I. SUMMARY

The Czech financial sector developed highly favourably from spring 2019 onwards. The banking sector maintained high resilience to potential adverse shocks and entered the coronavirus crisis in good shape. The disruption to economic activity due to the coronavirus pandemic has fundamentally affected financial market conditions, giving rise to a risk of sizeable credit losses and a marked reduction in lending by banks. The government's stabilisation and support measures are providing liquidity to the real economy and preventing a precipitous wave of credit defaults. The CNB's measures are stabilising the debt service of the real sectors and supporting the liquidity of financial institutions in a preventive manner. Nevertheless, it must be expected that the income of many households and corporations will fall markedly. This may have a sizeable effect on their solvency. The risks will increase in particular after the loan moratorium ends, when households and firms with higher debt levels may become insolvent.

The capital position of the domestic banking sector was robust at the onset of the coronavirus crisis thanks to capital buffers and capital surpluses in excess of the regulatory requirements. However, owing to the coronavirus contagion and the related preventive measures, it has become clear that economic activity will deteriorate significantly during 2020. This will have an adverse effect on the quality of institutions' loan portfolios. In this situation, releasing the existing countercyclical capital buffer (CCyB) is one measure that – in combination with the postponement of dividend payments – can support banks' ability to finance the real economy without interruption. At its meeting on 26 March 2020, the CNB Bank Board therefore decided to lower the CCyB rate from 1.75% to 1% with effect from 1 April 2020. At its meeting on financial stability issues on 18 June 2020, it decided to reduce the CCyB rate to 0.5%. These actions support banks' ability to lend to non-financial corporations and households without interruption, and the CNB remains ready to release the CCyB fully.

With effect from 1 April 2020, the CNB relaxed its recommendation for the assessment of new mortgages. The LTV (loan-to-value) limit was increased to 90% and the limit on the DSTI (debt service-to-income) ratio was raised to 50%. The obligation to assess new mortgages according to the DTI ratio, which reflects the number of annual net incomes needed to repay all the household's debts, has been removed from the CNB recommendation for banks. At its June meeting, the Bank Board confirmed the LTV limit at 90%. Given the expected economic consequences of the coronavirus pandemic and the risk perceptions among banks and their clients, it decided to abolish the upper limit on the DSTI ratio with effect from July 2020. However, it continues to point out to lenders that loans can usually be regarded as very risky above certain DTI and DSTI thresholds. Lenders should therefore provide such loans with great caution and only to applicants who are highly likely to repay without problems.

ASSESSMENT OF RISKS TO FINANCIAL STABILITY ASSOCIATED WITH THE REAL ECONOMY AND FINANCIAL MARKETS

The "low-for-long" scenario is beginning to materialise in advanced countries

The global economy started to slow in 2019, and the same was true for the euro area. Central banks responded to the potential disinflationary pressures by discontinuing monetary policy normalisation, lowering their monetary policy rates, and broadening their quantitative easing programmes. Most central banks reacted to the onset of the coronavirus epidemic with a further reduction of monetary policy rates and numerous other support measures. The "low-for-long" scenario is thus materialising. The exceptionally low interest rates on the one hand are helping to reduce the risks stemming from the potentially sharp and protracted economic contraction, but on the other are greatly limiting financial institutions' interest income, profitability and capital generation. Before the crisis, the CNB had been making progress with monetary policy normalisation, having increased its key monetary policy rate nine times since August 2017 to 2.25% with effect from 7 February 2020. After the onset of the coronavirus crisis, this rate was lowered in three steps to 0.25% with effect from 11 May 2020. This led to a significant decline in long-term interest rates.

Yields on safe financial and real assets dropped further globally, and risk premia on risky assets were abruptly repriced

Yields on high-quality government bonds dropped further in 2019, due in part to monetary easing by major central banks, and were close to zero or negative. As a result, institutional investors continued to reallocate their portfolios into riskier

and less liquid assets, most notably shares, property and riskier corporate bonds. Following the outbreak of the coronavirus crisis, markets panicked and risk premia surged. Central banks and government responded with numerous measures, but these only partly stabilised the situation on financial markets, which were hit by sell-offs of risky assets as investors tried to flee to relatively safe assets and cash. Government bond yields declined further in many advanced countries, including the Czech Republic. However, institutional investors are facing a growing shortage of high-quality financial assets, as the share of high-quality government bonds held by central banks, be it in foreign reserves or, as in the case of the ECB, in quantitative easing programmes, is constantly increasing.

