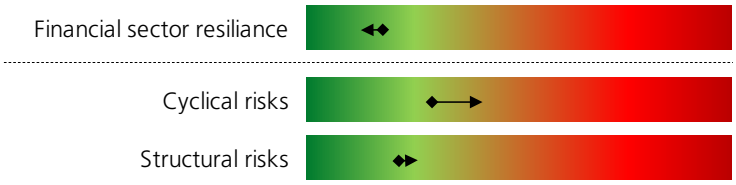
OVERALL ASSESSMENT



The Czech financial sector has developed favourably since spring 2015. Systemic risks have moved in line with expectations and with the conclusions of last year's Financial Stability Report, and they remain only potential in all areas. The aggregate macroprudential dashboard[1] shows that the sector's already high resilience to potential adverse shocks strengthened year on year. 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 an increase in cyclical risks and a very modest rise in structural risks. The increase in cyclical risks is due to a recovery in demand for loans and an easing of credit standards, exceptionally low loan interest rates, growth in property prices, a further decline in returns on high-quality assets and a fall in interest margins and risk premiums. Potential risks arising from the global environment increased. The CNB is responding to the increase in cyclical risks on an ongoing basis by configuring relevant instruments. The very modest rise in structural risks is due mainly to an increase in maturity transformation of deposits and loans in the banking sector and to a rising share of non-residents in the domestic government bond market.

DEVELOPMENTS IN 2015 AND 2016 Q1

The economic recovery in advanced economies remains fragile

Economic growth remained weak in the euro area and mixed across the member countries in 2015. The fourth quarter of 2015 saw a slowdown in GDP growth in the USA and many other advanced economies, including Asian ones. This was reflected in worsening outlooks for this

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. 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 financial cycle and structural factors. The arrows denote the shift in the period from April 2015 to April 2016, i.e. 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.

year. By contrast, the Czech Republic continued to enjoy robust economic growth in 2015. It was fuelled by a combination of domestic factors. In the area of economic policy, these included easy monetary conditions and increased growth in government investment.

Economic growth in emerging economies is slowing

Some emerging economies recorded slowing GDP growth and a downward revision of their outlooks for the next two years in 2015. This, together with expectations of interest rate growth on US markets, was reflected in a substantial outflow of capital from some emerging countries. Private and public sector debt continues to increase in many emerging economies. A large proportion of this debt consists of liabilities denominated in foreign currencies. This, coupled with low commodity prices and the slower economic growth, is putting pressure on important sectors of the economy.

The monetary policies of central banks remain very loose

The ECB cut its monetary policy rates further and expanded its quantitative easing programme in late 2015 and early 2016 on concerns about strengthening deflationary pressures. By contrast, the US Federal Reserve raised its monetary policy rates in December 2015 in response to robust data from the real economy. However, it did not continue tightening the monetary conditions at its subsequent meetings. 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 meeting in May this year, 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 2017. It stands ready to move the exchange rate commitment to a weaker level if there were to be a systematic decrease in inflation expectations manifesting itself in nominal variables, especially wages.

The easing of monetary and financial conditions is fostering growth in loans

The easy monetary and financial conditions combined with the renewed growth in the Czech economy also affected the conditions and activity on the domestic financial market. The result is a shift in the financial cycle to a phase of stronger recovery. Total bank loans to the private sector rose by almost 6% year on year in 2015 and their rate of growth accelerated. Bank loans for house purchase increased by more than 7% and loans to corporations by almost 10% in the second half of last year. Growth in loans to households and non-financial corporations in the Czech Republic ranks among the four fastest in Europe.

The condition of the corporate sector has improved further and the sector's debt remains relatively low despite rising growth in bank loans

The non-financial corporations sector as a whole recorded a further rise in performance and profitability in 2015. This was reflected in a drop in the non-performing loan ratio and a modest decrease in the sector's credit risk as measured by the 12-month default rate. However, exposures to businesses in the energy sector and to the smallest firms continue to show an elevated level of risk. Non-financial corporations' demand for bank loans increased considerably in 2015. The growth slowed slightly in the first quarter of this year. However, longer-term investment loans maintained fast growth. As regards the structure of

financing, the growth in the share of debt securities in the sector's total funds halted in 2015.

The environment of very low interest rates is fostering growth in household indebtedness

New loans to households (adjusted for refixations and refinancing) grew by more than 20% year on year in 2015. This trend continued into the first quarter of 2016. The growth was due to all types of loans, including consumer credit. Despite a marked improvement in the labour market situation, growth in total loans to households continued to outpace growth in households' income in 2015. This was reflected in a further increase in indebtedness. The higher indebtedness started to show up in the net interest burden of households, which increased in terms of annual totals at the end of 2015. Credit risk, as expressed by the 12-month default rate, is still relatively low in all segments.

