



Dear Readers,

Our main publication in the area of financial stability and macroprudential policy is the *Financial Stability Report*, which we have published every June since 2005. It is the key document for the regular spring Bank Board meeting on financial stability issues. The 14th Report – the **2017/2018** edition – is now at your disposal. I am sure you will welcome this opportunity to get again hold of information about this currently very important area of supervision and regulation. This year's FSR focuses mainly on the risks that may arise in connection with prices of risky assets in global markets, the environment of low interest rates and the financing of property purchases. Significant space is devoted to macroprudential capital buffers and instruments aimed at mitigating systemic risk arising in connection with mortgage lending.

According to the Act on the CNB, maintaining financial stability is one of our key objectives. In accordance with the Act, the CNB identifies, monitors and assesses risks jeopardising the stability of the financial system and, in order to prevent or mitigate these risks, contributes by means of its powers to the resilience of the financial system and the maintenance of financial stability. It is primarily employs macroprudential policy tools to do so.

The CNB defines financial stability as a situation where the financial system operates with no serious failures or undesirable impacts on the present and future development of the economy as a whole, while showing a high degree of resilience to shocks. The CNB's definition is based on the fact that financial stability may be disturbed both by processes inside the financial sector that lead to the emergence of weak spots, and by strong shocks, which may arise from the external environment, domestic macroeconomic developments, large debtors and creditors, economic policies or changes in the institutional environment. Any interaction between weak spots and shocks can result in the collapse of systemically important financial institutions and in disruption of the financial intermediation and payment functions of the financial system.

The CNB's aim with regard to financial stability is to ensure a degree of resilience of the system that minimises the risk of financial instability. To fulfil this aim, the CNB as an integrated supervisory and monetary authority uses the instruments made available to it by the Act on the CNB, the Act on Banks and other applicable laws. Cooperation with other national and international authorities is also very important in this area. In order to maintain financial stability, the CNB focuses on prevention and broad communication with the public regarding the potential risks and factors posing a threat to financial stability.

The CNB regularly monitors and closely analyses developments in all areas relevant to financial stability. The members of the CNB Bank Board meet with experts from key sections at regular meetings on financial stability issues. A wide range of information on developments of risks in the domestic financial system and abroad is presented at these meetings. The position of the Czech economy in the financial cycle is assessed. If any risks to financial stability are identified, discussions are held regarding the possible use of regulatory, supervisory and other economic policy tools to suppress such risks or their potential effects.

The CNB is a member of the joint EU institution for the identification of systemic risks and macroprudential policy – the [European Systemic Risk Board \(ESRB\)](#). Together with three pan-European sectoral supervisory authorities (EBA, ESMA and EIOPA), the ESRB makes up the European System of Financial Supervision (ESFS). CNB representatives are involved directly in the ESRB's work; the CNB Governor and another board member are members of the General Board of the ESRB, and CNB experts

participate in its working groups. In line with an ESRB recommendation, macroprudential policy focuses on the fulfilment of several intermediate objectives. These objectives include (a) to mitigate and prevent excessive credit growth and leverage; (b) to mitigate and prevent excessive maturity mismatch and market illiquidity; (c) to limit direct and indirect exposure concentrations; (d) to limit the systemic impact of misaligned incentives with a view to reducing moral hazard; and (e) to strengthen the resilience of the financial infrastructures. According to an ESRB assessment, the CNB is one of the most active authorities in the EU countries as regards the use of macroprudential policy at the national level.

The macroprudential policy tools we use include above all a set of prescribed capital buffers for credit institutions. We set a countercyclical capital buffer and a systemic risk buffer for systemically important banks at regular intervals. In recent years, we have dealt intensively with risks associated with property market developments and mortgage lending. To mitigate these risks, we use a set of recommendations regarding the provision of mortgage loans. We are also pushing for a legislative change in this area, aimed at effective prevention of the relevant risks.

The FSR is based on an advanced analytical and modelling framework and contains a set of stress tests of individual segments of the financial sector and sectors of the real economy. The financial sector's resilience is tested by means of an adverse macroeconomic stress scenario entitled the *Adverse Scenario*. This scenario, whose probability is very low, describes the risk of a pronounced and long-lasting decline in domestic economic activity. 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. The *Adverse Scenario* also assumes a pronounced increase in long-term bond yields, which will result in financial institutions incurring losses due to market risk. The results of the tests performed on the basis of this stress scenario are compared with the *Baseline Scenario*, which is based on the CNB's official January forecast. The impacts of both scenarios are assessed not only from the perspective of the financial sector, but also with regard to the property market and the non-financial corporations and household sectors.

The FSR is divided into five sections followed by thematic articles that respond to selected topical issues relating to financial stability. The *Real economy and financial markets* section deals with the macroeconomic environment, property markets, corporations and households and analyses overall developments in the financial markets. The section called *The financial sector* discusses developments in the banking and non-banking financial sector. The *Stress tests* section assesses the resilience of sectors on the basis of stress tests and sensitivity analyses. The section *Macroprudential policy* contains an overall risk assessment, information on macroprudential instruments for mitigating risks identified, and an analysis of risks associated with developments in the regulatory environment.

On behalf of the Czech National Bank



Jiří Rusnok
Governor