Many countries entered the coronavirus crisis with high private and public debt

Private and public debt was at historical highs in many countries at the end of 2019. In recent years, debt growth has been recorded in particular by emerging economies, China and some EU countries. Corporate sector debt has risen significantly in the USA. The adverse economic developments due to the coronavirus pandemic could cause some debtors to experience debt servicing problems via a decline in disposable income. The rapid introduction of massive liquidity assistance programmes and loan moratoria prevented a precipitous global wave of credit defaults. However, the pace of economic recovery remains highly uncertain and the risk of low economic growth might lead to an increase in credit risk in the years ahead. A lack of confidence in debt sustainability could result in a renewed increase in risk aversion and sell-offs of financial and real assets. A spiral of rising risk premia, falling prices, asset sales, and investor flight from the markets affected could result in both the financial sector and non-financial investors incurring high losses. At the same time, an increase in risk premia could be reflected in longer-term interest rates and significantly increase the cost of funding for both the private and public sector.

The domestic economy stopped growing for the first time in six years

The coronavirus contagion ended the favourable period for the domestic economy characterised since 2014 by solid growth, low unemployment, buoyant wage growth and accommodative financial conditions. The onset of the coronavirus pandemic and the subsequent anti-pandemic measures resulted in an economic downturn and a significant deterioration of the domestic economic growth outlook for 2020 and 2021. Macroeconomic risk is therefore the most significant source of risk to financial stability in the short and medium term.

Before the pandemic broke out, the non-financial corporations sector faced a gradual decrease in profitability but was still in relatively good financial condition

The profitability of non-financial corporations stopped falling in 2019, but had nevertheless dropped by 5 pp since 2015. The debt ratio remained constant over time, just below the peak recorded in 2013. Despite the decrease in profitability, the sector was in good financial condition overall. The stable situation observed in previous years changed dramatically after the outbreak of the coronavirus crisis at the end of 2020 Q1. Many firms got into liquidity difficulties due to the closure of business premises and a sharp fall in external demand. The government is trying to mitigate these problems with a set of support measures. Firms can also partly overcome them through increased use of operating or business loans. Despite the measures, net cash flows are likely to be significantly negative in some sectors of the economy, and the default rate will gradually increase. The re-introduction of quarantine measures and a slowdown in economic activity in the event of a resurgence of the epidemic in the Czech Republic and/or its trading partner countries represents the main risk to the non-financial corporations sector going forward. Non-financial corporations would enter a second wave of the pandemic in significantly less sound condition. A protracted economic slowdown caused by changes in the behaviour of households and non-financial corporations could also have an adverse effect.

The household sector faced a marked decline in income due to the state of emergency

The disposable income of households continued to record robust growth in 2019. Amid strong credit growth, this helped maintain the debt-to-income ratio at relatively low levels (around 60%). The consumer optimism of Czech households faded quickly after the coronavirus crisis broke out. Households' confidence in the economy dropped sharply at the beginning of Q2 as the negative consequences of the state of emergency gradually started to pass through to their income. Despite the government's support stabilisation and support programmes, some households saw a marked decline in income. This may have a sizeable effect on their solvency. The risks will increase in particular after the loan moratorium ends, when indebted households experiencing a sustained drop in income and high debt service may become insolvent. The situation will be aggravated by a gradual rise in the unemployment rate, which will have the biggest impact on low-income households, which often use consumer credit.

Credit risk in the private financial sector will see an abrupt reversal

Credit risk, as measured by the 12-month default rate, decreased slightly in the household sector and was flat in the non-financial corporations sector in 2019. In line with the favourable evolution of credit risk, the ratio of non-performing loans to total loans – measuring the materialisation of risks taken on in the past – also fell. After the coronavirus pandemic broke out, institutions took into account the change in economic conditions by reclassifying credit exposures into the

category of significantly increased credit risk and by increasing their expected credit losses. However, the expected credit losses in the sectors of households and non-financial corporations remain close to all-time lows in absolute terms. The previously muted response of expected credit losses reflects the application of flexibility in the regulatory and accounting frameworks, a more optimistic assessment of possible future economic developments, and the effect of economic stabilisation measures. Those measures are creating favourable conditions for dealing with the economic impacts of the coronavirus crisis and enhancing financial institutions' role in resolving them. However, they also require a balanced macroprudential policy response in the area of the banking sector's resilience, especially as regards capitalisation.

