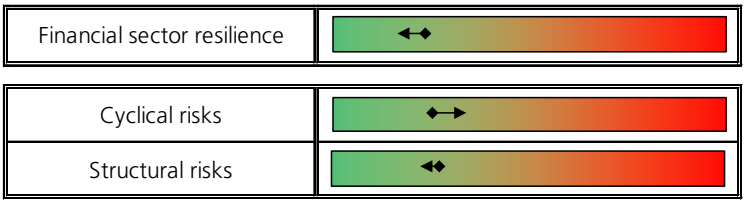
OVERALL ASSESSMENT



The Czech financial sector has developed mostly favourably since spring 2014. The aggregate macroprudential dashboard[1] shows that the sector's already high resilience to potential adverse shocks has strengthened. This was due mainly to an increase in capital adequacy, favourable liquidity developments and positive changes in risk management by financial institutions. As regards potential sources of risks to financial stability in the future, the aggregate macroprudential dashboard indicates a slight increase in cyclical risks and a modest decline in structural risks. The increase in cyclical risks was due to a further fall in loan interest rates and interest margins, a recovery in demand for loans and an easing of credit standards, and a decline in returns on high-quality assets to very low levels. The modest decline in structural risks primarily reflects the introduction of a systemic risk buffer, a reduction in the interconnectedness of financial institutions and new legislation governing the activities of credit unions.

DEVELOPMENTS IN 2014 AND 2015 Q1

Advanced economies are gradually recovering

The global economy continued to record uneven growth in 2014, as characterised by slow growth in the euro area, a sizeable recovery of the US economy and fast growth in emerging economies. However, some emerging economies recorded slowing growth, owing to an unexpectedly sharp fall in prices of the energy commodities they export or to an increase in the volatility of capital flows. The Czech economy returned to economic growth in 2014. Besides a modest pick-up in GDP growth in its main trading partner countries and more pro-growth fiscal policy, the domestic economic recovery was aided by a weaker koruna, which, together with decline of interest rates, led to a substantial easing of the real monetary conditions.

[1] The figure illustrates the overall situation in the Czech financial sector in aggregated form from the macroprudential perspective. In line with the macroprudential policy literature, the figure is divided into two main areas. The first describes the financial sector's current degree of resilience, i.e. its ability to absorb shocks stemming from potential risks (a position further to the right indicates a lower absorption capacity). This area is backward-looking, as the change in the financial sector's current degree of resilience is due to actual developments in the past. The second area, by contrast, is forward-looking, as it assesses the strength of potential sources of risks to financial stability in the future (a position further to the right indicates a higher level of risk). The sources of risks in this area are subdivided into factors linked with the business cycle and structural factors. The arrows denote the shift since the previous Financial Stability Report was issued. The aggregate dashboard reflects the results of an assessment of the individual factors contained in the detailed macroprudential dashboard (see section 4.1 of this Report) and an evaluation of other financial stability indicators.

Monetary policy in Europe remains very loose

Central banks in Europe further eased the economic conditions on concerns about strengthening deflationary pressures. Some lowered their monetary policy rates to negative values and used unconventional instruments. By contrast, the US Federal Reserve finished its quantitative easing programme and is expected to start tightening monetary policy at the end of this year. The CNB's monetary policy rate has been at "technical zero" since November 2012 and the CNB has been using the exchange rate as an additional instrument for easing the monetary conditions since November 2013. At its May meeting, the Bank Board confirmed the commitment to intervene on the foreign exchange market if needed to weaken the koruna against the euro so that the exchange rate is kept close to CZK 27 to the euro. It stated that the CNB would not discontinue the use of the exchange rate as a monetary policy instrument before the second half of 2016 and that it stands ready to adjust the level of the exchange rate commitment if there were to be a long-term increase in deflation pressures capable of causing, among other things, a slump in domestic demand or a systematic decrease in inflation expectations.

The financial condition of the non-financial corporate sector has improved, but remains differentiated

Both the performance and profitability of the non-financial corporations sector rose significantly in 2014. The financial situation of small enterprises did not improve much, however. The financial results of the energy sector deteriorated despite the economic recovery and a general improvement in the financial condition of most sectors. Overall credit growth in the corporate sector remained low in 2014 and 2015 Q1 despite favourable conditions on the credit supply side. The corporate sector's increasing export orientation is strengthening its dependence on the external environment. The escalation of geopolitical risks is increasing the potential riskiness of loans to non-residents and non-financial corporations with strong links to the countries concerned.

