

**Comprehensive Assessment of Implementation of the Core Principles for
Effective Banking Supervision in the Czech Republic as Performed by the
Czech National Bank to 30. 4. 2003**

June 2003

Degrees of Assessment

The scale of assessment is a four-degree one, ranging from the best to the worst, and is defined as follows:

1. “Compliant” means that there are no shortcomings in the legislation, in practical discharge of supervision or in internal regulations.
2. “Largely compliant” means that
 - a) there are minor shortcomings in the legislation and in practical discharge of supervision or in internal regulations, or
 - b) supervision is discharged, even though the practice of supervision is not based on standardised internal regulations.
3. “Materially non-compliant” means that
 - a) there are fundamental shortcomings in the legislation and in practical discharge of supervision or in internal regulations,
 - b) there is no legislation or regulations, but supervision is discharged, or
 - c) there is a legislative or regulatory framework, but practical discharge of supervision does not operate.
4. “Non-compliant” means that there is no legislative or regulatory basis and the discharge of supervision is insufficient.

Abbreviations of the Legal and Other Sources Used in the Material:

- Act no. 6/1993 Coll. on the Czech National Bank, in the wording of subsequent regulations (hereinafter only the “Act on the Czech National Bank”)
- Act no. 21/1992 Coll. on Banks, in the wording of subsequent regulations (hereinafter only the “Act on Banks”)
- Act no. 87/1995 Coll., on Savings and Credit Cooperatives and Certain Related Measures and on the Amendment to Act of the Czech National Council no. 586/1992 Coll., on Income Tax, in the wording of subsequent regulations (hereinafter only the “Act on Savings and Credit Cooperatives”)
- Act no. 513/1991 Coll., the Commercial Code, in the wording of subsequent regulations (hereinafter only the “Commercial Code”)
- Act no. 591/1992 Coll., on Securities, in the wording of subsequent regulations (hereinafter only the “Act on Securities”)
- Act no. 15/1998 Coll., on the Securities Commission and on the Amendment to Other Laws (hereinafter only the “Act on the Securities Commission”)
- Act no. 563/1991 Coll., on Accounting, in the wording of subsequent regulations (hereinafter only the “Act on Accounting”)
- Act no. 42/1994 Coll., on Supplementary Pension Insurance with a State Contribution and Amendments to Certain Acts, in the wording of subsequent regulations (hereinafter only the “Act on Supplementary Pension Insurance”)
- Act no. 71/1967 Coll., on Administrative Proceedings (Code of Administrative proceedings), in the wording of subsequent regulations (hereinafter only the “Code of Administrative proceedings”)
- Act no. 552/1991 Coll., on State Control, as amended by later regulations
- Act no. 254/2000 Coll., on Auditors and on the Amendment to Act no. 165/1998 Coll., in the wording of subsequent regulations (hereinafter only the “Act on Auditors”)
- Act no. 61/1996 Coll., on Some Measures Against the Legalisation of Proceeds from Criminal Activities and on the Amendment to Related Laws, in the wording of subsequent regulations (hereinafter only the “Act Against the Legalisation of Proceeds from Criminal Activities”)
- Act no. 219/1995 Coll., the Foreign Exchange Act, in the wording of subsequent regulations (hereinafter only the “Foreign Exchange Act”)
- Act no. 82/1998 Coll., on Liability for Damage Caused in the Exercise of Public Authority by a Decision or an Incorrect Official Procedure and on the Amendment to the Act of the Czech

- National Council no. 358/1992 Coll., on Notaries and their Activities (Notarial Code), in the wording of subsequent regulations (hereinafter only the “Act on Liability for Damage in the Exercise of Public Authority”)
- Act no. 65/1965 Coll., the Labour Code, in the wording of subsequent regulations (hereinafter only the “Labour Code”)
 - Act no. 140/1961 Coll., the Criminal Code, in the wording of subsequent regulations (hereinafter only the “Criminal Code”)
 - Act no. 124/2002 Coll., on Transfers of Funds, Electronic Payment Instruments and Payment Systems (Act on Payment Systems) (hereinafter only the “Act on Payment Systems”)
 - Decree of the Czech National Bank no. 166/2002 Coll., stipulating the Requisites of an Application for a Banking Licence, the Requisites of an Application for Consent of the Czech National Bank to the Acquisition or Increase of a Qualifying Holding in a Bank, to the Person Concluding a Controlling Agreement with a Bank or to the Person Performing a Legal Act Aimed at Control of a Bank and the Requisites of a Notification of a Decrease in a Qualifying Holding in a Bank or the Loss of the Position of the Controlling Person towards a Bank (hereinafter only the “Decree of the Czech National Bank no. 166/2002 Coll.”)
 - Decree of the Czech National Bank no. 333/2002 Coll., stipulating the Rules of Prudential Business of Controlling Persons on a Consolidated Basis (hereinafter the “Decree of the Czech National Bank no. 333/2002 Coll.”)
 - Provision of the Czech National Bank no. 2 of 27 April 2001 on the Standards of Liquidity Management of Banks (hereinafter only the Provision of the Czech National Bank no. 2/2001”)
 - Provision of the Czech National Bank no. 1 of 10 July 2002, stipulating the Minimum Requirements for Disclosure of Information by Banks and Foreign Bank Branches (hereinafter only the “Provision of the Czech National Bank no. 1/2002”)
 - Provision of the Czech National Bank no. 2 of 3 July 2002 on Capital Adequacy of Banks and Other Rules of Prudent Business on an Individual Basis (hereinafter only the “Provision of the Czech National Bank no. 2/2002“)
 - Provision of the Czech National Bank no. 3 of 30 July 2002 on Credit Risk Management in Banks (hereinafter only the “Provision of the Czech National Bank no. 3/2002”)
 - Provision of the Czech National Bank no. 4 of 30 July 2002 on Market Risk Management in Banks (hereinafter only the “Provision of the Czech National Bank no. 4/2002”)
 - Provision of the Czech National Bank no. 9 of 6 November 2002, stipulating the Rules for Evaluation of Receivables from Financial Activities, Creation of Provisions and Reserves and the Rules for Acquisition of Certain Types of Assets (hereinafter only the “Provision of the Czech National Bank no. 9/2002”)
 - Provision of the Czech National Bank no. 11 of 10 December 2002, stipulating the Requirements for Verification of the Management and Control System of a Bank, including its Risk Management System (hereinafter only the “Provision of the Czech National Bank no. 11/2002”)
 - Provision of the Czech National Bank no. 12 of 11 December 2002 on the Internal Management and Control System of a Bank (hereinafter only the “Provision of the Czech National Bank no. 12/2002”)
 - Official Notification of the Czech National Bank no. 2 of 31 January 2002 relating to the Issues of Conclusion of Controlling Agreements by Banks (hereinafter only the “Official Notification no. 2/2002”)
 - Official Notification of the Czech National Bank no. 22 of 13 December 2002 relating to Assessment of the Professional Competence, Trustworthiness and Experience of Persons Nominated to Positions in the Senior Management of Banks and Positions in the Management of Foreign Bank Branches (hereinafter only the “Official Notification relating to Assessment of the Professional Competence, Trustworthiness and Experience of Persons“)
 - Official Notification of the Czech National Bank of 16 December 2002 relating to Certain Regulations of the Provision of the Czech National Bank no. 11 of 10 December 2002, stipulating the Requirements for Verification of the Management and Control System of a Bank, including its Risk Management System
 - Official Notification of the Czech National Bank of 19 March 2003 relating to the Provision of Section 22 paragraph 3 of Act no. 21/1992 Coll., in the wording of Act no. 126/2002 Coll.