Residential and commercial property prices continued to go up

Property prices in the Czech Republic went up in 2015, as they did in many other European countries. Transaction prices of apartments rose by almost 5% year on year. The methodology used by the CNB assesses apartment prices as being slightly above the level consistent with fundamentals at the end of 2015. The apartment price trend in Prague is characterised by faster growth in asking prices than actual transaction prices. Due to a further reduction of interest rates on loans for house purchase, the affordability of loans and the perceived profitability of buying an apartment on credit meanwhile increased. In line with the global trend in commercial property markets, prime yields on the domestic market declined further in 2015. The volume of realised transactions remained relatively high, close to the 2007 level. Increased construction is being reflected in a relatively high vacancy rate for office property.

The developments in the Czech financial sector were favourable

The developments recorded in the Czech financial sector were positive in 2015. The performance of the banking sector was positively affected by the strong economic recovery. This was reflected in an increase in profitability and sustained high capitalisation and favourable liquidity. Deposits continued to increase despite a continuing decline in deposit interest rates. The domestic banking sector has long been independent of foreign sources of funding. 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 remains 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 main sources of risks are the fragility of the world economy…

Uncertainty surrounding the continuation of the economic recovery is one of the key sources of risks to financial stability in advanced countries. In the euro area, it is being magnified by the unfinished process of stabilisation of banks' balance sheets. This uncertainty started to increase this year due to a worsening of the economic growth outlooks in some emerging economies. Weak global demand is creating anti-inflationary

pressures. Central banks are responding to the risks to price stability by maintaining very loose monetary policies or by easing them further.

…and the related environment of very low interest rates

On the one hand, the exceptionally low interest rates are supporting domestic demand and helping achieve the objective of price stability. However, they are also encouraging banks and other types of financial institutions to invest in assets with riskier profiles to maintain their existing profitability or hit profit targets. This is being done through softer lending conditions. Likewise, the willingness of financial institutions' clients to accept higher risk may increase. The perceived advantageousness of low loan interest rates may significantly boost the interest of households and firms in new loans. This may result in excessive growth in loans provided under insufficiently prudent standards and in a potentially unsustainable rise in asset prices.

The low interest rates are squeezing the profitability of financial institutions

The falling market interest rates and returns on financial assets are directly affecting the income and profitability of financial institutions in the Czech Republic. In the case of banks, this may occur primarily via declining interest margins. With the exception of consumer credit, a further marked decline in margins on new loans in the Czech Republic is not very likely. Nevertheless, it is necessary to assume that interest margins will have a negative impact on domestic banks' income and profitability over the next few years. This may negatively affect their ability to strengthen their capital adequacy. The performance of banks, insurance companies and pension funds may also be adversely affected by very low, or even negative, yields on government bonds and other high-quality assets in the longer run.

Developments on the Czech government bond market are being reflected in a change of the structure of risks

A side-effect of the monetary policies of the ECB and the CNB is increasing interest among foreign investors in government bonds issued in Czech koruna, which is pushing down domestic government bond yields to negative values even at longer maturities. This trend is becoming a potential source of vulnerability for the domestic financial sector, particularly in relation to interest rate risk. Higher sales of Czech government bonds by foreign investors combined with low market liquidity could result in increased market volatility and potentially also a marked drop in their prices. In addition, persisting supply of government bonds with negative yields could squeeze domestic financial institutions out of this market and motivate them to buy riskier assets.

The risk of domestic property prices becoming significantly overvalued has increased

The combination of exceptionally low interest rates and easy access to loans for house purchase is creating conditions for growth in residential property prices above levels consistent with fundamentals. The source of this risk is rapid growth in new mortgage loans fostered by falling interest rates. After adjustment of new mortgage loans for refixed and refinanced loans, genuinely new mortgage loans (including loan increases) recorded year-on-year growth of around 30% in 2015. Their rate of growth stayed at around 20% in the first quarter of this year.

Some new mortgage loans have increased risk characteristics…

In June 2015, the CNB issued a *Recommendation on the management of risks associated with the provision of retail loans secured by residential property* directed against potential growth in risks in the area of new

loans secured by residential property. The Recommendation set quantitative LTV limits and qualitative criteria for prudential provision of such loans. Based on detailed data for the second half of 2015, the CNB assessed the riskiness of new loans and compliance with the quantitative and qualitative criteria contained in the Recommendation. The assessment revealed that the LTV limits are mostly being observed at an aggregate level. However, some institutions are providing some new loans with LTVs of over 100% and exceeding the 10% limit on new loans with an LTV of 90%–100%. A comparison of property price growth, average loan size and average collateral value indicates that the introduction of the Recommendation might have led to a deliberate increase in estimated collateral value in some cases.

