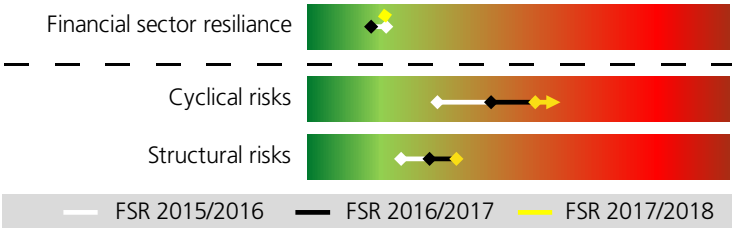
OVERALL ASSESSMENT



The Czech financial sector has developed highly favourably since spring 2017. According to the CNB's aggregate assessment presented in the macroprudential dashboard,[1] it has maintained a high level of resilience to possible adverse shocks. This is being fostered mainly by the maintenance of sufficient capitalisation, stable funding sources and an extensive buffer in the form of quickly available liquidity. As regards potential sources of risks to financial stability in the future, the macroprudential dashboard indicates that the CNB overall identifies a slight increase in cyclical risks and an unchanged level of structural risks. Domestic risks of a cyclical nature are emerging due to increased investment optimism typical of a long period of good times, and the vulnerability of the banking sector is increasing as a result. This is linked to a large extent with persisting favourable conditions for the development of a spiral between property prices and property purchase loans. The CNB is responding to the increase in cyclical risks on an ongoing basis by configuring relevant macroprudential instruments, specifically the countercyclical capital buffer and the conditions for mortgage lending. The CNB's monetary policy is also currently helping to mitigate these risks. A major potential risk – whose source, however, lies outside the domestic economy – is a sudden and disorderly increase in risk premia on global financial markets, which might lead to high volatility on asset markets with an impact on the real economy.

DEVELOPMENTS IN 2017 AND 2018 Q1

Solid growth of the global economy was reflected in favourable developments in the domestic economy, which is above its potential output level

The growth of the world economy exceeded forecasts in 2017, and the strong dynamics are expected to continue this year. In 2017, the euro area outpaced the average rate of growth observed in previous years, and its growth outlooks for 2018 are optimistic as well. However, differences in economic growth between the member states persist. The economic recovery remains particularly subdued in countries with high levels of indebtedness. Annual growth of the Czech economy stood at

1 The logic used to construct the macroprudential dashboard is described in Box 5 of FSR 2015/2016.

4.6% in 2017 and, according to the available estimates, was above its potential. According to the CNB's forecast published in Inflation Report II/2018, domestic economic growth will be above 3% this year and the next. The growth was fuelled largely by household consumption and also by growth in private investment. Favourable domestic economic activity, optimistic income expectations of both households and non-financial corporations and low interest rates affected the conditions and activity on the domestic credit market. Despite having cooled slightly, credit growth in the non-financial private sector is still above its five- and ten-year averages and remains above-average by comparison with other EU countries. It is being driven mainly by loans to households for house purchase. The year-on-year rate of growth of bank loans to non-financial corporations was volatile in 2017 and slowed slightly overall.

Financial conditions remain very relaxed despite the monetary policy normalisation process started by some central banks

Monetary policy rates remain low or negative in Europe. The ECB is continuing to pursue unconventional monetary policy. The easy monetary conditions are leading some euro area countries to delay tackling their high debt levels. In other countries, these conditions are contributing to a shift into the growth phase of the financial cycle, characterised by rapid growth in loans and property prices. Following three hikes in 2017, the US Federal Reserve increased its monetary policy rate further to 1.75% in March 2018. The market expects another two increases by the end of 2018. In response to the performance of the Czech economy and inflation, the CNB also tightened the monetary conditions. It raised its key monetary policy rate twice in 2017 and increased it further to 0.75% at the start of 2018. The tightening of monetary policy by the CNB was reflected only partially in client interest rates. The CNB forecast in Inflation Report II/2018 assumes that market interest rates will be flat this year and start rising in late 2018/early 2019.