- International Accounting Standards (hereinafter only “IAS”)
- Financial Action Task Force on Money Laundering (hereinafter only “FATF”)

Basic Prerequisites for Effective Banking Supervision

Principle 1. An effective system of banking supervision will have clear responsibilities and objectives for each agency involved in the supervision of banks. Each such agency should possess operational independence and adequate resources. A suitable legal framework for banking supervision is also necessary, including provisions relating to authorisation of banking establishments and their ongoing supervision; powers to address compliance with laws as well as safety and soundness concerns; and legal protection for supervisors. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.

1(1): An effective system of banking supervision will have clear responsibilities and objectives for each agency involved in the supervision of banks.

Comprehensive Assessment of Part 1(1):

Compliant.

Essential Criteria

The Czech National Bank discharges banking supervision based on the Act on the Czech National Bank. The objectives and responsibilities of the Czech National Bank in the banking supervision area have been stipulated by this Act. The laws and secondary legislation, to the issuing of which the Czech National Bank has been authorised by the Act on the Czech National Bank and the Act on Banks, provide the minimum framework of prudential standards that banks are required to comply with. The Czech National Bank participates in the decision-making on problem situations of banks. The frequency of modifications to banking laws, specifically the Act on Banks, is sufficient in terms of the needs of regulation and discharge of supervision. The legal framework of the banking sector and banking supervision has been practically fully harmonised with the law of the European Community (EC).

Additional Criteria

The Czech National Bank has prepared a medium-term conception covering regulation and discharge of banking supervision, adopted by the Bank Board of the Czech National Bank. Annual working plans are based on the conception and their fulfilment is assessed every year by the appointed member of the Bank Board. A substantial summary of the conception content has been published on the website of the Czech National Bank. In addition to that, the Governor of the Czech National Bank submits twice a year a report on the activities of the Czech National Bank to the Parliament of the Czech Republic that includes also information on the banking sector and discharge of banking supervision. The Czech National Bank publishes quarterly information on the financial condition of the banking sector on its website, including basic prudential indicators for the banking sector.

Analysis of the Individual Criteria

Essential Criteria

1. Laws are in place for banking, and for (each of) the agency (agencies) involved in banking supervision. The responsibilities and objectives of each of the agencies are clearly defined.

Compliant.

Banking and discharge of banking supervision are regulated by the Act on the Czech National Bank and by the Act on Banks. Activities of banks on the capital market are also subject to supervision of the Securities Commission (Act on the Securities Commission) and activities of a bank as a depositary of a pension fund are subject to state supervision of the Ministry of Finance of the Czech Republic (Act on Supplementary Pension Insurance) and to the Securities Commission (Act on the Securities Commission). The issues concerning savings and credit cooperatives are solved by the Act on Savings and Credit Cooperatives. In accordance with the valid laws, however, these cooperatives are not banks and, therefore, are not subject to banking supervision of the Czech National

Bank and state supervision over them is discharged by the Office for Supervision over Cooperative Savings Banks. This is why the submitted assessment of the Core Principles for Effective Banking Supervision does not include assessment of supervision over cooperative savings banks. The Act on the Czech National Bank in Section 2 stipulates the objectives in the area of discharge of banking supervision and emphasises their conformity with the main goal of the activities of the Czech National Bank, which is care for price stability. The aim of the Czech National Bank in the area of discharge of banking supervision is stipulated in Section 2 paragraph 2 subparagraph d) as care for safe operation and purposeful development of the banking system in the Czech Republic. The range of entities which are subject to banking supervision is set down in the same sentence: “the Czech National Bank discharges banking supervision over the activities of banks, foreign bank branches and consolidated groups, a part of which is a bank having its registered office in the Czech Republic.” The Act, therefore, authorises the Czech National Bank to discharge supervision on an individual basis, to discharge consolidated supervision and to take measures to ensure safety and development of the banking system as a whole. Its competences in the area of discharge banking supervision in relation to the entities supervised are defined in Section 44 of the Act on the Czech National Bank. These competences involve assessment of applications for a banking licence, supervision over observance of the conditions given by the licence, supervision over compliance with the laws and prudential measures and imposition of remedial measures and sanctions.

2. The laws and/or supporting regulations provide a framework of minimum prudential standards that banks must meet.

Compliant.

Banking regulation is expressed by normative legal acts, or legal regulations, the basis of which is the Act on the Czech National Bank and the Act on banks. Some important regulatory rules are expressed directly as provisions of the Act on Banks. The provisions concerned are in particular the following (the enumeration is not complete):