The domestic banking sector entered the recessionary phase of the financial cycle in good condition, but its resilience is largely dependent on capital surpluses

The domestic financial sector recorded growth in most segments in 2019, but the coronavirus crisis is likely to affect the rate of growth in 2020. The banking sector entered the recessionary phase of the financial cycle – accompanied by the coronavirus crisis – with a robust capital and liquidity position and strong profitability. Profitability was at a historical high but started to fall with the onset of the crisis due to emerging growth in credit losses. Their continued growth will further increase the pressure on profitability. The banking sector's capacity to absorb losses and lend to the real economy was supported by a reduction of the countercyclical capital buffer rate to 1% and subsequently to 0.5%. The capital surplus, whose major role in safeguarding the banking sector's resilience is indicated by the results of the Adverse Scenario of the macro stress test, therefore increased. In this scenario, in contrast to the Baseline Scenario, without capital surpluses most domestic banks – and the sector as a whole – would not meet the Pillar 1 and Pillar 2 capital requirements.

The domestic non-banking sector has shown resilience to systemic liquidity stress in connection with the coronavirus crisis

The financial market shocks resulted in liquidity stress for some domestic non-bank financial institutions. This stress, however, did not lead to systemic market failures. The risk of insufficient liquidity of domestic institutional investors was reduced by the extension of the CNB's instruments to include the option of conducting repo operations with non-bank financial institutions. Risks relating to increased volatility of market variables and the long-term impacts of the coronavirus crisis on demand for investment products nevertheless persist.

The insurance company and pension fund sectors have retained their stability

Insurance companies and pension management companies have stayed sufficiently capitalised following the outbreak of the coronavirus crisis. However, a prolonged economic decline and an environment of sustained low yields could affect insurance companies in both the life and non-life areas. The fall in asset prices on global financial markets did not halt the growth in the value of pension funds' investment portfolios. However, the low capitalisation of pension management companies relative to the size of their transformed funds makes them vulnerable in the event of a need to top up their funds. This vulnerability may be induced in particular by the potential volatility of Czech government bond prices.

The CNB expanded its preventive liquidity-providing facilities

A traditional strength of domestic financial institutions is their sufficient reserve of liquid funds. As a preventive measure, the CNB Bank Board nevertheless on 16 March 2020 amended the rules of the liquidity-providing monetary operations introduced in 2008 to support the domestic financial market during the global financial crisis. It decided that, starting 18 May 2020, these operations would be announced twice a week for two-week maturity and once a week for three-month maturity. Credit institutions' bids in these operations are fully satisfied at a fixed rate corresponding to the two-week repo rate, i.e. with a zero spread. The range of eligible collateral for these operations was broadened to include mortgage bonds. Following an amendment of the Act on the CNB, a liquidity-providing instrument was introduced for some non-bank financial institutions licensed by the CNB, again for preventive reasons. These institutions are now able to obtain liquidity in the form of two-week credit from the CNB at a fixed rate equal to the two-week repo rate plus 20 bp. This credit must be collateralised by Czech government securities or CNB bills.

The crisis will result in historically high government deficits and a sharp increase in government debt

The Czech Republic's expansionary fiscal policy has been strengthened to mitigate the effects of the coronavirus pandemic. Rising government spending combined with falling tax revenues will lead to a sizeable government budget deficit and an increase in government debt. If the *Adverse Scenario* of the public finance stress test were to materialise, the government debt-to-GDP ratio could increase by up to 19 pp at the three-year horizon. Despite the relatively comfortable position of Czech public finances due to the low government debt and high demand for the government's currently increased issuance activity, the sharp rise in debt entails risks to financial stability in the medium term. However, the results of the Czech public finance stress test do not currently indicate a need to require credit institutions to meet an additional capital requirement to cover the risk of systemically important exposures to the Czech government.