More favourable income conditions are having a positive effect on household debt indicators

The economic recovery helped improve the labour market situation. This had a positive effect on the financial condition of households. Growth in income coupled with a fall in interest rates on mortgage loans and consumer credit led to a decrease in the ratio of households' net interest payments to their gross disposable income. This favourable trend was not yet fully reflected in an improvement in household credit risk indicators. Their level was similar to that in 2013. The overall proportion of financially distressed households was also unchanged from the previous year. However, stress tests of households indicate a decline in the rate of distress in the quarters ahead.

Residential property prices continued rising, while activity in the commercial property market strengthened

Residential property prices rose modestly in 2014, but the trends remain mixed across regions. Growth in apartment prices accelerated in Prague, whereas in the rest of the Czech Republic the signs of a recovery observed last year weakened. The commercial property segment saw a surge in investment activity, which may reflect search for yield by foreign investors. However, the renewed construction of office property is leading to a further rise in the vacancy rate. The development activity is being financed largely from developers' own funds or from abroad.

The Czech financial sector developed favourably

The developments recorded in the Czech financial sector were positive in 2014. In an environment of economic recovery, the banking sector increased its profitability and strengthened its capital adequacy and liquidity. It is comfortably compliant with the new European regulatory rules. Deposits continued to increase despite an ongoing decline in deposit rates. Thanks to a high volume of residents' deposits, the domestic banking sector has long been independent of foreign sources of funding and its net external position remains positive. Insurance companies are well capitalised and most of them are maintaining stable profitability even in the current period of low interest rates. Investment funds are showing dynamic growth. The pension management companies sector is also stable. Following the abolition of the second pillar, planholders are saving in traditional transformed funds and new participation funds, which may have a riskier profile.

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

The resilience of the euro area financial sector strengthened

The results of a comprehensive assessment of banks' balance sheets prior to the launch of the Single Supervisory Mechanism in the banking union boosted the confidence of investors in the European banking system. Despite uncertainty surrounding repayments of Greek sovereign debt, the bond market situation has calmed, thanks in part to the ECB's unconventional monetary policy measures. Uncertainty surrounding the continuation of the economic recovery and deflationary pressures are significant sources of risks to financial stability in the euro area and in some other advanced countries. Central banks will therefore continue to pursue very easy monetary policy.

The historically low interest rates may encourage overvaluation of some assets

Low interest rates on loans and other sources of external financing are encouraging people to buy property or other assets in order to take advantage of the favourable conditions to attain better returns. This may result in some asset prices rising above levels consistent with the long-term trends in fundamental factors. A sudden change in market sentiment towards expectations of higher returns could lead to a sharp revaluation of bonds and sizeable market losses. However, this scenario is very unlikely, as there are factors that may result in long-term interest rates staying at historical lows for an extended period.

The Czech economy will continue to grow in 2015 and accelerate in 2016

According to the CNB's May forecast, economic activity will grow by 2.6% this year. This growth will be fostered by a recovery in external and domestic demand, an overall environment of easy monetary conditions, low oil prices and partly also rising government investment. It will accelerate further to 3.2% in 2016, reflected in a decline in the general unemployment rate and higher income growth. Household consumption expenditure will increase thanks to faster growth in wages and salaries, which are the main component of households' disposable income. The relatively robust economic growth will lead to a weakening of credit risk in the private sector. Domestic demand growth and the recovery in economic activity will be boosted by a decline in interest paid and a recovery in credit growth.

The risk of weak demand decreased as a result of the financial surpluses generated by households and corporations

In addition to potential renewed adverse developments in trading partner countries, a halt in domestic demand growth may pose a risk to the Czech economic recovery. Signals that the financial surpluses generated by corporations and households could have an adverse effect on aggregate domestic demand amid a decreasing government finance deficit intensified in 2014. The easy monetary conditions together with appropriate fiscal policy reduce the risk of a balance-sheet recession, i.e. a mismatch between expected future income and expenditure. Nevertheless, signals regarding the intensity of this risk must continue to be monitored.

The risk of domestic property prices becoming significantly overvalued is low for the present

An assessment of the degree of overvaluation/undervaluation of property prices is important for evaluating the risks associated with credit institutions' exposures to the property market. According to the CNB's new quantitative method, apartment prices can be regarded as having been slightly overvalued at the end of 2014. In line with the assumptions regarding the macroeconomic environment, modest but accelerating growth in residential property prices can be expected over the next two years. However, this growth does not imply any major deviation of prices from levels consistent with fundamental factors.

A potential renewed recession and a long period of low interest rates remain risks to the financial sector

Given the fragility of the economic recovery in Europe, the main risk scenario for the Czech financial sector is still a renewed economic recession leading to a sharp deterioration in its profitability. The profitability of credit institutions, whose income depends heavily on interest margins, could also be adversely affected by a continued decline in interest rate levels. Low interest rates will negatively affect the performance of insurance companies, too. The environment of very low interest rates also calls for increased prudence in interest rate risk management.

