OVERALL ASSESSMENT

Global financial markets have seen substantial volatility since the publication of last year’s Financial Stability Report. Signals from the Federal Reserve regarding a possible tapering of its bond purchase programme and a subsequent revision of these signals led to an increase in long-term interest rate volatility in late May/early June 2013. A temporary rise in government bond yields in advanced countries caused a sizeable outflow of capital from emerging economies. In autumn 2013, however, the markets again started to expect that the monetary policies of major central banks would remain very easy for an extended period and that for this reason, among others, long-term interest rates in advanced countries would stay very low. In spring 2014, these expectations were supported by hints by the ECB that it might adopt quantitative easing. Euro area financial markets calmed considerably, as evidenced by a gradual decrease in government bond yields in the periphery countries towards levels usual in the core countries. However, financial stability in the euro area remains fragile and strongly dependent on the measures and forward guidance of the ECB.

The Czech financial market was also affected by the volatility in global financial markets, albeit significantly less so than emerging economies. Despite unfavourable economic activity, the risks to financial stability are virtually unchanged compared to spring 2013 and can still be regarded as weak. A potential deterioration of the credit portfolio resulting from renewed adverse developments in the real economy is the main risk to the Czech banking sector. Its sources lie not only in a potential worsening of the situation abroad, but also in a potential decrease in domestic demand. Some elements of planned EU regulations and of the rules being created for the operation of the banking union are also a source of partial risks to banking sector stability. The Czech financial sector as a whole is facing risks linked with persisting low long-term yields, as it could be adversely affected by bond market volatility given its focus on bond portfolios.

DEVELOPMENTS IN 2013 AND 2014 Q1

Expectations of a recovery in advanced countries materialised only partially in 2013. The US and UK economies experienced a visible recovery, but the same was not true of the euro area, where economic activity dropped slightly overall. The Czech economy only gradually emerged out of recession in 2013, with GDP falling by almost 1% year on year. However, the indicators for 2013 Q4 and preliminary data for 2014 Q1 confirm a recovery in the domestic economy and the euro area.

As in previous years, an absence of demand-pull inflation pressures allowed the major central banks to maintain easy monetary conditions by means of low monetary policy interest rates or unconventional instruments. The CNB’s monetary policy rate has been at “technical zero” since November 2012. However, the negative output gap started to contribute to strong anti-inflationary or even deflationary pressures in the Czech economy during 2013. The CNB therefore began to use the
exchange rate as an additional monetary policy instrument. The koruna weakened following the start of the interventions and its exchange rate has since been fluctuating slightly above the exchange rate commitment level of CZK 27 to the euro. The current regime will be maintained at least until early 2015. At its May meeting, the CNB Bank Board assessed the risks to the new forecast as being slightly anti-inflationary and commented in its statement on the monetary policy decision that the probability of a later exit from the exchange rate commitment was increasing.

The performance of the non-financial corporations sector gradually increased in late 2013. At the same time, however, the differentiation of economic results in this sector also increased, both in terms of sub-sectors (for example a continuing decline in construction) and in terms of size, as small firms often face a substantially larger financial burden than large ones. The strengthening export orientation of the Czech economy is increasing its dependence on the external environment. The low credit growth in 2013 was not caused by lower availability of credit to corporations and can be explained mostly by demand-side factors. There was an increase in foreign currency borrowing, which may make some corporations more sensitive to exchange rate movements.

The household sector faced an adverse labour market situation, as the unemployment indicators were flat or slightly rising and real wages fell in 2013. On the other hand, the net interest payments of households relative to gross disposable income decreased, owing primarily to a further four in mortgage interest rates. This decrease occurred despite a slight rise in the debt of Czech households. The debt burden of households is homogeneous across income groups. By contrast, the loan-to-value ratios for mortgage loans are highly heterogeneous across regions. Household credit risk as expressed by the default rate fell slightly in 2013 and is set to continue declining this year. Stress tests of households indicate that the proportion of distressed households was flat last year and should remain so 2014.

In 2013, residential property prices picked up for the first time in a long time. Their growth was moderate by international comparison and can be interpreted as a correction of the previous slight undervaluation of apartment prices. A decline in the number of property market transactions indicates no marked recovery in residential property demand. However, the increase in prices was reflected in a slight decrease in housing affordability and a modest reduction of the scope for making profits by purchasing property as an investment.