…mainly concerning clients' ability to service loans in an adverse economic situation

Very easy credit standards are evidenced by indicators of clients' potential ability to service loans from their own resources in a worse economic situation. Many new loans are being provided with a relatively high LTI (the ratio of loan size to net annual income) or DSTI (the ratio of the monthly loan instalment to net monthly income). At the same time, these loans often have a high LTV or are provided to applicants with relatively low incomes. In the event of shocks in the form of interest rate growth or a drop in income, a significant number of these borrowers could run into repayment problems.

The risk of exposures to the commercial property market is also increasing

Low returns on alternative investments and excess liquidity are leading to growth in demand for domestic commercial property among domestic and foreign investors. Given signs of increased activity on the commercial property market and a fast-growing volume of loans to developers, the CNB started to conduct surveys on new loans secured by commercial property provided since the second half of 2014. According to the data gathered, the amount of new loans in this category rose by 17% year on year in second half of 2015. The highest year-on-year growth was recorded for loans for investment in office property. The CNB considers the fact that loans with a high LTV are in many cases being provided with low debt service coverage by income from the property to be a potential risk. A drop in property prices accompanied by a fall in incomes in individual segments could thus give rise to a higher default rate and a lower recovery rate in the subsequent sale of collateral. If newly completed space remains vacant or if the rent obtained is lower than planned, the quality of loans to developers may worsen.

The banking sector remains highly resilient; credit risk has decreased, but interest rate risk is increasing

Credit risk, which is the principal source of potential losses in the domestic financial sector, has decreased. The structure of non-performing loans (NPLs) has also improved, but this in turn has led to a drop in their coverage by provisions. The provisions created by banks at the aggregate level nevertheless seem to be sufficient to cover the current expected loss given default. However, there are significant differences across the sector in the prudence of banks with regard to NPL coverage. Risk weights in the main credit portfolios remain stable. By contrast, interest rate risk is potentially increasing on account of bond market developments.

The interconnectedness of financial market institutions is broadly unchanged and the structural component of systemic risk remains low

The evolution of financial assets and liabilities forming the links between institutions in the financial sector does not indicate significant changes in

their interconnectedness. The risk of transmission of financial distress across segments in the event of adverse developments remains low. Interconnectedness inside the banking sector has decreased slightly and the risk of interbank contagion has therefore dropped. Contagion risks are also being suppressed by the banking sector's large liquidity buffer. The structural component of systemic risk has increased slightly despite the stable level of interconnectedness. This is due mainly to an increase in maturity transformation of bank deposits and loans and to increasing holdings of government bonds by non-residents. Despite that, the structural component of systemic risk remains low.

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 and pension management companies using alternative economic scenarios. The *Baseline Scenario* is based on the CNB's May forecast and is considered by the CNB to be the most probable. The *Adverse Scenario*, whose probability is very low, assumes a strong recession and a fall of the economy into deep deflation. 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, losses from operational risk and the collapse of the largest debtors of each bank. The *Adverse Scenario* also assumes a pronounced increase in long-term government bond yields, which will result in financial institutions incurring losses due to market risk. The potential upward adjustment of interest spreads and asset prices is thus increasing the importance of high-quality management of interest rate risk.

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

The stress test results demonstrate that the banking sector remains highly resilient to adverse scenarios. While the *Baseline Scenario* predicts credit risk to remain flat, 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 its overall capital adequacy sufficiently above the regulatory threshold of 8% even in such an unfavourable scenario. The banking sector is also highly resilient to short-term liquidity risk. In the stress test, the LCR took an aggregate value of 191%, well above currently required 70%. All banks would also be compliant with the regulatory limit of 100% required as from 2018. The pension management companies sector remains sensitive to an increase in yields on securities holdings. Pension management companies should therefore prudently assess the size of the impact of the potential rise in interest rates and the ensuing decline in the prices of their debt securities holdings.

MACROPRUDENTIAL POLICY

The Czech economy is still in a growth phase of the financial cycle and the countercyclical buffer rate can be left at its current level of 0.5% for the time being

When setting the countercyclical buffer rate, the CNB assesses credit growth and other indicators of the financial cycle so as to ensure that the capital buffers are consistent with any losses that the banking sector as a

whole might be exposed to in the future. In December 2015, the CNB reacted to the shift of the domestic financial cycle into a phase of stronger recovery by setting the countercyclical capital buffer rate at 0.5% of exposures located in the Czech Republic with effect from January 2017. This year, the Czech economy continues to be in a growth phase of the financial cycle, characterised by rapid credit growth in many credit segments, increasing household debt relative to income and growth in residential property prices. However, there has been no significant change in cyclical risks indicating growth in systemic risk since the last decision on the setting of the countercyclical buffer rate was made in March 2016. The rate can therefore be left at the current level of 0.5% for the time being. However, if credit growth remains high, credit standards ease further and investor optimism continues to grow, the CNB will stand ready to increase this buffer rate further.