Rapid growth in households' income improved their financial situation and encouraged strongly optimistic expectations…

Unemployment in the domestic economy hit record lows. In line with this, the income situation of households improved. The observed economic developments coupled with low loan interest rates are encouraging the emergence of optimistic expectations and increasing households' willingness to finance their expenditure through debt. A risk scenario going forward is a situation in which some households start to consider the current income growth to be permanent and succumb to the illusion that it will be easy to service the rising debt. Debt servicing costs remain sustainable due to low interest rates and rising income. However, growth in interest rates, the probability of which is increasing due to the global situation, may give rise to repayment problems in some indebted households. The stress test indicates increased sensitivity mainly in low-income households with a debt-service-to-income ratio of over 40%.

…but also squeezed the profitability of non-financial corporations

Buoyant wage growth fostered an increase in wage costs and is squeezing the profitability of non-financial corporations. Firms dealt with the shortage of labour and the related rapid wage growth partially by investing more in machinery and equipment. The main risk scenario for the non-financial corporations sector is a combination of continued rapid wage growth and exchange rate appreciation not accompanied by

corresponding labour productivity growth. This would gradually erode exporters' competitiveness and reduce demand for their products.

Czech government bond yields went up, especially at short maturities

In line with the increases in the CNB's monetary policy rates, Czech government bond yields went up in 2017. Short-term bond yields rose the fastest, causing the government yield curve to flatten slightly. This was probably due to a shift in foreign investors' interest towards medium-term bonds. Non-residents' share in Czech government bond holdings remains significant and stood at 35% in 2018 Q1 according to Czech Ministry of Finance statistics. The potential risk of volatility in Czech government bond prices remains elevated, as non-residents tend to react more sensitively to negative economic or other factors than domestic investors. Nevertheless, the results of the stress test of domestic public finances showed that this risk does not pose an immediate threat to the sustainability of Czech public finances.

Residential property prices continued to rise

Transaction prices of housing in the Czech Republic grew at the fastest pace in the entire EU for most of 2017. The average year-on-year growth rate of apartment prices was almost 16% in the individual quarters of 2017. The year-on-year growth started to slow slightly in 2017 Q4, but remained relatively high. At the same time, apartment prices considerably outpaced wages, so the affordability of apartments deteriorated. The high prices in the capital Prague were due mainly to a low rate of construction of new apartments, reflecting the slow process of issuing building permits. Prices of prime commercial property also increased in 2017. The historically low yields observed last year declined further for some types of commercial property.

The developments recorded in the domestic financial sector were positive in 2017

The developments recorded in the Czech financial sector were positive in 2017. Continued growth in economic activity was positively reflected in profitability, sustained adequate capitalisation and favourable liquidity of the banking sector. Insurance companies are also well capitalised and most of them are maintaining stable profitability. Investment funds are continuing to show dynamic growth. The importance of pension funds as a household investment vehicle is also increasing.

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

Conditions for the development of a spiral between property prices and property purchase loans persist

Since 2016, the CNB has identified a continued spiral between property prices and property purchase loans as the most significant domestic risk. The total stock of housing loans increased by almost CZK 100 billion last year. The year-on-year growth rate of genuinely new mortgage loans accelerated to more than 30% in 2017 Q1. It started to slow in June 2017. However, this result partly reflected base effects of 2016, and the effect of frontloading before stricter recommended LTV limits take effect may also be playing a role. The amount of new mortgage loans remains very high. The volumes of genuinely new mortgage loans started to rise again in early 2018 (by 7% year on year on average in Q1). The CNB's model-based approach indicates that housing prices were overvalued by around 14% at the end of 2017. The degree of the property price

overvaluation may in some cases be higher than the level of over-collateralisation implied by the current recommended LTV limits. Overall, the current settings of the recommended LTV limits should be sufficient to cover the relevant risks for the time being.