The developments recorded in the Czech financial sector in 2013 were mostly positive. The banking sector strengthened its capital adequacy. Despite a year-on-year decrease in profits, the sector remains sufficiently profitable and is well prepared overall for new European regulatory rules. The amount of deposits continued to increase despite a decline in deposit interest rates. Thanks to a high volume of residents’ deposits, the domestic banking sector has long been independent of foreign funding. Its net external position is positive, despite having decreased as a result of...
the CNB’s foreign exchange interventions. Insurance companies also have solid capitalisation. Like banks, they saw a decline in profits in 2013. Collective investment funds – in 2013 especially mixed funds – recorded increased interest from the public for the second consecutive year. The sector of pension management companies is stable, but there was insufficient interest in participation in the second pillar, which is thus likely to require some adjustment.

Despite the continuing contraction in economic activity in 2013, financial sector’s total assets increased year on year across all its segments. The revocation of licence of the then largest credit union in December meant a year-on-year drop in the total assets of the credit union segment in absolute terms, but adjusted for this one-off effect the total assets of this segment and the amount of deposits accepted rose further year on year.

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

In spring 2014, the euro area financial sector is more stable than it was a year earlier and the level of uncertainty should decline further after the completion of the comprehensive assessment of banks’ balance sheet tests at the end of this year. Thanks mainly to the measures and forward guidance of the ECB, the vicious circle between public finance problems, risks in banks’ balance sheet and weak economic activity stopped dominating the euro area financial markets last year. However, the sources of this vicious circle persist, as in many countries the share of banks in the financing of growing government debt is continuing to rise and the economic recovery is very fragile, mainly because of high private sector debt. Lowering the euro area’s debt burden will be a protracted process even given the easy monetary conditions owing to very low growth in nominal income. This is currently due not only to slow real output growth, but also to suboptimally low inflation.

2013 saw a global surge in new risks associated with the response of financial investors to low yields on safe assets. Efforts to achieve higher returns are being reflected in increased risk-taking, as a result of which bubbles are starting to form in some markets. The developments in bond markets and some property markets are generating potential for sizeable credit and market losses in the years ahead. The current situation therefore represents an unusual combination of risks that originated before the crisis and newly emerging risks related to the search for yield. Central banks and supervisory authorities are facing the task of avoiding a renewed decline in demand and a fall of their economies into the deflation trap while simultaneously preventing excessive risk-taking in the financial markets. So far, Czech assets have been affected relatively little by the search for yield and the CNB is actively combating the deflationary risks by means of an interventional monetary policy regime. 

According to the CNB’s May forecast, GDP will rise by 2.6% in 2014 thanks to stronger economic growth abroad, easy domestic monetary
conditions and to a lesser extent also a fiscal stimulus. The growth will then pick up further to 3.3% in 2015, aided significantly by more expansionary fiscal policy. The performance indicators of non-financial corporations, which are important as regards the future evolution of their credit risk, started to improve at the end of 2013. The labour market situation, which determines household credit risk, will not improve significantly until 2015, when wage growth will pick up pace and unemployment will start to fall.

In addition to potential renewed adverse developments in trading partner countries, a deterioration in domestic demand poses a risk to the Czech economic recovery. Signals that the financial surpluses generated by corporations and households could lead to domestic demand shortfalls amid a decreasing government deficit intensified in 2013. The use of the exchange rate as a monetary policy instrument and the weakening of the koruna significantly weakened the risk of a mismatch between expected future income and expenditure in the economy. Nevertheless, signals regarding the intensity of this risk must be monitored carefully in the quarters ahead.

The external balance of the Czech Republic again developed mostly favourably in 2013. The ratio of the gross external debt of the Czech economy to GDP rose from 51% to 57%. However, this rise was partly due to the statistical effect of the weaker koruna. Conversely, the coverage of the external debt by banks’ external assets rose from 70% to 78%, mainly because of an increase in the CNB’s international reserves. The government’s net external debt continued to increase, and any further growth could be a source of systemic risk from the long-term perspective. The ratio of government debt to GDP was flat at 46%, where it will probably remain in the years ahead. The Czech Republic’s current fiscal situation is sustainable and does not pose a threat to financial stability at the moment.

Residential property prices are currently close to their equilibrium levels. Given the assumptions regarding the macroeconomic environment, slight increases in prices of residential property and further differentiation between regions can be expected for the future. The scope for stronger price growth will be reduced by slow growth in household income and worsening demographic characteristics. Given the modest growth in loans for house purchase and the falling number of property market transactions there is no danger of a more significant price bubble emerging at the moment. The commercial property segment saw a renewal of investment activity, which, however, is not yet underpinned very much by an improvement in price fundamentals. The rise in investment activity is being driven mainly by foreign entities and may also reflect a search for yield. The potential impact of volatility in this segment on the Czech financial sector is small.