- the duty of a bank to provide on its premises in the Czech language information on the terms and conditions of granting credits pursuant to Section 11 of the Act on Banks;
- the duty of a bank to proceed with prudence pursuant to Section 12 of the Act on Banks;
- prohibition of a bank’s membership in a limited partnership or in an ordinary partnership pursuant to Section 12 of the Act on Banks;
- prohibition to conclude agreements under conspicuously disadvantageous conditions for the bank pursuant to Section 12 of the Act on Banks;
- the duty to observe the limits of credit exposure pursuant to Section 13 of the Act on Banks;
- prohibition to exercise control over another legal entity and stipulation of limits for qualifying holdings of a bank pursuant to Section 17 of the Act on Banks,
- limitations with respect to persons having a special relation to the bank pursuant to Section 18 of the Act on Banks,
- provisions of the Act on Banks relating to the granting of prior consent of the Czech National Bank for the conclusion of an agreement on the sale of a business or a part thereof (Section 16, paragraph 1, subparagraph a)), for a decision of the general meeting to wind up the bank (Section 16, paragraph 1, subparagraph b)), for a merger of the bank (Section 16, paragraph 1, subparagraph c)), for reduction of the bank’s initial capital, unless it is a reduction of initial capital to cover a loss (Section 16, paragraph 1, subparagraph d)), for a resolution of the general meeting pursuant to Section 7a, paragraph 1, subparagraph c), i.e. for a decision that the bank will no longer carry out the activities for which it is necessary to have a banking licence, further for consent prior to acquisition of a qualifying holding in a bank or prior to increasing a qualifying holding in a bank so that it attains at least 20%, 33% or 50% of the initial capital or the voting rights, for consent to the person concluding a controlling agreement with the bank as the controlling person or a person or performing any other legal act aimed at control of the bank (Section 20, paragraph 3), for approval of an excerpt from the register of the issuer of book-entry shares, listing all shareholders and trustees prior to the holding of a general meeting (Section 20a,

paragraph 3), for the decisions of a conservator on matters within the powers of the general meeting (Section 29, paragraph 2), for the decision of a conservator to suspend, partially or fully, the transactions of depositors with their deposits in the bank (Section 29, paragraph 3),

- confirmation of the auditor selected by the bank (Section 22, paragraph 3).

The greater part of the regulatory rules, however, are expressed by normative acts of lower legal force, i.e. by decrees of the Czech National Bank and provisions of the Czech National bank.

A decree of the Czech National Bank is a secondary, generally binding legal regulation (which means that its operation is broader than that of a provision of the Czech National Bank and that it sets down generally binding rules also for non-bank entities), which is issued by the Czech National Bank on the basis and within the scope of its authorisation stipulated by a special act. The Czech National Bank is authorised to issue decrees by the laws (Act on the Czech National Bank, Act on Banks, Foreign Exchange Act, Payment Systems Act). A decree of the Czech National Bank is announced in the Collection of Laws.

A provision of the Czech National Bank is a secondary regulation which the Czech National Bank is authorised to issue on the basis of its authorisation included in Section 49b of the Act on the Czech National Bank. A provision is binding on banks and foreign bank branches and is announced in the Bulletin of the Czech National Bank.

3. There is a defined mechanism for coordinating actions between agencies responsible for banking supervision, and evidence that it is used in practice.

Not applicable, only the Czech National Bank discharges banking supervision.

Note: The activities of banks on the capital market are also supervised by the Securities Commission. Co-operation with the Commission is governed by the tripartite Agreement on Co-operation among the Czech National Bank, the Securities Commission and the Ministry of Finance of the Czech Republic in Discharge of Banking Supervision and State Supervision (see also Principle 1, Part 1(6)).

4. The supervisor participates in deciding when and how to effect the orderly resolution of a problem bank situation (which could include closure, or assisting in restructuring, or merger with a stronger institution).

Compliant.

The Czech National Bank participates in solving problem situations of banks by applying the means given to it by the Act on Banks. These means include: imposition of a remedial measure, introduction of conservatorship, revocation of the licence, consultations for investors regarding the regulatory environment, approving of significant investors entering banks (see Principle 4). The remedial measures imposed may also have a restructuring character (increase of the bank's initial capital, limitations on acquisitions of certain types of assets, limitations on execution of certain types of operations, *et alia*).

Note: The procedural rules for solving problem situations of banks are being modified at present. The procedural rules in question are the rules for:

- a) departure of banks from the sector, i.e. the so-called controlled liquidation,
- b) recovery of a (system-important) bank within the framework of conservatorship, *et alia*.

Ad a) The draft rules for controlled liquidation of a bank in the wording subdivided into sections were approved by the Bank Board of the Czech National Bank in July 2001 and the Czech National Bank has passed them on to the Ministry of Justice of the Czech Republic to be incorporated into the new bankruptcy bill. This act should contain a special regulation for bankruptcy of banks and other financial institutions.

Ad b) The Bank Board of the Czech National Bank has discussed a material on the institute of conservatorship. The material is still in the process of preparation. The principal problem in this area

rests in the question of application of the EC law for granting public support during the recovery of such bank.

5. Banking laws are updated as necessary to ensure that they remain effective and relevant to changing industry and regulatory practices.

Compliant.

The Act on Banks, which constitutes the basic norm for regulation of the banking sector, has been amended 14 times from its issuance in 1992 until the end of 2002, with the proviso that 11 of these amendments were of considerable importance for reinforcement of the powers of banking supervision or harmonisation of the Czech law with the EC law or for increasing of the protection of depositors. The Act on the Czech National Bank has been amended 6 times since 1993. Considerable progress has been gradually made in comparison with the state at the beginning of the transformation, so that after the Parliament of the Czech Republic in the first half of 2002 approved all legislation that had been prepared for harmonisation of the Czech legislation in the area of the position of the central bank, commercial banking and in the area of payments systems, a state of harmonisation of the Czech law with the EC law, which is required for accession of the Czech Republic to the European Union, has been attained - with some, very particular, exceptions. On the basis of this it is possible to state that the laws that constitute the basis of the legal form of banking regulation and banking supervision already meet the recognised international standards.

Additional Criteria

1. The supervisory agency sets out objectives, and is subject to regular review of its performance against its responsibilities and objectives through a transparent reporting and assessment process.

Compliant.

The Czech National Bank has prepared for the years 2002-04 a medium-term conception for the area of banking regulation and discharge of banking supervision, which was approved by the Bank Board of the Czech National Bank in the form of conceptions of both its banking supervision sections. Annual plans of each section link up with these conceptions. The content of the plan for the next year and the fulfilment of the plan in the past year are evaluated every year by an appointed member of the Bank Board and by the management and staff of the sections, which are materially interested in the fulfilment of the plan. As regards public relations the Czech National Bank issues every year a publication on banking supervision in which the development of the banking sector is analysed and the activities of the Czech National Bank in the area of banking supervision and regulation are described. The Governor of the Czech National Bank submits twice a year a report on the activities of the Czech National Bank to the Assembly of Deputies of the Parliament of the Czech Republic. This report also includes a passage on the banking sector and banking supervision. If necessary, the management of the Czech National Bank meets representatives of the Parliament of the Czech Republic more frequently. Decisions within the framework of licensing proceedings (granting of a licence, change of a licence, consent prior to the acquisition or increase of a qualifying holding in a bank, etc.) and also imposition of remedial measures on banks, except for Section 26 paragraph 1 subparagraph a) of the Act on Banks, are implemented in the form of administrative proceedings. All these decisions in administrative proceedings are reviewable by a court and every person or entity affected by them may bring the matter into court to be reviewed.