Credit risk dropped slightly, but the easing of credit standards may foster underestimation of such risk

The economic recovery helped reduce credit risk in most sectors of non-financial corporations and stabilise credit risk in households. The credit risk of both non-financial corporations and households is being suppressed by the relatively low debt ratios of these sectors and by low interest rates on loans. However, these may also become a source of vulnerability due to easier availability of loans. The softer lending conditions coupled with historically low interest rates may boost the interest of households and firms in new loans and increase their willingness to take on more debt. As the economy is starting to shift to a more expansionary phase of the business cycle, the CNB will closely monitor credit standards.

The quality of NPLs is decreasing, but other complementary indicators of credit risk suggest positive tendencies

The structure of non-performing loans (NPLs) is continuing to deteriorate in the form of migration to riskier subcategories. The coverage of NPLs by provisions rose slightly, but the deteriorating NPL structure means there is still risk of its appropriate level being underestimated. At the same time, there are substantial differences between banks in the prudence of NPL coverage. The amount of loans classified as performing but regarded as non-performing by other banks is decreasing. The volume of guarantees and loan commitments given to clients who have a loan classified as non-performing is also falling. Lending to the most risky segments dropped

and the default rates on loans provided by banks to non-financial corporations in 2014 were lower by comparison with new loans in previous years. The long-running decline in risk weights in large banks reversed as well.

The credit unions segment still poses a risk, but new legislation will help stabilise it

The adverse trends in the credit union segment continued in 2014. Credit risk in this segment is still much higher than in the case of banks and the NPL ratio rose further to almost 30%. New legislation adopted last year should lead to a reduction in the level of risk of this segment in future. However, increased attention will be needed as the segment adjusts to the new legislative requirements.

The domestic financial system was exposed in stress tests to very adverse developments associated with a lengthy recession

The resilience of the domestic financial system was assessed by means of stress tests on banks, insurance companies and pension management companies using alternative economic scenarios. The *Baseline Scenario* is considered by the CNB to be the most probable. The *Adverse Scenario*, whose probability is very low, describes the risk of a pronounced and long-lasting decline in domestic economic activity caused mainly by low external demand. The adverse economic situation will erode the financial reserves of households and non-financial corporations and cause a significant deterioration in their ability to service their debts. This will lead to sizeable credit losses in the banking sector. This scenario is supplemented in sensitivity analyses with other shocks, e.g. write-offs of claims on indebted EU countries and the collapse of the largest debtors of each bank. The *Adverse Scenario* also assumes a pronounced increase in long-term interest rates, which will result in financial institutions incurring losses due to market risk.

According to the stress tests, banks and insurance companies are highly resilient, but pension management companies show elevated sensitivity to interest rate risk

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, materialisation of the *Adverse 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 methodology of which was extended to account for the new regulatory framework. The insurance company sector also showed sufficient resilience to an adverse scenario thanks to its large capital buffer. The pension management companies sector remains sensitive to an increase in yields on securities holdings.

SOURCES OF SYSTEMIC RISK AND MACROPRUDENTIAL POLICY

The current macroeconomic environment is heightening the importance of macroprudential policy

The combination of economic recovery and very easy monetary policies amid sufficient balance sheet liquidity of credit institutions is creating conditions for increased risk-taking and underestimation of risks. Given the fragility of the economic recovery, the high private and public sector debt levels in most advanced countries and the marked growth in the prices of many assets, financial institutions and their clients are exposed to a potential rise in credit and market risks to an increased extent. The

growing probability that central banks will continue to pursue very easy monetary policy and keep interest rates very low for an extended period is heightening the importance of preventive macroprudential policies.

The Czech economy is gradually bouncing back from the bottom of the financial cycle, and the countercyclical capital buffer rate remains at zero

The Czech economy is currently in a phase of the financial cycle that can be regarded as the onset of a recovery. The risk of excessive growth in lending remains low. The evolution of banks' credit standards is a major factor indicating a shift of the economy to an expansionary phase of the financial cycle. However, it has not yet been accompanied by changes in other types of cyclical risks. A zero countercyclical capital buffer rate will probably be applied in the next two years as well. However, this probability has decreased as a result of a recovery in credit growth, an easing of credit standards and a slight improvement in investment sentiment.