A prolonged period of very low yields on advanced countries’ government bonds may also lead to a search for yield in these markets. Such behaviour may be reflected in inappropriate swings in prices of other countries’ government bonds and other assets such as risky

The risk of the emergence of insufficient demand persists as a result of financial surpluses of households and corporations

The Czech Republic’s external balance and public finances are not generating any short-term risks to financial stability

The risk of domestic property prices becoming overvalued is relatively low

The focus of investors on yield is increasing the risk of overvaluation of some government and corporate bonds
A potential renewed recession leading to a substantial rise in credit losses and a drop in profitability represents a risk to the banking sector.

Credit risk stabilised during 2013 but cannot be expected to decrease significantly in the near future.

Some indicators suggest a still elevated level of credit risk, which could rise sharply in the event of adverse developments in the real economy.

The coverage of NPLs by provisions may not be sufficiently prudent from the aggregate perspective.

The concentration of the portfolios of banks, insurance companies and pension management company funds on domestic government bonds remains significant.

2013 was an unfavourable year from the perspective of credit unions; the segment remains risky and draft legislation has been prepared to change this.

corporate bonds. A sudden change in market sentiment may cause sudden repricing of the assets concerned and related market losses. If risks were to be reassessed quickly and unexpectedly, a wave of sell-offs and a market liquidity crisis could occur.

Risks to the banking sector stem from a potential economic slowdown leading to higher credit losses and a considerable decline in banking sector profitability. In addition, interest profit decreased slightly year on year for the second consecutive year. In a context of low interest rates, this trend can be expected to continue in the years ahead. The Baseline Scenario assumes a continuing decline in interest profit of around 5% year on year.

Credit risk in banks’ balance-sheets, as expressed by the ratio of non-performing loans (NPLs) to total loans to residents, decreased slightly in 2013. By contrast, the volume of NPLs increased somewhat for loans to residents. Despite the improving macroeconomic environment, no significant decrease in credit risk can be expected in the near future, not least because some sectors are still experiencing a downturn and some corporations are recording a deterioration in financial indicators and a fall in financial reserves.

Other complementary indicators also suggest elevated credit risk. The quality of the NPL portfolio is still worsening and loan migration to riskier NPL subcategories is continuing. Within the NPL category, the share of loans that are not actually past due is decreasing and the proportion of loans that are more than three months past due is continuing to rise. Banks’ balance sheets include loans categorised as performing even though another bank regards a loan to the same client as non-performing. Credit losses could therefore rise significantly in the event of worse-than-expected developments in the real economy.

The current coverage of NPLs by provisions could also represent a risk. It has been virtually flat in recent years and may therefore not be fully consistent with the deteriorating NPL structure. There are substantial differences between banks in the prudence of NPL coverage.

The share of domestic government bonds in the total assets of banks, insurance companies and pension management company funds decreased slightly year on year. However, the interconnectedness of the financial and government sectors remains significant. The current yields on Czech government bonds are very low in relation to their fundamentals. However, the financial market trends could suddenly turn around as market expectations change. This would lead to a fall in bond prices, which, in turn, would have a negative impact on the profitability of financial institutions. If the CNB were to assess the risks connected with sovereign exposures as systemic, it could take action against banks in accordance with the updated Pillar 2 in the sense of evaluating concentration risk or applying the systemic risk buffer.

2013 was an unfavourable year from the perspective of credit unions. One credit union had its licence revoked. Another was prohibited from...
accepting deposits from the public and some of its other activities were limited. In aggregate terms, the credit union segment is still riskier than the banking segment. The ratio of NPLs to total loans rose by 9 percentage points year on year to almost 23%. The CNB is looking into the situation in the credit union segment. Together with the Ministry of Finance it has drafted legislative changes that will lead to a reduction in the level of risk in this segment.

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 management companies using a Baseline Scenario and a Europe in Deflation 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 adverse developments in EU countries and low external demand. 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. write-downs of claims on indebted EU countries and the collapse of the largest debtors of each bank.