Note:

The Czech National Bank has established within the framework of its banking supervision sections a team that elaborates internal assessments of the activities of banking supervision and its decisions. Such team is operates in a number of foreign regulators, it is known as the Quality Assurance Unit.

2. The supervisory agency ensures that information on the financial strength and performance of the industry under its jurisdiction is publicly available.

Compliant.

The Czech National Bank publishes quarterly detailed information about the banking sector on its website. This includes a list of banks and foreign bank branches, a list of representative offices of foreign banks and information on the development of the number of banks, broken down by their ownership structure. The Czech National Bank also publishes quarterly information on assets and liabilities of the banking sector, its off-balance sheet activities, profitability and effectiveness, just as selected indicators of prudent business with respect to the banking sector. This comprises in particular the liquidity indicators, capital adequacy and data on endangered credits, which are supplemented with data on the covering of potential losses from endangered credits by provisions and collateral. The Czech National Bank also publishes indicators on the shares of bank groups in total assets, credits and deposits. Apart from this, the individual banks are obliged to disclose information on their activities. The Czech National Bank has issued for this purpose the Provision of the Czech National Bank no. 1/2002, which stipulates the minimum requirements on disclosure of information by banks and foreign bank branches.

1(2): Each such agency should possess operational independence and adequate resources.

Comprehensive Assessment of Part 1(2):

Largely compliant.

Essential Criteria

The Czech National Bank's independent position, corresponding with the EC law, has been laid down by the Act on the Czech National Bank. The act guarantees operational independence, personal independence and financial independence of the Czech National Bank, which the CNB makes use of in performance of all its statutory goals, i.e. including the banking supervision area.

Additional Criteria

The Bank Board is the top managing body of the Czech National Bank whose members are appointed by the President of the Republic for the statutory period, i.e. for six years. The Governor and the other members of the Bank Board may be recalled only in cases specifically defined by the law. No express disclosure duty of the recall reasons has been, however, stipulated.

Analysis of the Individual Criteria

Essential Criteria

1. There is, in practice, no significant evidence of government or industry interference in the operational independence of each agency, and in each agency's ability to obtain and deploy the resources needed to carry out its mandate.

Compliant.

The Czech National Bank, on the basis of the Act on the Czech National Bank, is independent. Its operational independence in discharge of banking supervision is ensured by the Act on the Czech National Bank, which in Section 9 paragraph 1 stipulates that: "the Czech National Bank and the Bank Board in fulfilment of the main goal of the Czech National Bank and in performance of other activities may neither accept nor require any instructions from the President of the Republic, the Parliament, the Government, administrative authorities or from any other person or entity". Personal independence is ensured by the manner of appointment, the length of the term of office and the statutory possibilities of recalling the Governor and the other members of the Bank Board stipulated in Section 6 of the Act on the Czech National Bank. The financial independence of the Czech National Bank is provided for by Section 1, paragraph 4 of the Act mentioned, which stipulates that the Czech National Bank shall manage independently, with professional care, property entrusted to it by the state, just as by the provision of Section 30, paragraph 2, which prohibits the Czech National Bank from directly granting credits or any other financial assistance to the Czech Republic, its authorities, territorial self-governing units, public-law entities and legal entities controlled by the state, by a territorial self-governing unit or a public-law entity, except for banks. Until now there have been no attempts to influence the independence of the Czech National Bank, nor any pressures which might affect the ability of the Czech National Bank to discharge banking supervision.

2. The supervisory agency and its staff have credibility based on their professionalism and integrity.

Largely compliant.

From the historical point of view, the authority of the supervisory and regulatory institutions in the Czech Republic is relatively low. In view of this fact it is not possible to state that the Czech National Bank, when discharging banking supervision, at present enjoys full confidence of the staff of commercial banks or the general public. It must continue its efforts to increase this trustworthiness and authority, even though it appears that in recent years there has been a positive change in the attitude of both the professional and lay public towards understanding of the role of the Czech National Bank in the area of discharge of banking supervision.

3. Each agency is financed in a manner that does not undermine its autonomy or independence and permits it to conduct effective supervision and oversight. This includes, *inter alia*:

- **salary scales that allow it to attract and retain qualified staff.**

Compliant.

Selection procedures for job vacancies in the Czech National Bank for the area of regulation and discharge of banking supervision indicate that interest in work in banking supervision markedly exceeds the offer of job vacancies. Staff turnover has markedly decreased during the recent four years. This also applies to the category of managers and key experts. The possibility of employment of CNB staff members in European institutions (European Commission, European Central Bank) appears as a challenge for the future.

- **the ability to hire outside experts to deal with special situations.**

Compliant.

The Czech National Bank disposes of sufficient human resources for its control activities, methodological activities, analytical activities and also for fulfilment of its other tasks in discharge of banking supervision (relations with domestic and foreign regulators, operation of a register of credits etc.) Besides, its units involved in methodological and analytical activities and those which discharge banking supervision may rely on the extensive professional background represented by other units of the Czech National Bank. Therefore, the need to hire external staff is low and applies to exceptional cases only. The use of so-called outsourcing of the fundamental activities in discharge of banking supervision is also hindered by legislative obstacles. Banks might refuse to provide internal documents and other information necessary for discharge of banking supervision to external staff members with regard to the fact that these persons would not be statutory staff members of the Czech National Bank. The Czech National Bank has employed and still employs the services of legal experts in connection with certain complicated legal cases, which arose in discharge of banking supervision. In the area of banking supervision, in particular for the purposes of incorporation of the EC law into the Czech banking regulation, for training of its banking supervision staff and for developing modern methods in discharge of banking supervision the Czech National Bank has repeatedly and to a significant extent availed itself also of the assistance of foreign experts, above all within the framework of the programs of co-operation with the European Union (Phare, the so-called Twinning).

- **a training budget and program that provides regular training opportunities for staff.**

Compliant.

The staff training system of the Czech National Bank operates and corresponds to the needs of life-long training, as regards innovations in the area of banking and in the area of banking supervision (risk management systems, amendments to legal regulations, amendments to accounting regulations, new Basle Accord, assessment of risk management models, coping with innovated software, language teaching etc.).

