Czech banking sector stress test results
(August 2010)

Summary
The results of new stress tests of the Czech banking sector confirm that the banking sector remains resilient to potential negative shocks. The capitalisation of the entire sector would remain above the regulatory minimum of 8% even in an extreme and very improbable scenario combining a deterioration in economic activity and a decline of 50% in the value of the Czech banking sector’s exposures to indebted countries from the southern part of the EU.¹

1. Introduction
The Czech National Bank regularly conducts stress tests to assess the impacts of highly adverse and implausible future economic scenarios on the resilience of the domestic banking sector. This document presents the results of the August stress tests, which were conducted on the data as of 30 June 2010 and focus on the coming two years. In the assessment of resilience, the impact of future economic developments – represented by one baseline scenario and one stress scenario – on selected indicators of the banking sector’s soundness was tested.

2. Macroeconomic scenarios
The baseline scenario corresponds to the CNB’s official August macroeconomic forecast published in Inflation Report III/2010. This scenario assumes slow growth of the economy, a gradual increase in inflation towards the inflation target, moderate appreciation of the exchange rate and stability of short-term interest rates with gradual growth in rates as from the second half of 2011.

The Debt Crisis stress scenario captures a combination of weak economic activity in the Czech Republic and abroad (a W-shaped recession) and adverse financial market developments. Concerns regarding the sustainability of public finances will result in a rise in yields on Czech government bonds and rapid depreciation of the koruna. That will lead to an increase in inflation pressures, to which monetary policy will react by raising short-term interest rates. At the same time, a crisis on the government bond markets of the southern EU states is assumed, causing a decline of 50% in the value of the Czech banking sector’s exposures to these countries. This scenario is considered very extreme and highly improbable.

Charts 1–4 below illustrate the evolution of the key macroeconomic variables of the stress scenario compared to the baseline scenario.

¹ Italy, Portugal, Greece and Spain.
3. The impact of the macroeconomic scenarios on the banking sector

The ratio of non-performing loans (NPLs) to total loans in the non-financial corporations sector continues to rise even under the baseline scenario, nearing 10% in mid-2011. In the case of households, the NPL ratio is estimated to rise slightly by around one percentage point at the end of 2010 from 4.5% in June 2010. The NPL ratios predicted in the stress scenarios are much higher owing mainly to the weaker assumed economic activity (see Charts 5 and 6).

In the adverse Debt Crisis scenario, the increase in NPLs is reflected in relatively high loan impairment losses. This is exacerbated by losses caused by a decline in the prices of Czech government bond holdings and also by losses on exposures to the indebted southern EU states.
While the baseline scenario assumes that operating profit generation in the period ahead will remain roughly same as last year, the estimate of operating profits in the Debt Crisis stress scenario is roughly 30% lower. In the stress scenario some banks might thus get into a resultant loss-making situation, which will immediately cause regulatory capital to decline.

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Despite the relatively high credit and market losses in both macroeconomic scenarios, however, the banking sector as a whole remains stable and its aggregate capital adequacy stays constantly above the regulatory minimum of 8% (see Chart 7). This is achieved despite the conservative settings of many of the assumptions of the individual scenarios. Another reason is that the banking sector’s capital adequacy was almost 15% at the end of June.

In the Debt Crisis stress scenario, some banks could get into a situation of insufficient capital adequacy. To make up their capital adequacy to the regulatory minimum of 8%, all banks having their registered offices in the Czech Republic (i.e. excluding foreign bank branches) would have to increase their regulatory capital by just under CZK 3.5 billion (i.e. around 0.1% of GDP); this is an insignificant figure relative to the size of the sector.

Czech National Bank
Contact: financial.stability@cnb.cz
This document has been placed on the CNB website http://www.cnb.cz/en/financial_stability/stress_testing/index.html