Loans for house purchase are becoming a potential source of systemic risk

Expectations of further property price growth combined with favourable conditions on the market for house purchase loans may become a source of systemic risk. Thanks to low interest rates, these loans are becoming more affordable for borrowers with lower and less stable income, who are more likely to experience repayment problems at times of rising interest rates or worse economic growth. At the same time, the attractiveness of buying to let is increasing. The growth in residential property prices and the increasing profitability of buying to let are creating potential for the emergence of a price spiral between property prices and housing loans.

The CNB is introducing a preventive macroprudential approach targeted at preventing future growth in risks in the area of loans secured by residential property

The CNB assesses the current configuration of credit standards in the segment of loans for house purchase as mostly conservative. At the same time, however, it sees growing diversity between banks' approaches and increasing tendencies to provide riskier loans for house purchase. This is indicated by the results of the CNB's survey of new loans secured by residential property. As these loans represent the largest part of the credit portfolio of domestic banks, the CNB deems it necessary to deploy preventive tools to counteract growth in the risks associated with providing such loans in the years ahead. These tools consist in a set of recommendations for credit institutions providing loans for house purchase. If the domestic property market started to show signs of overheating fostered by faster growth in lending in the years ahead, the CNB would tighten or extend the parameters of these recommendations or apply other tools defined in the CRD IV/CRR legislation. In particular, these tools include higher sector-specific risk weights for the calculation of capital requirements for banks.

The CNB has created a methodology for reviewing and assessing the systemic aspect of sovereign exposure concentration, but will not apply additional capital requirements under this methodology over the next three years

Given the continued growth in client deposits and subdued corporate demand for loans, credit institutions are allocating a significant proportion of their funds to government bonds (mainly Czech ones). As a result, credit institutions are displaying increased sovereign exposure concentration. CRD IV requires credit institutions to ensure consistent and effective management of concentration risk in their risk management systems. Concentrated sovereign exposures are no exception. However, it is difficult for individual institutions to assess the systemic aspect of this risk. The CNB has therefore prepared a new methodology for reviewing

and assessing the risk of systemic concentration of sovereign exposures under Pillar 2 (SREP). If the CNB comes to the conclusion that this risk is not sufficiently covered by an institution, it will decide on the basis of the above methodology to apply an additional capital requirement. A stress test of Czech public finance reveals that the current fiscal situation in the Czech Republic does not represent a threat to financial stability. Consequently, the CNB will not apply additional capital requirements to credit institutions at the three-year horizon.

The interconnectedness of financial institutions is tending to decrease

The evolution of assets and liabilities forming the links between institutions in the financial sector indicates a tendency towards a decrease in their interconnectedness. This weakens the structural component of systemic risk and reduces the risk of transmission of financial distress across segments in the event of adverse developments. The structural component of systemic risk is also being suppressed by the banking sector's large liquidity buffer.

Banks must be prudent in in their lending activities and subsequent loan classification, provisioning and NPL portfolio management.

The robust capital adequacy and high degree of liquidity and profitability of Czech banks form a stable basis for absorbing shocks. They are also of key importance for maintaining high public and investor confidence in the stability of the Czech banking sector and the financial sector as a whole. To preserve this positive situation, it is vital for banks to remain prudent in their lending activities, loan classification, collateral quality assessment, provisioning and NPL portfolio management.

Pension management companies should be more prudent with regard to interest rate risk

A sharp rise in interest rates from their current very low levels and an ensuing decline in the prices of debt securities held by pension management companies pose a potential risk to this sector. This would lead to negative valuation differences, as occurred in 2007–2009. Owners would have to inject large amounts of capital to meet the capital adequacy requirement. Pension management companies should therefore prudently assess the impact of such developments.

The CNB considers stabilisation of the regulatory framework in the EU to be a priority

Besides contributing positively to the stability of financial systems, the plethora of international and European regulatory initiatives rolled out in past years may have some unintended adverse consequences for the Czech banking sector, which has a traditional structure and is small compared to the euro area. One of the regulatory initiatives with potentially adverse effects is the directive on recovery and resolution of credit institutions and investment firms (BRRD). The CNB commented in detail on the draft regulatory technical standard on setting the minimum requirements for own funds and eligible liabilities (MREL) prepared by the European Banking Authority (EBA). The draft did not take sufficient account of conservative and locally oriented retail banks, which finance their activities fully or mostly from insured deposits. Were it to be implemented, it could have a negative effect on the asset and liability structure of domestic banks. Within the EBA, the CNB will lobby for resolution authorities to be allowed to take account of a bank's business model, mode of financing and risk profile when setting its MREL. The CNB's general priority is stabilisation of the regulatory framework. It is therefore cautious about the EU capital markets union project, which should be limited to minor steps until the functioning of the new regulatory framework for banks has been assessed.