- **a budget for computers and the other equipment sufficient to equip its staff with tools needed to review the banking industry.**

Compliant.

The technological equipment and software of banking supervision is on a level which corresponds to the needs of discharge of banking supervision, analytical and methodological activities and any other activities related to discharge of banking supervision.

- **a travel budget that allows appropriate on-site work.**

Compliant.

Additional Criteria

1. The head of each agency is appointed for a minimum term and can be removed from office during such term only for reasons specified in law.

Compliant.

The supreme managing body of the Czech National Bank is the Bank Board, which is, therefore, also the top managing body for the banking supervision area. The Governor and the other members of the Bank Board are appointed by the President of the Republic for a period of 6 years and may be recalled only for reasons mentioned in Section 6 of the Act on the Czech National Bank.

2. Where the head of an agency is removed from office, the reasons must be publicly disclosed.

Materially non-compliant.

The reasons for recalling the Governor and the other members of the Bank Board are given by the law (see Section 6 of the Act on the Czech National Bank). The Act, however, does not stipulate explicitly the duty to disclose them in the case that the President of the Republic should decide to recall the Governor or any of the other members of the Bank Board. It is, of course, possible to presume that the President would substantiate such a significant decision in public and, therefore, this criterion is not assessed at the lowest degree, i.e. non-compliant. Fulfilment of this additional criterion would require an amendment to the Act on the Czech National Bank. Such amendment is not under preparation at present.

1 (3): A suitable legal framework for banking supervision is also necessary, including provisions relating to authorisation of banking establishments and their ongoing supervision.

Comprehensive Assessment of Part 1(3):

Compliant.

Section 44 of the Act on the Czech National Bank sets down the Czech National Bank's jurisdiction in discharge of banking supervision. That includes, *inter alia*, assessment of applications for banking licenses, supervision over adherence to the conditions of the granted licences and imposition of remedial measures and sanctions (including withdrawal of a licence). The Czech National Bank is authorised to issue secondary legislation, such as decrees and provisions – regulating the banking sector.

Analysis of the Individual Criteria

Essential Criteria

1. The law identifies the authority (or authorities) responsible for granting and withdrawing banking licences.

Compliant.

The authority entrusted with granting of banking licences is the Czech National Bank (the Ministry of Finance of the Czech Republic issues its standpoint to the application) – see Section 4 of the Act on Banks (establishment of a bank) and Section 5 of the Act on Banks (establishment of a foreign bank branch). The requisites of an application for a banking licence and the conditions for its granting are defined in detail in the Decree of the Czech National Bank no. 166/2002 Coll. The Czech National Bank also decides on the withdrawal of a banking licence, for which it will again request the standpoint of the Ministry of Finance of the Czech Republic. The withdrawal of a licence is governed by Sections 33 - 34 of the Act on Banks.

2. The law empowers the supervisor to set prudential rules administratively (without changing laws).

Compliant.

The Act on the Czech National Bank and the Act on Banks authorise the Czech National Bank to stipulate in its provision the rules of prudential business of banks and foreign bank branches and in its decree the rules of prudential business of controlling persons, the consolidated groups of which are subject to banking supervision on a consolidated basis, and the extent to which the individual types of controlling persons are subject to these rules and further the manner, extent and periodicity of submission of information by the entities included in the consolidated group. The issuance of such regulation does not require an amendment to the Act (see Principle 1, Part 1 (2), Essential Criterion 2).

3. The law empowers the supervisor to require information from banks in the form and frequency it deems necessary.

Compliant.

Pursuant to the provision of Section 41 of the Act on the Czech National Bank, the Czech National Bank is empowered for the purpose of discharge of banking supervision to request from banks information, which should be submitted in certain form, at certain terms and in certain manner. The Czech National Bank is also empowered to request any information within the framework of its on-site inspections. As regards information from banks submitted to the banking supervision, see also Principle 1, Part 1(4), Essential Criterion 3, no. 7, Essential Criterion 5 and also Principle 19, Essential Criterion 4.

1 (4): A suitable legal framework for banking supervision is also necessary, including powers to address compliance with laws, as well as safety and soundness concerns.

Comprehensive Assessment of Part 1(4):
Largely compliant.

Essential Criteria

The Czech National Bank is authorised under the Act on the Czech National Bank to discharge banking supervision (as well as to operate in certain other areas, such as foreign exchange control) as an administrative agency and it is empowered, *inter alia*, to ensure legal compliance of banks' activities where so authorised under the Act. The compliance includes, in the first place, compliance with the Act on Banks (but also e.g. compliance of both banks and non-bank entities with the Foreign Exchange Act, etc.). The same applies also to secondary legislation, i.e. decrees and provisions of the Czech National Bank. If the Czech National Bank identifies an infringement of the law or secondary legislation, it is authorised at law to impose a remedial measure or a fine. The Act on the Czech National Bank requires expressly that the Czech National Bank should care of safe functioning and purposeful development of the banking system in the Czech Republic. In discharge of banking supervision the Czech National Bank is authorised to use also qualitative judgements that are based on a series of qualitative standards for banking enterprise that are included in the Czech National Bank provisions and the Czech National Bank has been utilising the power. The system of standards regulating qualitative features of the activities of banks will be developed into the so-called comprehensive (or joint) provision on risk management. This provision of the Czech National Bank will be compatible with the law of the European Community (EC) and the recommendations by the Basle Committee on Banking Supervision that represent an internationally accepted standard for the area.

Analysis of the Individual Criteria

Essential Criteria

1. The law enables the supervisor to address compliance with laws and the safety and soundness of the banks under its supervision.

Compliant.

The Czech National Bank, by operation of law, has the duty to discharge banking supervision over the execution of banking activities and cares for safe functioning and purposeful development of the banking system in the Czech Republic. According to the diction of the Act on the Czech National Bank, discharge of banking supervision includes: a) assessment of applications for a banking licence, b) supervision over adherence to the conditions set down in these licences, c) control over adherence to the legal regulations and provisions issued by the Czech National Bank as well as to other Acts, provided that the Czech National Bank is authorised to do so, d) imposition of remedial measures and fines (44 paragraph 2). In connection with item c) it is necessary to note that Section 12 of the Act on Banks mentions that a bank, when performing its activities, is obliged to proceed with prudence, in particular to perform its business in a manner which is not detrimental to the interests of its depositors from the viewpoint of return of their deposits and which does not endanger the safety and stability of the bank.

