term interest rates could cause a wave of sell-offs and a market liquidity crisis.

The main risk to the banking sector is a continuing recession leading to a substantial drop in profitability

The main risks to the banking sector stem from the continuing economic slowdown leading to higher credit losses and a considerable decline in banking sector profitability. The stable sources of profit – especially interest profit and profit from fees and commissions – are recording a year-on-year (albeit slight) decline for the first time since the start of the crisis, and this trend can be expected to continue in the years ahead. The *Baseline Scenario* expects interest profit to decline further by around 5% year on year over the scenario horizon.

Credit risk stabilised during 2012, but the outlook is not very optimistic

A significant deterioration in the credit portfolio resulting from adverse developments in the real economy remains a risk to the Czech banking sector. Credit risk in banks' balance-sheets, as expressed by the ratio of non-performing loans (NPLs) to total loans to residents, continued to follow the gradual downward trend of the last two years in 2012. However, the adverse outlook for the income situation of households and corporations is generating potential for a renewed rise. It can be deduced from the growth in NPLs and the related provisioning that the inflow of new NPLs has accelerated slightly in the last two quarters, and this trend can be expected to continue.

The coverage of NPLs by provisions may not be fully in line with the growth in credit risk in banks' balance sheets

Other complementary indicators also suggest a rise in credit risk. Within NPLs, the share of loans that are not actually past due is decreasing and the share of loans that are more than three months past due is continuing to rise. The migration of NPLs to the highest-risk category – loss loans – will continue in the period ahead. Moreover, the collateralisation of loss loans is falling slightly over time. The current coverage of NPLs by provisions, which has been almost unchanged in recent years and may therefore not be fully consistent with the evolution of bank loan risk described above, may also pose a risk. In addition, there are substantial differences between banks in the prudence of NPL coverage. The current credit margins for some types of loans may also not be consistent with appropriate credit risk valuation.

The impacts of credit risk could increase non-linearly as the recession lengthens

If the recession continues or even deepens, the balance sheets of Czech banks may become more sensitive to changes in the income situation of corporations and households. This could be reflected in a rapid non-linear increase in the default rate and losses given default. While the *Baseline Scenario* predicts a slight rise in credit risk, the persistent economic decline assumed in the *Protracted Depression* scenario would mean that the banking sector's credit losses would rise more than 2.5 times over the three-year test horizon. At the same time, it should not be overlooked that the currently low interest rates on loans may partly be concealing distress among many debtors as regards their ability to service debts with their existing income flows.

The concentration of the portfolios of banks, insurance companies and pension funds on domestic government bonds continues to rise

Within the financial sector, the concentration of the portfolios of banks, insurance companies and pension funds on domestic government bonds continues to rise. This is further increasing the links between the financial sector and the government sector. Owing to a decline in Czech bond yields during 2012, domestic financial institutions recorded a rise in gains from the revaluation of some of these instruments to fair value. In future, this may represent a risk of a decline in the market prices of the securities held, with an adverse impact on profitability, if the financial market situation changes suddenly.

Credit unions remain highly risky; some institutions should increase the prudence of their business

Despite a relative year-on-year improvement in some aggregate risk indicators and in the NPL coverage ratio in credit unions, these indicators deteriorated substantially in 2013 Q1. Maintaining relatively high interest rates on deposits in the current period of low rates represents a risk to credit unions, creating an incentive to grant risky loans at high interest rates. The credit union sector also shows a high concentration of loans provided. Any repayment problems among important clients could jeopardise the unions' stability. Some institutions should also considerably increase the prudence of their business and the quality of their risk management.

The domestic financial system was exposed to strong shocks in stress tests

With regard to the risks identified above, the resilience of the domestic financial system was assessed as usual by means of stress tests on banks, insurance companies and pension funds using a *Baseline Scenario* and a *Protracted Depression* stress scenario. The *Baseline Scenario* is considered by the CNB to be the most probable. The stress scenario describes the risk of a long-lasting and pronounced decline in domestic economic activity caused by low external demand and falling domestic consumption and investment. A long-lasting adverse economic situation will erode the financial reserves of households and non-financial corporations and cause a significant deterioration in their ability to repay their debts, leading to high credit losses in the banking sector. This scenario is supplemented in sensitivity analyses with other shocks, e.g. the assumption of adverse financial market developments, write-downs of claims on indebted EU countries, collapse of the largest debtors of each bank and the assumption of a much deeper recession leading to a significant increase in credit losses in the banking sector.