The stress tests demonstrate that the banking sector remains highly resilient to adverse scenarios even in a strong recession accompanied by deflation. While the Baseline Scenario predicts a slight decline in credit risk, the adverse developments assumed in the Europe in Deflation scenario would mean, among other things, that the banking sector’s credit losses would more than triple over the three-year test horizon. However, the banking sector has a large capital buffer which enables it to absorb highly adverse shocks and maintain the sector’s overall capital adequacy sufficiently above the regulatory threshold of 8% even in such an unfavourable scenario. Banks also passed a liquidity stress test. The insurance company sector also showed sufficient resilience to the adverse scenario thanks to its large capital buffer. The pension management company sector remains sensitive to a rise in yields on securities holdings and would probably have to increase its capital in the event of a sharp future rise in yields.

SYSTEMIC RISK AND MACROPRUDENTIAL POLICY

The domestic financial sector is currently in a phase of the financial cycle that can be regarded as a modest credit recovery. The lending capacity of the banking sector is not limited by a shortage of balance-sheet liquidity or capital, but the absence of unhealthily optimistic expectations due to weakened economic activity is discouraging strong lending activity and excessive risk-taking. Lending growth remains subdued overall, although it started accelerating in late 2013 on the back of the economic recovery. The transposition of the EU Capital Requirements Directive (CRD IV) into Czech law through an amendment to the Act on Banks, which will take place this year, opens the door to the use of the countercyclical capital buffer. According to CNB analyses, however, the financial cycle in the
Czech Republic has not yet entered its upward phase, so a non-zero countercyclical capital buffer is not needed at present.

From the point of view of credit risk, one positive factor is that banks are not relaxing their credit standards. At the same time, the decrease in margins on new loans has come to a halt. This can be regarded as a stabilising factor, since in the previous two years margins fell to levels that may not always have been consistent with appropriate credit risk valuation. The low interest rates on bank loans have been reflected in an absolute decline in interest paid, which is having a countercyclical effect by fostering a drop in the debt servicing costs of corporations and households.

The direct and indirect links between financial market segments are the source of the structural component of systemic risk. Indirect links through exposures to the same sectors were weakened slightly year on year by the falling exposures of individual segments to the government sector. However, this link is still significant in the domestic financial sector. The similarity of banks’ portfolios, which reflects the structure of bank exposures to all sectors of the economy, increased further in 2013. Direct links through mutual exposures within the financial sector rose in 2013, especially between banks and other financial intermediaries. The structural component of systemic risk is being suppressed by robust banking sector liquidity. The ratios of quick assets to total assets and to client deposits increased further in 2013. However, the ratio of liabilities payable on demand to total liabilities continued to rise, causing maturity transformation to increase.

A stabilisation of the property market and a related improvement in sales of apartments in residential development projects led to a drop in the share of NPLs in the property development sector in 2013. However, the favourable trends, particularly on the domestic commercial property market, may be disrupted by a correction of imbalances in European property markets and a related exit of foreign investors from the Czech market. For the eventuality of an overheating of the residential and commercial property markets, the CNB will legislate for and apply prudential tools able to moderate any excessive future credit expansion. These tools include sector-specific risk weights applicable under CRD IV/CRR and quantitative limits on the loan-to-value (LTV) ratio as recommended by the ESRB.

Domestic banks are able to achieve reasonable profitability even in an adverse macroeconomic environment. This is aided by their ability to obtain funds at relatively low cost. For this situation to continue, the high confidence of the public and investors in the stability of the Czech banking sector needs to be maintained. Given the deterioration in the NPL structure, among other things, it is vital for banks to remain prudent in their lending activities and subsequent loan classification and provisioning.

The transposition of CRD IV authorises the CNB to set requirements for domestic banks partly on the basis of their systemic importance.
Although the Czech banking sector currently faces no acute risks and therefore is not a source of risk to the stability of the financial sector as a whole, the long-term structural characteristics of the Czech financial and economic system have led the CNB to introduce regulation of bank capital on the basis of systemic importance as soon as this mandate takes effect. Given the current situation in the Czech banking sector, the systemic risk buffer appears to be the most suitable of the capital buffers offered by CRD IV. CNB analyses show that compliance with this buffer needs to be required of two of the four most systemically important banks. The relevant banks were informed about this in the second half of 2013.

The CNB will be able to demand compliance with the systemic risk buffer – together with the capital conservation buffer, which will apply to all banks – as soon as the relevant legislation is adopted. However, the banks that will be subject to the additional capital requirements already have capital exceeding the new potential requirements. Therefore, banks will not be forced to suddenly increase their capital adequacy. The newly introduced capital requirements should therefore not have a negative effect on their ability and willingness to lend and thereby adversely affect the domestic economy.

The additional capital requirements will not cause a need to suddenly increase capital adequacy.