2. The law permits the supervisor to apply qualitative judgement in forming this opinion.

Largely compliant.

The authority to apply qualitative judgments when assessing how a bank conducts its business, including the quality of the bank's management, derives from the diction of Section 26 of the Act on Banks which in paragraph 1 authorises the Czech National Bank to apply remedial measures if it detects any shortcomings in the activities of a bank. Paragraph 3 of the Section mentioned lists the facts which have the nature of a shortcoming in the activities of a bank. Among the shortcomings, the

identification of which is based on qualitative judgement, is infringement of the conditions stipulated in the licence or non-fulfilment of the conditions under which the licence was granted, in all areas where qualitative requirements for the risk management systems and the internal control system have been set down in them. The areas in which qualitative judgements are applied further include a number of activities, in the case of which an infringement or evasion of prohibitions can be stated (for example the prohibition of exercising control over another legal entity pursuant to Section 17 of the Act on Banks), just as the qualitatively formulated duties contained in the provisions of the Act on Banks or in the secondary legislation issued by the Czech National Bank. This includes for example ascertainment, whether the bank does not conduct business in a manner that is detrimental to the interests of its depositors or endangers its security and stability; whether the bank is not managed by persons who do not have sufficient professional qualification or are not trustworthy, etc. It is evident that ascertainment of such shortcomings relies in the first place on legal analysis, which will lead to qualitative judgement.

The Act on Banks in Section 26 includes among shortcomings in the activities of a bank, or among facts justifying the decision on the imposition of a remedial measure the following: the volume of reserves and provisions not sufficient to cover the risks ensuing from the bank's classified assets, a decrease in the bank's capital under the minimum level of initial capital stipulated by law, just as insufficient capital adequacy. The stating of these shortcomings requires that they are proven by an analysis of the financial condition of the bank in question, as reflected in its accounting, and that they are quantified. Even here, however, qualitative judgment is of cardinal significance. This relates in particular to justification of the opinion on the quality of receivables, on the value of collateral in relation to provisioning, etc. All of this is reflected, through revenues and expenses, in the bank's capital and capital adequacy.

On the basis of the Act on the Czech National Bank and the Act on Banks the Czech National Bank has stipulated in its provisions a number of fundamental qualitative standards for bank business. The provisions concerned include in particular:

- Provision of the Czech National Bank no. 2/2001 on the Standards for Managing Liquidity in Banks,
- Provision of the Czech National Bank no. 3/2002 on Credit Risk Management in Banks,
- Provision of the Czech National Bank no. 4/2002 on Market Risk Management in Banks,
- Provision of the Czech National Bank no. 12/2002 on the Internal Management and Control System (effectiveness from 1 July 2003).

These so-called qualitative provisions also include the Provision of the Czech National Bank no. 1/2002, stipulating the Minimum Requirements on Disclosure of Information by Banks and Foreign Bank Branches. The measures mentioned also cover a number of important aspects of operational risk. However, no comprehensive system of standards has been as yet created for this area.

3. The supervisor has unfettered access to banks' files in order to review compliance with internal rules and limits as well as external laws and regulations.

Largely compliant.

On the basis of the Act on the Czech National Bank and the Act on State Control the staff of the Czech National Bank entrusted with discharge of banking supervision have access to all documents of a bank in the course of on-site inspections. The right of the Czech National Bank to set down which information and background materials a bank is obliged to submit to the Czech National Bank on a regular basis is stipulated by the Act on the Czech National Bank (Section 41 paragraph 3). If necessary, the extent of this information and background materials may be adjusted by the Czech National Bank. The right of the Czech National Bank to access a bank's documents outside the discharge of on-site inspections is not sufficiently provided for in the legal regulations. In practice, cases of refusal to provide information outside the discharge of on-site inspections sporadically occur. Mostly, however, banks provide the information requested. The Czech National Bank will initiate an amendment to the respective provisions of the Act on Banks, so that access to a bank's documents outside the discharge of on-site inspections should be unequivocally provided for (see also Principle 7, Essential Criterion 5 and also Principle 19, Essential Criterion 4).

4. When, in a supervisor's judgement, a bank is not complying with laws and regulations, or it is or is likely to be engaged in unsafe or unsound practices, the law empowers the supervisor to:

- **take (and/or require a bank to take) prompt remedial action,**
- **impose a range of sanctions (including the revocation of the banking licence).**

Largely compliant.

The Act on Banks, *inter alia* in a link-up with the Act on State Control, starts from the fact that a remedial measure will be imposed upon ascertainment of a shortcoming in the activities of a bank. Pursuant to Section 26 of the Act on Banks the Czech National Bank has the right to apply remedial measures for example in the case when a bank breaches or evades the laws, the regulations and provisions issued by the Czech National Bank or conducts business in a manner which is detrimental to the interests of its depositors or endangers the security and stability of the bank or the branch of a foreign bank. In addition, the Act on Banks in Section 12 paragraph 1 stipulates that a bank is obliged in the performance of its activities to proceed with prudence, in particular to conduct its business in a manner which is not detrimental to the interests of its depositors from the viewpoint of the return of their deposits and which does not endanger the security and stability of the bank. In paragraph 2 it then stipulates that a bank must not conclude any agreements under conspicuously disadvantageous conditions for the bank, especially such that bind the bank to economically unjustified performance or performance which fails conspicuously to correspond to the counter-value provided and that any agreements concluded in contradiction with this provision are invalid. It is above all the provisions issued by the Czech National Bank which set down the standards for liquidity, credit risk and market risks management and the standards for the bank's internal control system (see above, Principle 1 Part 1(4), Essential Criterion 2) that contribute to the effective application of these provisions of the Act.

1(5): A suitable legal framework for banking supervision is also necessary, including ... legal protection for supervisors.

Comprehensive Assessment of Part 1(5):

Largely compliant.

Essential Criteria

Protection of the staff members of the Czech National Bank entrusted with discharge of banking supervision has been provided by the Criminal Code accordingly to the other staff members of public administration agencies and is guaranteed on principle by the constitutionally stipulated independence of the judicial authority. Apart from the diplomatic immunity institute ensuing from the international legal commitments of the Czech Republic, a higher level of protection (the immunity institute) is possessed only by selected individuals, or groups of individuals (the President of the Republic, members of the Czech Parliament (both MPs and senators), judges and, to a certain degree, also the Ombudsman).