MACROPRUDENTIAL POLICY

The CNB responds to risks in the banking sector associated with the financial and business cycle by setting the countercyclical capital buffer

The countercyclical capital buffer (CCyB) is designed to increase the resilience of the banking sector to risks associated with the effect of the financial cycle. An appropriately set CCyB rate should help reduce the negative impacts of the manifestations of this cycle on the banking sector and in particular to maintain the stability of banks and their ability to lend to the real economy even in the event of adverse shocks. The CNB set the CCyB rate at 0.5% as of the end of 2015 and has increased it six times since then. A rate of 1.75% was applied to domestic exposures as from January 2020, to be increased to 2.0% as from July 2020. On 26 March 2020, based on an assessment that the coronavirus contagion and the related preventive measures were highly likely to significantly reduce economic activity, which would in turn have an adverse effect on the quality of institutions' loan portfolios, the CNB Bank Board decided to lower the CCyB rate to 1%. By taking this step, the CNB confirmed that it would implement macroprudential policy in such a way that banks have sufficient room to cover the expected increase in the business sector's need for financing.

Consistent with the assessment of cyclical risks and the degree of vulnerability of the banking sector made at the Bank Board meeting in June is a reduction of the CCyB rate to 0.5%…

The final decision on the CCyB rate is always a result of a comprehensive assessment of indicators of the financial cycle and the vulnerability of the banking sector and other factors affecting the sector's resilience. Following this assessment, the CNB Bank Board decided at its meeting on 18 June 2020 to reduce the CCyB rate to 0.5% with effect from 1 July 2020 (from the current level of 1%). The partial release of the CCyB will support banks' ability to lend to non-financial corporations and households. Most banks continue to be compliant with the overall capital requirement, consisting of the minimum regulatory level in Pillar 1, the requirements based on the supervisory review of risks in Pillar 2, and capital buffers, and have a sufficient spare lending capacity.

…but the CNB stands ready to fully release the CCyB

The CNB remains ready to release the CCyB fully. The direct signal for such a step will be the materialisation of cyclical risks accepted earlier as credit losses and an increase in risk weights.

The domestic economy has probably entered the recessionary phase of the financial cycle

The starting point for the Bank Board's decision on the CCyB rate was an assessment of the position of the domestic economy in the financial cycle. According to the aggregate Financial Cycle Indicator, the domestic economy was near the peak of the expansionary phase of this cycle in 2019. However, year-on-year growth in loans to the private non-financial sector slowed steadily during 2019, and a decline in genuinely new loans can be expected this year and the next as a result of the coronavirus crisis. Given the current markedly worse economic developments, it is highly likely that the domestic economy has entered the recessionary phase of the financial cycle this year. Newly accepted cyclical risks will thus continue to decline in the coming quarters.

The cyclical risks in banks' balance sheets remain elevated and will materialise in the coming quarters

The cyclical risks in banks' balance sheets increased in the preceding expansionary phase. Despite the sharp economic deterioration, the cyclical risks previously accepted in the banking sector are not materialising at the systemic level yet. This is due mainly to the stabilisation and support measures adopted by the government. However, the risks will doubtless materialise in the form of rising credit losses after the loan moratoria end. Risk weights are also likely to increase gradually in the coming years as the default rate rises. In this regard, the lowering of the CCyB rate is a forward-looking response to the expected adverse economic developments and will create room for banks to absorb their impacts.

Robust capital buffers are the basis for maintaining banks' stability

The main task of microprudential supervision and macroprudential policy in the current situation is to ensure that the banking sector is sufficiently resilient to the impacts of the coronavirus crisis – both those that have already been felt, and the long-term ones. The capitalisation of the Czech banking sector is still robust. Besides the combined capital buffer (the sum of the CCoB, the CCyB, the SRB and the O-SII buffer[1]), a capital surplus and earnings retained in accordance with the CNB's recommendations meanwhile form a significant part of the capital buffer in excess of the regulatory minimum.