A slight increase in risks can also be observed in commercial property financing

The CNB's model-based estimate suggested that some types of commercial property were also slightly overvalued at the end of 2017 Q4. The share of loans for financing commercial property provided by domestic banks in the total loan volume is limited and the volume of new loans is not increasing. For these reasons, despite some easing of credit standards for such loans, the risks associated with commercial property markets pose no major threat to the stability of the Czech banking system.

High financial asset prices may be a source of market risks and increased volatility on global and national financial markets

A sudden and disorderly increase in the risk premium, leading to high volatility on asset markets, is still the main global risk to financial stability. This risk is being fostered by an increase in prices of some global financial assets above levels consistent with fundamentals. Risky corporate bonds have recorded a decline in risk premia to the levels observed in the years before the financial crisis. Stock prices are high both in historical comparison and also relative to expected corporate earnings. Owing to the significant share of non-residents in domestic asset holdings, the risk of a sudden repricing of investment assets is also present in the domestic financial system. The CNB assessed the severity of this risk by means of a simple simulation. The results showed that a decline in prices of investment assets would not represent a major disruption to financial stability in terms of the impact on individual institutions, but in the event of considerable market uncertainty and limited market liquidity it could contribute to the creation or multiplication of systemic risk in the form of mass sales of assets.

The situation of the domestic banking sector remains favourable

The banking sector is displaying adequate capitalisation and profitability and low ratio non-performing loan loan (NPL) ratio. The overall capital ratio of domestic banks rose further due to an increase in capital and a decline in aggregate risk weights. This is linked mainly with an increase in banks' exposures to the CNB. For banks applying the advanced IRB approach, the decline was also due to favourable economic developments, which the parameters of internal models reflect. If this trend were to be sustained, the decline in risk weights might ultimately increase the vulnerability of banks to adverse shocks. Risk weights of mortgage loans fell further to 22.9% despite the potential overvaluation of property prices. This level can be assessed as fairly low in relation to the risk weights of banks using the standardised STA approach.

Credit risk for bank loans is probably close to bottoming out

Credit risk, which is the principal source of potential losses in the domestic banking sector, has decreased further in terms of the backward-looking NPL ratio. The structure of NPLs has also improved. The provisions created by banks at the aggregate level seem to be sufficient to cover the current expected loss given default. Credit risk as measured by the 12-month default rate was flat year on year in the case of households and decreased slightly to a new historical low in the non-financial corporations sector and reaching. According to the *Baseline*

Scenario of the macroprudential test, however, credit risk in the non-financial private sector is not likely to fall any further and is expected to increase gradually (non-financial corporations) or remain flat (households).

The profitability of the banking sector remains high and is being positively affected by incipient growth in interest margins and low impairment losses

The slight increase in interest rates in 2017 interrupted the long-running downward trend in interest rate margins on new loans and is positively affecting the profit of the banking sector. The increase in earnings was also fostered by growth in profit from foreign currency operations and by a continued decrease in impairment losses. The performance of banks may be negatively affected by a turnaround in the growth phase of the economic and financial cycle.

Investment products are growing in importance in the non-bank financial sector, thus increasing its sensitivity to financial market corrections

A shift from insurance-based investment products to investment fund products continued to be visible in the non-bank financial sector in 2017. However, the related dynamic growth in the investment funds segment is associated with increased sensitivity to potential financial market corrections and possible impacts on the resilience of investment funds and their investors. Growth in the assets of transformed and mandatory conservative pension funds was accompanied by weaker profitability due to growth in government bond yields and a decline in the capitalisation of such funds. Despite recording more subdued growth, the insurance sector is maintaining its profitability and resilience to adverse shocks for the time being.

The interconnectedness of financial institutions has not increased and the structural component of systemic risk remains stable

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. The potential for contagion is also being suppressed by the banking sector's large liquidity buffer. The structural component of systemic risk was unchanged year on year. The concentration of property exposures in banks' balance sheets remains high. Such exposures account for just under 60% of total loans to the private non-financial sector. A further increase in concentration combined with a decrease in the risk weights of these exposures would lead to a rise in structural risk.