Analysis of the Individual Criteria

Essential Criteria

1. The law provides legal protection to the supervisory agency and its staff against lawsuits for actions taken while discharging their duties in good faith.

Largely compliant.

In the Czech Republic it holds good that all citizens, except for the exceptions specified by the law, may be prosecuted for their actions. The protection from the point of view of criminal law is ensured as follows: the inspector or, as the case may be, any other member of the staff of the Czech National Bank during the discharge of supervisory activities has the position of a public figure, provided that in doing so he uses the authority which was entrusted to him within the framework of responsibility for the fulfilment of these tasks (for example, he may take an administrative decision or execute administrative supervision). On the other hand, this may also lead to a potential liability under the criminal law (for example to abuse of the authority of a public figure). If criminal proceedings are taken against a member of the staff of the Czech National Bank in the matter of a criminal offence, which the staff member allegedly committed in connection with discharge of banking supervision, the position of such staff member in the criminal proceedings is the same as that of any other citizen who allegedly committed a criminal offence. Increased protection in such cases would be improper from the moral point of view and contrary to the constitutional order of the Czech Republic from the legal point of view (only the President of the Republic, members of the Parliament (both MPs and senators), judges of the Constitutional Court and the Ombudsman possess, to a larger or lesser extent, immunity in terms of the criminal law).

The liability for (potential) damage caused in discharge of banking supervision (i.e. in performance of public authority by an unlawful decision or an incorrect official procedure) is provided for by the Act on Liability for Damage Caused During Performance of Public Authority by a Decision or an Incorrect Official Procedure. This liability is borne primarily by the state, not by an individual institution (the Czech National Bank) or a natural person – a staff member. The Act on Liability for Damage Caused During Performance of Public Authority stipulates the conditions, under which the state is liable for damage in the performance of public authority, etc. and in Section 6 paragraph 4 stipulates that the Czech National Bank represents the state in matters relating to its decisions in administrative proceedings or, as the case may be, to its incorrect official procedure. If the state compensates for the damage, it will require compensation in full from the Czech National Bank. This means that actions of the staff members of the Czech National Bank discharging banking supervision, just as the decisions they adopted in discharge of banking supervision, are imputed to the Czech National Bank. The Czech National Bank has the right of recourse (regress) against the authorised persons who participated in the adoption of the unlawful decision or in the incorrect official procedure and who wilfully breached their legal duties (this must be proven by the person requesting the regress compensation). The amount of this regress compensation against all members of the staff of the Czech

National Bank is limited by the Labour Code to a 4.5 multiple of the person's average monthly earnings at the maximum, unless the damage was caused by a wilful breach of a duty – see the provisions of Sections 172 – 186 of the Labour Code, which provide for liability of a staff member for damage. At that, the court may even decrease this limit. This possibility, however, cannot be taken into consideration, if the damage was caused by a wilful act.

The complete fulfilment of the criterion that requires, by operation of law, protection for the staff of banking supervision against prosecution for acts they performed in good faith when discharging their duties, would require a deep intervention in the legislation. Such amendment is not prepared at present.

Note: The term “action in good faith” is not used in the legislation relating to liability.

2. The supervisory agency and its staff are adequately protected against the costs of defending their actions while discharging their duties.

Largely compliant.

The Czech National Bank is adequately protected against the costs of (legal) defence of the decisions it adopted in the administrative proceedings by the fact that payment of these costs is a matter decided by the court. Simultaneously with deciding in the case, the court will also decide who will cover the costs of legal representation, etc. As a rule, the unsuccessful party to the dispute is obliged to cover the costs of the successful party (there are justified exceptions, when the court may decide otherwise). The staff members of the Czech National Bank do not bear the costs of judicial proceedings in matters relating to liability for damage caused in discharge of banking supervision, i.e. in performance of public authority, by an unlawful decision or an incorrect official procedure. If, however, the state or the Czech National Bank were obliged to pay compensation for the damage and would apply regress against the staff member in question, the respective staff member, if unsuccessful, may bear the costs of the potential proceedings on the regression payment. The staff members of the Czech National Bank, however, are not protected *ex ante* against the costs of criminal law disputes, if criminal proceedings in the matter of abuse of the authority of a public figure are conducted. What matters in this case is the result of the proceedings.

The complete fulfilment of this criterion would require a deep intervention in the legislation. Such amendment is not prepared at present.

1(6): Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.

Comprehensive assessment of Part 1(6):

Largely compliant.

Essential Criteria

Co-operation and information exchange between the Czech National Bank, the Securities Commission and the Ministry of Finance of the Czech Republic is provided by the Agreement on Co-operation between the Czech National Bank, the Securities Commission and the Ministry of Finance of the Czech Republic for the Performance of Banking Supervision and State Supervision over the Financial Market of 2003 that has replaced the previous agreement of 1998. The new agreement provides space for substantial expansion of the range of co-operation and reflects the progress achieved in building the legal framework of supervision of the financial system through harmonisation of the Czech law with the EC law. Harmonisation of the Czech law with the EC law enables also development of co-operation with international regulators. Co-operation agreements, so-called Memoranda of Understanding, have been signed with regulators from France, Austria, Federal Republic of Germany, Slovakia, the USA (New York State) and Belgium, while memoranda with regulators from Italy and the Netherlands are underway. Representatives of the Czech National Bank have been invited also to the relevant sub-committees of the European Union. Obviously, the system of agreements (memoranda) is not complete as yet and co-operation within the EU bodies has been just started. However, a fundamental progress has been achieved in this area. The effort for a deeper involvement of the Czech National Bank within the international regulator community, most importantly on a practical day-to-day level of co-operation, has continued successfully. The Act on Banks balances the institute of the bank secret protection, as well as the confidentiality institute protecting information acquired in discharge of banking supervision on the one hand and, on the other hand, requirements for co-operation with the investigative, prosecuting and adjudicating bodies, other domestic regulators, as well as requirements for international co-operation; the foregoing explains that the Act has been harmonised with the law of the European Community also in that respect.

Analysis of the Individual Criteria

Essential Criteria

1. There is a system of co-operation and information sharing between all domestic agencies with responsibility for the soundness of the financial system.

Largely compliant.