According to the stress tests, banks, insurance companies and pension funds are resilient to shocks

The stress tests demonstrate that the banking sector remains highly resilient to adverse scenarios even in a recession. Banks have a large capital buffer which enables them to absorb adverse shocks and maintain the sector's overall capital adequacy sufficiently above the regulatory threshold of 8% even in a very unfavourable scenario. Banks also passed a liquidity stress test. The insurance company sector also showed sufficient resilience to an adverse scenario thanks to its large capital buffer. The pension fund sector remains sensitive to the price volatility of securities holdings, but a capital increase in 2012 enhanced its resilience compared to the previous year.

SYSTEMIC RISK AND MACROPRUDENTIAL POLICY

The modest credit recovery ended with the onset of the recession, and credit growth is currently subdued

The domestic financial sector is currently in a phase of the financial cycle dominated by risks relating to the weak economic activity seen over the last few years. Although the sector's lending capacity is not limited by a lack of balance sheet liquidity or capital, increased risk aversion and an absence of optimistic expectations are not creating conditions for increased credit activity reflected in excessive risk-taking. The modest post-crisis credit recovery observed in 2010–2011 ended with the onset of the recession and demand for loans and risky assets is now subdued despite the historically low interest rates. As a result, the Czech financial sector faces no risks due to excessive credit growth, and if the CNB had the option of using a countercyclical capital buffer it would set it at zero for exposures in the domestic economy for the next two years.

The interest rate component of the credit conditions is having a countercyclical effect

One positive development is that the interest rate component of the credit conditions has eased further, dampening the risks connected with the economic contraction and having a countercyclical effect. Interest rates on new loans are at record lows for both of the most important bank loan categories, allowing corporations and households to move gradually to lower debt servicing costs commensurate with the new macroeconomic environment. As stated above, however, very low interest rates may sometimes imply credit margins that are not necessarily consistent with credit risk.

The links between financial institutions are increasing

The links between financial market segments are the source of the structural component of systemic risk. In 2011 and 2012, most of the direct links between sectors intensified further. Indirect links through exposures to the same sectors were strengthened by the rising exposure of all segments to the government sector. Growth in the links between non-bank financial corporations has been observed in the financial corporations sector in recent years. The structural component of systemic risk is being suppressed by robust banking sector liquidity. In conditions of low deposit interest rates, however, the ratio of liabilities payable on demand to total liabilities is rising. This is causing maturity transformation to increase. Overall, therefore, the importance of the structural component of systemic risk is gradually rising.

The potential risks associated with the fact that a large proportion of banks' assets are held in government bonds require attention

Czech banks have a large proportion of their assets held in domestic government bonds and thus have significant exposure to sovereign risk. As the Czech Republic's current fiscal situation is stable and sustainable, this exposure – despite its size – does not pose an immediate threat to financial stability. However, some banks are showing elevated concentration risk. To mitigate this risk, the regulator can impose an additional capital requirement on banks under Pillar 2 if necessary. In addition to sovereign risk, government bond holdings bear interest rate risk. The current very low yields on domestic government bonds may prove to be unsustainable in the long term. The CNB will assess the intensity of this risk on an ongoing basis, and if it decides that the capital requirement for the general interest rate risk of the trading portfolio under Pillar 1 is inadequate, it will consider increasing it under Pillar 2.

The property financing segment is a significant source of credit risk for banks

Despite a relative stabilisation of the property market and a recovery in sales in residential development projects, the NPL ratio in this segment remains high. This contrasts to some extent with the asymmetric easing of lending conditions for the dominant segment of loans for house purchase in both 2012 and 2013, which is probably due to competition between providers of these loans. Given the high proportion of property financing loans in banks' balance sheets, the CNB is preparing a set of appropriate instruments enabling it to react to any risks associated with movements in property prices and loans to this sector.

Banks must maintain a high ability to absorb potential credit and market losses

To maintain high public and investor confidence in the stability of the Czech banking sector in the current adverse economic environment, banks must maintain a high capacity to absorb potential credit and market losses. The CNB will therefore continue to regularly assess the sufficiency of provisions created to cover expected losses as well as the adequacy of capital buffers created to cover unexpected losses on both a solo and consolidated basis.

The regulator's powers to set specific capital surcharges will enhance the robustness of systemically important banks

Maintaining robust capital buffers in systemically important banks is of particular importance. The recently approved EU Capital Requirements Directive, known as CRD IV, allows the national regulator to set requirements for domestic banks partly also on the basis of their size and importance, and therefore on the basis of the impact their collapse would have on the stability of the financial sector and the economy as a whole. The national regulator may set additional capital buffers for systemically important banks. Given the dominant role of banks in the Czech financial system and the high concentration of the Czech banking sector, the CNB is ready to apply these capital buffers in the future. CRD IV and CRR will also enable the CNB to apply other previously unavailable macroprudential tools. However, some elements of the banking union project may hinder the conduct of macroprudential policy in the EU.