The domestic financial system was subjected in stress tests to a very adverse scenario assuming a severe recession

The resilience of the domestic financial system was verified by means of stress tests on banks and pension management companies using alternative economic scenarios. The *Baseline Scenario* is based on the CNB's forecast published in Inflation Report I/2018 and is considered by the CNB to be very probable over the three-year testing horizon. The probability of the *Adverse Scenario* is conversely very low. Its configuration reflects a rule stating that a higher level of stress should be applied at times of favourable economic growth than, for instance, in periods of recession. The *Adverse Scenario* assumes a sizeable fall in domestic economic activity accompanied by deflationary pressures and a rise in unemployment. 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.

According to solvency and liquidity stress tests, banks are highly resilient

The stress test results demonstrate that the banking sector remains resilient to adverse scenarios. While largely flat credit risk is consistent with the *Baseline Scenario*, 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. The level of these losses is affected, among other things, by the application of the IFRS 9 accounting standard in the stress test methodology. The banking sector currently has an adequate capital buffer which enables it to absorb relatively strong adverse shocks and maintain its overall capital adequacy above the regulatory threshold of 8%. The banking sector is also highly resilient to liquidity shocks. This is due to its strong client deposit base and high capitalisation on the liabilities side and to a significant proportion of exposures to the CNB on the asset side. The solid liquidity position of the domestic banking sector was confirmed by a liquidity macro stress test.

The risks to pension management companies decreased year on year due in part to a change in portfolios towards safer assets

The risks to pension management companies assessed in the stress test decreased year on year. Assuming identical exposures as in the test conducted last year, the application of this year's scenario would result in a smaller decline in the total assets of transformed funds. The impacts of the stress scenario were also reduced compared to last year by a change in portfolios towards safer assets. Pension management companies remain naturally vulnerable to adverse financial market developments.

MACROPRUDENTIAL POLICY

The domestic economy shifted further upwards in the growth phase of the cycle in 2018 Q1, albeit at a slower pace

When setting the countercyclical buffer rate, the CNB assesses credit growth and other indicators associated with the effect of the financial cycle. In December 2017, given the shift in the financial cycle and a rise in the domestic banking sector's vulnerability, the CNB announced an increase in the countercyclical capital buffer (CCyB) rate to 1.25% with a duty to apply this rate to domestic exposures as from 1 January 2019. The dynamics of some indicators (such as credit growth and housing price growth) in 2018 Q1 suggest that the economy might be close to the peak of the financial cycle. However, financial conditions remain very relaxed as regards the levels of most indicators, the volumes of new loans being provided to households are still high and prices of housing and some other assets remain overvalued relative to fundamentals. Overall, the CNB assesses cyclical indicators as indicating that the domestic economy has shifted further upwards in the growth phase of the cycle since the last decision to increase the CCyB rate was made.

Consistent with the overall assessment of the cycle and the potential sources of banking sector vulnerability mentioned below is a further increase in the CCyB rate to 1.50%

The potential systemic risks connected with the effect of the business and financial cycle are rising further. When discussing the appropriate setting of the CCyB rate, the Bank Board accentuated the effect of the good times the economy is currently experiencing. They are characterised by exceptionally low asset impairment losses, which may not be sustainable. The same goes for the risk mark-up in interest margins on loans and for the level of risk weights for some types of loans. Although banks are showing high profitability in the current favourable environment, their

vulnerability to a turn for the worse in the cycle is increasing. That vulnerability is being potentially increased by one of the effects of the switch to the new IFRS 9 accounting standard. It was supposed to be beneficial to financial stability from a long-term perspective, as the expected loss concept means that it creates conditions for early and sufficient provisioning against losses. However, IFRS 9 may also have a significant procyclical effect, as pointed out in an ESRB report published in July 2017.[2] A CNB macro stress test shows that the application of the expected credit loss concept in the *Adverse Scenario* leads to temporarily stronger impacts on capital than under the previous IAS 39 methodology. Following a sudden change in economic conditions leading to a marked reassessment of macroeconomic fundamentals, banks need to create a large amount of new provisions. This sharp increase may in turn cause sizeable losses and a fall in capital and contribute to a credit crunch. This effect may be partly dampened by compensation for the rise in provisions in the amount of regulatory capital. The overall assessment of the available information by the Bank Board was that a further increase in the CCyB rate to 1.50% with effect from 1 July 2019 is consistent with the current cyclical developments and the above-mentioned potential sources of banking sector vulnerability.