Highly relaxed standards for the provision of loans for house purchase necessitate a macroprudential response from the CNB

The CNB does not assess the trends in the area of loans for house purchase as an acute market overheating giving rise to direct risks to financial stability. However, the CNB considers credit standards to be highly relaxed. It has identified the taking on of higher risks by some institutions. This primarily involves the provision of new loans with simultaneously high LTV, LTI and DSTI ratios. Households with such loans are very sensitive to potential income and interest rate shocks. However, the falling interest rates on new loans may not be increasing the affordability of housing, as the growth in property prices is being reflected simultaneously in the size of the loans needed to finance property purchases. This situation necessitates a macroprudential response from the CNB.

The CNB is tightening some parameters of the Recommendation on the provision of loans secured by residential property

The CNB is tightening its *Recommendation on the management of risks associated with the provision of retail loans secured by residential property* by lowering the maximum LTV levels. The current upper LTV limit of 100% will be reduced to 95% as from 1 October 2016 and to 90% as from 1 April 2017. The current recommended limit of 10% of new loans with an LTV of 90%–100% will change to a limit of 10% of new loans with an LTV of 85%–95% as from 1 October 2016. The limit will be set at 15% of new loans with an LTV of 80%–90% as from 1 April 2017. The CNB has also issued a new recommendation that institutions should use all available information to determine whether a loan is being used to finance owner-occupied housing or as an investment. If they find that an application for an investment loan shows a combination of characteristics with a higher risk level, they should apply an LTV of 60% at most. If the domestic property market were to show increasing signs of overheating in the years ahead, the CNB would tighten the conditions further or, where appropriate, use other instruments defined by law.

The CNB will pay increased attention to banks' collateral valuation procedures

As there is a risk of a softening of collateral valuation standards connected with the Recommendation, the CNB will assess the collateral valuation procedures in individual institutions from the perspective of both internal methodologies and practices.

The CNB will seek enactment of the power to set risk parameters for loans for house purchase

In accordance with ESRB recommendations, the CNB will also seek enactment of the power to set risk parameters for loans for house purchase. They include the option to set binding LTV, LTI and DSTI limits as well as other risk parameters for loans for house purchase. Such powers would enable the CNB to respond effectively to emerging risks to financial institutions and consumers which might arise from excessive softening of credit standards. The alternative would be strong measures in the area of institutions' capital, which could be more costly from the perspective of the national economy.

Given the favourable results of the Czech public finance stress test, the CNB will not apply additional capital requirements to cover sovereign exposure concentration risk

Since 2015, the CNB has been applying an internal methodology for reviewing and assessing the risk of systemic concentration of sovereign exposures under Pillar 2. One reason for this is the large share of Czech government bonds in domestic banks' assets. This share dropped from 14% to 11% between March 2015 and March 2016. If the domestic credit institutions fail to address this risk sufficiently, the CNB could apply an additional capital requirement to them under the above methodology. Despite the slight year-on-year decline, the CNB considers the exposure to Czech government debt to be systemically important. The CNB has therefore conducted a stress test of Czech public finance. Its results indicate that the current fiscal situation in the Czech Republic does not represent a threat to the financial stability of the domestic banking sector. Consequently, the CNB will not apply additional capital requirements to credit institutions at the three-year horizon.

The CNB is paying attention to risks associated with systemically important institutions

Robust capital adequacy is a condition for maintaining high public and investor confidence in the stability of the Czech banking sector and the financial sector as a whole. Maintaining sufficient capital buffers is of particular importance for banks that are systemically important by dint of their position and character. The CNB sets a systemic risk buffer for such banks. It is required by law to review this rate at least once every two years. It has therefore assessed the systemic importance of domestic banks using data from 2015. Based on the results of this assessment, it will inform banks and the relevant authorities during the course of this year about whether it will be confirming or changing existing systemic risk buffer rates or introducing new ones for banks that have not previously been required to create a systemic risk buffer.

The CNB considers stabilisation of the EU regulatory framework to be a priority and it continues to see risks in the BRRD, particularly in the configuration of the MREL

The CNB's general priorities for the regulatory area in future years are stabilisation of the EU regulatory framework and enhancement of national authorities' powers to respond to sources of systemic risk in a timely and adequate manner. The CNB's activities in the regulatory area stem from the fact that proposals for new regulations in the EU do not always take account of the features of the financial sectors of non-euro area countries and hence may not suit the comparatively small and conservative Czech financial sector. One example is the Bank Recovery and Resolution Directive (BRRD), especially the minimum requirement for own funds and eligible liabilities (MREL). The CNB has therefore been actively involved in the debate on the parameters of this tool. As the interpretation of legislation and standards has not yet been unified in the EU, the future configuration of the MREL for the domestic banking sector remains a potential risk.