The CNB regards the use of banks' capital buffers to absorb losses as natural and desirable

The CNB views the capital buffers defined in EU legislation as cushions to absorb banks' losses in bad times. Their release and use is associated primarily with the materialisation, or high probability of materialisation, of credit losses and

1 CCoB – capital conservation buffer, CCyB – countercyclical capital buffer, SRB – systemic risk buffer, O-SII – capital buffer for other systemically important institutions, G-SII – capital buffer for global systemically important institutions.

the effects of those losses on the capital position of banks. If systemic losses were to occur, the CNB expects it would first completely release the CCyB. It also expects that, where necessary, credit institutions will use the CCoB buffer to absorb potential losses, i.e. maintain their capital ratios at least at a level corresponding to the sum of Pillar 1, Pillar 2 and, where relevant, the current SRB. The CNB also does not rule out the use of the SRB buffer by systemically important institutions where necessary to maintain the smooth flow of credit to the real economy in very adverse economic situations. Overall, the CNB therefore considers it natural that, following the potential release of the CCyB, banks would temporarily not maintain the combined capital buffer in full and would use the CCoB and the SRB in order to be able to continue providing services to their clients in the event of strongly adverse developments.

The current buffers may not fully cover the increased risks and uncertainties of the present situation

The potential level of the banking sector's systemic losses depends on the future evolution of non-performing loans and the expected credit losses arising from them. However, besides the impact of macroeconomic risks on capital, the banking sector's resilience will be affected by previously approved and planned changes to EU regulations. One change scheduled to take effect next year will lead to a decrease in the capital buffers of domestic systemically important institutions. The CNB, like several other national macroprudential authorities in Europe, currently applies the SRB to mitigate risks associated with the systemic importance of institutions. After the transposition of CRD V/CRR II into Czech law, it will only be possible to use the capital buffer for other systemically important institutions (the O-SII buffer). As the CNB will be able to set the upper limit on the O-SII buffer no more than 1% above the foreign parent institution's O-SII or G-SII buffer rate as set by its domestic regulator, the O-SII buffer rates of some domestic systemically important banks will in all probability decline. The CNB will still be able to use the SRB to cover other types of structural risks.

Banks must apply a very prudent approach to capital management

Given the unfavourable economic outlook and the high degree of uncertainty about future developments, it is vital that banks apply a highly prudential approach to capital management. If the probability of macroeconomic developments following the *Adverse Scenario* were to increase, the capital buffers might not be sufficient to absorb the losses and the current capital surpluses might have to be used. In such a situation, premature use of a large proportion of banks' capital surplus could become a source of systemic risk. Banks should thus refrain from making dividend payouts and taking any other action that might jeopardise their resilience until both the acute and longer-term impacts of the coronavirus crisis disappear. The CNB stands ready to use all its supervisory and regulatory instruments to maintain the banking sector's high resilience and its ability to lend to the real economy.

The affordability of housing deteriorated in 2019 due to rapid growth in residential property prices

Previous *Financial Stability Reports* identified a spiral between credit financing of residential property purchases and rapidly rising residential property prices as a significant source of systemic risks in the Czech economy. Buoyant wage growth and favourable financial conditions for purchasing property boosted the attractiveness of investing in housing. The sustained property price growth may have increased the incentive for some households to buy property on credit and encouraged them to take on excessive debt in relation to income. A risk scenario going forward was a situation where a large proportion of households started to consider the current income growth to be permanent and succumb to the illusion that it would be easy to service increasing debt levels. Another risk was an assumption that house prices would continue to rise indefinitely. Property transaction prices continued to rise at a brisk pace of close to 9% year on year in 2019 Q4. As a result, the already low affordability of housing deteriorated slightly further despite robust growth in income. The overvaluation of apartment prices, which stood at 15%–25% at the end of 2019 by the CNB's estimation, also increased slightly. Available unofficial data for the initial months of 2020 suggest that the pandemic has not had a major effect on transaction prices so far, although the April and May statistics for Prague indicate a halt in price growth or even slight month-on-month declines. The estimate of future house prices is subject to significant uncertainty. Given the adverse developments in the real economy, however, there is potential for them to decrease in the quarters ahead. Commercial property prices also increased last year. They also have the potential to fall, especially in segments hit by the pandemic.