The CNB's approach to setting the CCyB rate is forward-looking and flexible; it is ready to lower the buffer immediately or release it fully should financial market tensions increase and jeopardise the smooth provision of loans to the sound part of the economy

Most banks meet the overall capital requirement consisting of the minimum regulatory level in Pillar 1, the requirements based on supervisory review of risks in Pillar 2 and capital buffers. Assuming reasonable dividend policies, banks have sufficient space for any increase in the CCyB and growth in their credit portfolios on an aggregate level. The CNB's decision on the CCyB rate is made using a set of quantitative approaches. However, it is always based on a comprehensive assessment of systemic risks, not on mechanistic application of the result of these approaches. The CNB stands ready to increase the countercyclical buffer rate further in the event of continued rapid credit growth, increasing risks connected with property purchase financing, a strengthening of other cyclical sources of systemic risk and a rise in the vulnerability of the banking sector. On the other hand, the CNB is ready to immediately lower the buffer or release it fully and allow it to be used as a capital buffer to cover losses if the business and financial cycles reverse and financial market stress intensifies, jeopardising the smooth provision of loans to the sound part of the economy. In addition to growth in new loans, the CNB will use indicators of financial market stress and indicators of the general availability of (unsecured) financing to assess the need to release the countercyclical capital buffer. These indicators are able to indicate a significant change in market conditions without any delay.

2 See Financial stability implications of IFRS 9, ESRB, July 2017

In line with the conclusions of the discussion in the BCBS, the CNB temporarily regards a leverage ratio excluding exposures to the CNB from the denominator for the calculation as a more relevant leverage indicator; at the same time, it has temporarily raised the minimum leverage ratio from 3.00% to 3.75%

The CNB is paying systematic attention to the leverage ratio. It is reacting to the conclusions of the discussion at the BCBS regarding the national discretion allowing central bank reserves to be temporarily excluded from the denominator of the leverage ratio under exceptional macroeconomic circumstances and the minimum required leverage ratio to be simultaneously recalibrated upwards under exceptional macroeconomic circumstances. This discretion is related to banks' high exposures to the central bank. Such exposures arose in some countries in connection with monetary policy, specifically quantitative easing and the use of the exchange rate commitment as an additional monetary policy instrument. The size of these exposures in some banks lead to could lead to non-compliance with the minimum leverage ratio requirement. Given the CNB's use of an exchange rate commitment as additional monetary policy instrument in 2013–2017, this topic is relevant to the Czech Republic, where banks' exposures to the CNB have increased substantially. In line with the conclusions of the discussion in the BCBS, the CNB temporarily regards a leverage ratio excluding exposures to the CNB from the denominator of the leverage ratio as a relevant leverage indicator. This is accompanied by a temporary rise in the minimum leverage ratio requirement from 3.00% to 3.75%. The CNB will regularly assess whether the reasons for this change persist and inform institutions about this in its publications.

Risks associated with the provision of mortgage loans persist

In view of the risks presented in the previous Financial Stability Reports, the CNB published a Recommendation on the management of risks associated with the provision of retail loans secured by residential property (the "Recommendation"). It sets quantitative LTV limits and qualitative criteria for prudential provision of such loans, primarily in the area of assessing clients' ability to service loans. The CNB assesses the risks associated with mortgage lending and banks' compliance with the Recommendation twice a year. The assessment based on data on loans provided in 2017 as a whole reveals that despite the positive effects of the tighter LTV limits in effect since April 2017, credit financing is a source of systemic risks which must be addressed with macroprudential policy instruments.

Banks were mostly compliant with the recommended LTV limits as from July 2017

The CNB responded on an ongoing basis to the increasing overvaluation of property prices, high growth rates of new mortgage loans and the results of analyses of lenders' approaches to the valuation of collateral by gradually lowering the LTV limits in the Recommendation. The reduction of the LTV limits was consistent with the rise in the estimated overvaluation of apartment prices, which is increasing the riskiness of mortgage loans with higher LTVs for mortgage lenders using less conservative valuation techniques. The CNB recommended that lenders should not provide loans with LTVs of over 90% (individual limit) and should limit the volume of new loans with LTVs of 80%–90% to a maximum of 15% (aggregate limit). The recommended LTV limits were reduced in a forward-looking manner based on the estimated overvaluation of apartment prices, which is increasing the riskiness of mortgages for mortgage lenders. An assessment of detailed data on new loans reveals that numerous institutions were non-compliant with the aggregate LTV limit in 2017 Q2, but the situation started to improve

significantly in June 2017. Loans with LTVs of 80%–90% accounted for 15% and 12% of lending in 2017 Q3 and Q4 respectively. Loans with LTVs of over 90% accounted for around 4% of credit production in the two quarters.

The CNB positively assesses banks' reaction to the tighter recommended LTV limits and does not deem it necessary to change the LTV limits at the moment

Given the signs of slowing growth in housing prices and the favourable trend in household income, the CNB does not deem it necessary to further tighten the recommended LTV limits at present. Despite lenders' delayed compliance with the stricter recommended LTV limits, the CNB considers the effect of its measures targeted at the risk of a spiral between housing prices and property purchase loans to have been positive. The adjustment by lenders to the recommended limits has led to a sharp increase in the proportion of loans with LTVs of 70%–80% at the expense of loans with LTVs of 80%–90%, to which the aggregate limit is applied. The stricter LTV limits have also caused the rapid growth in new mortgages to halt and made loans with high LTVs more expensive. In 2017, there was also a larger increase in rates on loans with riskier characteristics in terms of LTI and LSTI ratios. In year-on-year comparison, lenders started to take more account of clients' risk characteristics when setting interest rates. It cannot be ignored, however, that lenders may in some cases have an incentive to reduce the LTV level through an optimistic assessment of a property's value in order to get just below the individual or aggregate limit. The CNB regards the existing LTV limits as the limit as regards prudential hedging of potential risks. It will therefore monitor compliance with the principle of conservative collateral valuation and will require lenders to report purchase price data and the estimated values of properties being purchased.

Institutions are providing a significant volume of mortgage loans with riskier characteristics as regards borrowers' ability to repay debt from their current income

In addition to the LTV ratio, the CNB monitors LTI (loan-to-income) and LSTI (loan service-to-income) ratios for new loans. Given the possibility of obtaining data on applicants' total debt and debt service, lenders should have started, in line with the Recommendation, to monitor the DTI (debt-to-income) and DSTI (debt service-to-income) ratios, set internal limits for them and prudently assess loan applications on their basis at the start of 2018. In FSR 2016/2017, the CNB identified loans with a DSTI ratio of over 40% and a DTI ratio of over 8 as highly risky. The share of loans with an LSTI ratio of over 40% and/or an LTI ratio of over 8 remained broadly stable in 2017. Almost 10% of the loans had both ratios concurrently above the said levels. When reducing the volume of loans with LTVs of 80%–90%, lenders did not significantly reduce the volume of loans that simultaneously had an LSTI ratio of over 40% or an LTI ratio of over 8. Loans with a high probability of default and a potentially large loss given default were thus not reduced.