The CNB is responding to the risks associated with credit financing of housing by changing its macroprudential policy instruments

To mitigate the risks associated with credit financing of housing, the CNB has since 2015 been applying a set of rules formulated in its *Recommendation on the management of risks associated with the provision of retail loans secured by residential property* (the "Recommendation"). LTV, DSTI and DTI limits are the most visible part of these rules. Last year, banks were recommended not to provide such loans with LTVs of over 90% and to limit the provision of loans with LTVs of 80%–90% to 15% of new loans. Since October 2018, the CNB has also advised lenders not to exceed a DTI ratio of nine annual incomes and a DSTI ratio of 45%. For years, the CNB has been seeking the statutory power to set upper limits on mortgage loan ratios. The relevant legislative amendment is currently being discussed in the Czech Parliament.

The volumes of genuinely new mortgage loans were increasing until 2020 Q1

Following a surge in loans in the second half of 2018 linked with the media campaign accompanying the introduction of the DTI and DSTI caps, the volume of genuinely new loans (excluding refinanced and refixed loans) naturally dropped in 2019 H1. Besides adjustment to the DTI and DSTI limits, this decrease was due to a set of factors including frontloading before the limits came in, a continued deterioration in housing affordability owing to rising property prices, and undersupply of new apartments in cities. The market gradually recovered in the second half of 2019. In the first four months of this year, the volume of genuinely new housing loans and mortgage loans reached a record high compared with the same period in previous years. However, it can be expected that the impacts of the coronavirus crisis will manifest themselves in the months ahead and lending for house purchase will decrease. The spiral between debt financing of property purchases and optimistic expectations regarding future property price growth should halt as a result.

Banks were mostly compliant with the recommended LTV limits

The share of loans with LTVs of 80%–90%, which could account for a maximum of 15% of new loans last year, was below the recommended limit throughout 2019, averaging 11.6%. However, banks continued to provide some loans with an individual LTV of over 90%, the level above which no loans should be provided under the Recommendation. The share of these loans in total loans averaged 2.8% of new loans in 2019 as a whole, remaining relatively constant over time. In the second half of 2019, lenders took greater account of the level of risk undertaken when setting interest rates. The risk was reflected mainly in interest rates on loans with LTVs of over 80% where they simultaneously had a DTI ratio of over 9 or a DSTI ratio of over 45%.

Lenders also complied with the DTI and DSTI limits

The process of adjustment to the limits had been far from complete in 2018, whereas the average shares of loans with a DSTI ratio of over 45% and a DTI ratio of over 9 dropped to 5.4% and 2.9% respectively in 2019. Banks overall were therefore mostly compliant with these limits or, in the case of the DSTI ratio, were only very slightly above them. A reduction in the supply of loans to clients with higher additional debt and ensuing debt service can be regarded as the main channel of adjustment to the recommended limits for both ratios.

The CNB confirmed the LTV limit and abolished the DSTI limit

At the decision of the Bank Board, the recommendations for assessing new mortgages were relaxed with effect from 1 April 2020. The LTV was increased to 90% (from 80%), which means that applicants can have less money saved to buy a house. As of the same date, the DSTI limit was relaxed to 50% (from 45%). This reduced the level of income necessary for servicing a specific debt. The obligation to assess new mortgages according to the DTI ratio was removed from the CNB's Recommendation for banks. Since the expectations of a significantly adverse change in market conditions are materialising, the Bank Board decided at its meeting on financial stability issues in June to abolish the recommended DSTI limit with effect from July this year. At the same time, the Bank Board decided that it is not desirable at the moment to change the current recommended LTV limit of 90% (with the option of applying a 5% exemption) given the persisting overvaluation of house prices. The CNB assumes, given the expected economic impacts of the coronavirus pandemic, that lenders and their clients will be well aware of the risks and will act in a very conservative way. Nevertheless, based on the conclusions of its analyses and stress tests, the CNB continues to point out to lenders that loans can usually be regarded as very risky above certain thresholds (a DTI of 8 and a DSTI of 40%). Lenders should therefore provide such loans with great caution and only to applicants who are highly likely to repay without problems.

The CNB will publish additional detailed analyses of risks to financial stability and information about the macroprudential policy settings in December 2020 in its regular document *Risks to financial stability and their indicators – December 2020*, which will be an underlying document for the autumn Bank Board meeting on financial stability issues.