The potential risks in the area of borrowers' vulnerability necessitate an extension of the scope of application of the CNB Recommendation

Housing prices in the Czech Republic have tended to grow faster than the disposable income of households in recent years. This is being reflected in an increase in the amounts of loans needed to purchase housing and hence in the relative indebtedness of borrowers. Borrowers are thus becoming more vulnerable. Given the current housing prices, the likelihood of problem applicants with lower risk aversion seeking loans to an increasing extent is meanwhile rising. In the event of shocks in the form of a rise in interest rates or a drop in income, borrowers with higher

indebtedness or debt service could run into repayment problems. The CNB is therefore extending the Recommendation to include upper limits on the DTI and DSTI ratios. Both ratios are of critical importance. The DTI ratio is designed primarily to mitigate risks associated with excessive household debt, while the DSTI ratio is targeted at risks connected with excessive debt service of households.

The CNB has set recommended upper limits on the DTI and DSTI ratios of 9 times and 45% of the applicant's net annual income respectively with effect from 1 October 2018

According to the CNB's analyses, many borrowers with loans with DTIs of over 8 and DSTIs of over 40% do not have a sufficient financial reserve to maintain their ability to service their loans in the event of adverse changes in their income situation or in the level of interest rates. To mitigate these risks while not reducing the availability of loans, the CNB is supplementing its warning about the riskiness of loans with these DTI and DSTI levels by setting upper limits on the DTI and DSTI ratios of 9 times and 45% of the applicant's net annual income respectively. However, applications for loans with DTIs of 8 and DSTIs of 40% should still be assessed with an increased degree of prudence. In countries which apply DTI and DSTI limits, the relevant limits are set at similar or stricter levels. The CNB respects the fact that a small proportion of credit cases have specific characteristics and that strict insistence on the application of the set caps could lead to excessive regulatory hardship. It therefore considers it admissible to exceed the limits on the two ratios in exceptional cases for a maximum of 5% of the total volume of loans provided. These limits on the two ratios in combination with the 5% exemption do not constitute a constraint for most of the loans provided to date.

The CNB recommends that lenders should assess clients' loan servicing capacity if lending rates increase by 2 pp

The CNB Recommendation contains a provision that institutions should assess clients' ability to service loans from their own resources under adverse conditions (i.e. they should stress-test clients' ability to service the loan). A standard risk which should be tested is that of a rise in interest rates, which can occur in the event of loan refixation or refinancing. Given the need for equal treatment, the CNB has reconfigured the rule for this test so that lenders use interest rate at least 2 pp above the planned contractual rate.

The CNB intensified microprudential supervision in the area of credit institutions' practices in the provision of consumer credit

In 2017, the CNB increased the intensity of microprudential supervision of prudent provision of secured and unsecured consumer credit by credit institutions and the management of intermediary networks by individual credit institutions. In November 2017, it published a *Supervisory benchmark on the provision of loans to households by credit institutions* summarising principles for prudent lending and management of associated risks. CNB microprudential supervision responds to risk profiles differing from the CNB Recommendation (the volume of risk) and/or insufficient risk management processes relative to the Supervisory Benchmark using an additional capital requirement under SREP. The CNB will also start to focus on identifying banks' DTI and DSTI monitoring practices and on how elevated levels of these ratios are reflected in assessments of loan riskiness.

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

Given the lower legal force of the Recommendation, the CNB – in cooperation with the Ministry of Finance of the Czech Republic and in

line with ESRB and IMF recommendations – is preparing a new legislative proposal giving it the power to set risk parameters for house purchase loans. It contains the possibility of setting upper LTV, DTI and DSTI limits under the Act on the CNB. The CNB will base such limits on an assessment of housing loans, indicators of the potential overvaluation of housing prices and indicators of the resilience of the banking sector and the economy as a whole to adverse economic shocks. The proposal will be based on a compromise wording incorporating proposed amendments approved in the parliamentary budget committee in 2017. It is being prepared primarily for preventive reasons, as foreign institutions not subject to CNB supervision may also start to provide mortgages to a much greater extent in future. The only way to ensure a level playing field on the market in this situation is to set universal conditions for all lenders by law. This would enable the CNB to respond directly and quickly to non-compliance with the rules by applying remedial measures to all types of lenders. It is also vital for the CNB to have access to data on loans provided, as this will enable it to conduct effective checks of compliance with the relevant rules.

Numerous national authorities are vested with statutory powers regarding credit ratios

Limits on credit ratios are currently applied in various forms in numerous EU countries. The LTV ratio, for example, is currently limited in one way or another in 15 EU countries. The possibility of limiting credit indicators has been enacted in a number of countries. In some EU countries, macroprudential authorities have the right to set ratios but have not exercised it yet due to low risks.

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

Since 2015, the CNB has been applying an internal methodology for reviewing and evaluating the risk of systemic concentration of sovereign exposures under Pillar 2. It considers credit institutions' exposures to the Czech government to be systemically important and concentrated even though the share of these exposures to the total assets of these institutions declined from about 8.5% to 7.8% between March 2017 and March 2018. A public finance stress test confirmed that the current fiscal situation in the Czech Republic did 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 pays attention to risks associated with the activities of systemically important institutions

To maintain high public and investor confidence in the stability of the Czech banking sector and the financial sector as a whole, it is particularly important to keep sufficient capital buffers in banks that are systemically important by dint of their position and character. The CNB prescribes a systemic risk buffer for five banks at present. The CNB is obliged to review the setting of this capital buffer every two years. This review will be conducted in 2018 H2. Following this review, the buffer rates will be confirmed or adjusted for individual banks with effect from the start of 2019.

The CNB as a resolution authority has set general thresholds serving as a guide to selecting the preferred approach to resolution.

The CNB as a resolution authority is continuing to work on the implementation of a relevant framework and preventive mechanisms establishing a foundation for effective crisis resolution. The main aim of this framework is to ensure continuity of critical functions, prevent

adverse impacts on financial stability and protect public funds and insured depositors. In its areas of responsibility, the CNB therefore prepares relevant resolution plans for institutions and groups, or is involved in their preparation within colleges in the case of cross-border entities. Having regard to the differences in the nature of their business, their shareholding structures, legal forms, risk profiles, sizes and interconnectedness to other institutions, and the scope and the complexity of their activities, it is obvious that different institutions and groups require different approaches. The CNB has set general thresholds serving as a guide to selecting the preferred approach to the resolution of specific institutions or groups.

The debate about systemic risk beyond banking, specifically in insurance companies and investment funds, is gaining in intensity at EU level

Documents were produced at EU level in 2017 presenting the main types of systemic risk in the insurance sector: fire sales, termination of the provision of economically vital insurance products and the interconnectedness of insurance companies with the rest of the financial sector. Consequently, a question arose as to how suitable the existing microprudential instruments in insurance are for reducing these risks and whether new macroprudential instruments need to be prepared. In the case of investment funds, the ESRB produced a set of recommendations for the European Commission and the ESMA. These recommendations are aimed at limiting asset and liability liquidity mismatches and credit financing of investment funds and improving the quality of stress tests conducted by investment funds. The CNB agrees that it is necessary to address systemic risk beyond banking. However, macroprudential instruments must reflect the specificities of the non-bank sector in EU Member States. Sufficient decision-making powers should be left with national authorities.

The CNB regards stabilisation of the EU regulatory framework and adequate powers of supervisory and macroprudential authorities at the national level as priorities

The CNB's long-term priorities for the regulatory area are the stabilisation of the EU regulatory framework and ensuring that national authorities have sufficient powers to respond to sources of risks in a timely and appropriate manner. As regards the review of the macroprudential policy framework in the EU, the CNB supports an increase in the flexibility of the use of capital buffers when reacting to systemic risks at the national level. The CNB and the Czech Ministry of Finance were heavily involved in discussions about changing the cap on the O-SII buffer. Like a number of other states, the Czech Republic is proposing that the general cap increase to at least 3% and that the subsidiary cap be abolished or, as a bare minimum, raised to at least 1.5% above the buffer of the parent. The CNB has consistently pointed out that a lower level would not be sufficient to cover the systemic risk that some large banks pose to the domestic economy.