The co-operation and information sharing between the Czech National Bank, the Securities Commission and the Ministry of Finance of the Czech Republic is provided for by the Agreement on Co-operation between the Czech National Bank, the Securities Commission and the Ministry of Finance of the Czech Republic for the Performance of Banking Supervision and State Supervision over the Financial Market of 2003, which has replaced the previous agreement of 1998. The basic principles of the new agreement are:

- outgoing co-operation of the parties to the agreement without unnecessary formalities as the basic standard of mutual conduct,
- the duty to inform any other party to the agreement of any facts that might be of importance for it, if such facts are not known to it,
- coordination of the activities of the parties to the agreement, as regards supervision over the financial market as a whole,
- the rules for determining the agency responsible for supervision on a consolidated basis,
- the duties of the other parties to the agreement towards the agency responsible for supervision on a consolidated basis in discharge of consolidated supervision,
- co-operation in the area of licensing and granting of prior consents,
- coordination of the preparation of control plans and coordination of on-site inspections,

- possibility to ask another party to the agreement for execution of on-site inspections,
- mutual information sharing with respect to the imposed remedial measures and sanctions and the ascertained shortcomings in the activities which justify the imposition of the measures,
- provision of background data necessary for the conduct of administrative proceedings to the other parties to the agreement,
- a regular exchange of analytical information with respect to the sub-sectors of the financial market supervised,
- deeper co-operation in the creation of legislation and regulation,
- endeavour to eliminate double or multiple regulation of analogous relations and facts,
- coordination of co-operation with foreign regulators, with the bodies of the European Union and international institutions,
- authorisation to establish working teams for fulfilment of both long-term and one-off tasks and for fulfilment of the obligations ensuing from the agreement,
- establishment of a working team for each consolidated group, composed of representatives of those parties to the agreement which supervise at least one member of the consolidated group,
- an exchange of information may take place only on condition that the legal regulations concerning confidentiality of the staff of regulatory agencies are respected,
- each party will prepare an annual report on the situation in the sub-sector of the financial market it supervises; it is also possible to issue a joint report of the parties to the agreement on the situation in the financial sector,
- the agreement is published on the websites of all parties to the agreement.

Article XII of the Agreement is worth a special mention. This article anticipates the establishment of the so-called “Committee for the Coordination of Supervision over the Financial Market” (hereinafter the “Committee”), composed of two leading staff members of each party to the agreement. These members will meet whenever necessary, always, however, at least once a year. The subject of meetings of the Committee ought to be above all formation of general policies, conceptions and strategies of further discharge of supervision over the financial market in the Czech Republic, solution of serious system problems on the financial market and in discharge of supervision over it, evaluation of fulfilment of the obligations ensuing from the agreement and solution of any grave problems arising between the parties to the agreement from this agreement.

2. There is a system of cooperation and information sharing with foreign agencies that have supervisory responsibilities for banking operations of material interest to the domestic supervisor.

Largely compliant.

The legislative basis for co-operation with foreign regulators is the Act on Banks, which in Section 25 and Sections 38c to 38h authorises the Czech National Bank to exchange information on any facts that are essential for discharge of banking supervision over banks with cross-border operations and also provides for the possibility of execution of on-site inspections by the domestic agency of banking supervision in the host country. These legal regulations have been harmonised with the EC law. In practice, agreements on co-operation in discharge of banking supervision (so-called Memoranda of Understanding) have been concluded with foreign regulators from Austria, Federal Republic of Germany, France, Slovakia, the USA (New York State) and Belgium, while agreements with regulators from Italy and the Netherlands are underway. The negotiations of the agreements have considerably reinforced the mutual contacts between the staff of the institutions and expanded the possibilities of information sharing, which is now employed far more than in the past. The amendment to the Act on Banks, which has harmonised our act with the respective Directive of the European Union, has enabled conclusion of the above-mentioned agreements in the scope usual for regulators from countries of the European Union. It has thus enhanced their confidence in the Czech National Bank and shifted the importance of the co-operation onto the level of co-operation between regulators of the countries of the European Union.

3. The supervisor

- **may provide confidential information to another financial sector supervisor.**

Compliant.

Pursuant to Section 25a paragraphs 2 and 3 of the Act on Banks it is possible to provide information acquired in connection with discharge of banking supervision to an agency supervising financial institutions or financial markets in the home country or to an agency supervising banks, financial institutions or financial markets in another state.

- **is required to take reasonable steps to ensure that any confidential information released to another supervisor will be considered as confidential by the receiving party.**

Compliant.

The Act on the Czech National Bank or, as the case may be, the Act on Banks, does not require this. The reason is that it is presumed that the Czech National Bank and its staff in discharge of banking supervision are bound by confidentiality and that this obligation also applies to the agencies of state supervision over the capital market and non-bank financial institutions and their staff. Domestic regulators are bound by confidentiality pursuant to Section 73 of the Labour Code (Basic Duties of State Administrative Authorities Staff Members) and other special acts (for instance the Insurance Act), and also the Agreement on Co-Operation between the Czech National Bank, the Securities Commission and the Ministry of Finance of the Czech Republic for the Performance of Banking Supervision and State Supervision in Article 25 requires maintenance of confidentiality with respect to the information provided. A provision on the duty to maintain confidentiality with respect to the information acquired within the framework of co-operation with an agency of banking supervision of another state is incorporated in each of the agreements which the Czech National Bank concluded with foreign agencies of banking supervision and also in drafts of the agreements which are still the subject of negotiations. The entities must have at least the same level of the obligation of confidentiality as the Czech National Bank pursuant to Section 25a paragraph 6 of the Act on Banks.

- **is required to take reasonable steps to ensure that any confidential information released to another supervisor will be used only for supervisory purposes.**

Compliant. See above.

This is ensured in an analogous way as in the previous case.

4. The supervisor is able to deny any demand (other than a court order or mandate from a legislative body) for confidential information in its possession.

Compliant.

The Czech National Bank in discharge of banking supervision is obliged to maintain confidentiality as required by the Act on Banks. Pursuant to Section 25a paragraph 1 of the Act on Banks all persons executing banking supervision or conservatorship are obliged to maintain confidentiality with respect to any data acquired in connection with discharge of their profession, employment or function. They may provide to third parties only information in summary form, in which it is not possible to identify which specific bank or person/entity it relates to. The obligation of confidentiality continues even after the termination of the profession, employment or function. The Act on Banks at the same time enumerates the agencies and persons/entities to which it is possible, under the statutory conditions, to provide such information. Pursuant to Section 25a paragraph 2 information acquired in discharge of supervision may be used only for the fulfilment of the tasks of banking supervision, conservatorship or in judicial proceedings in the matter of an action against a decision made in connection with discharge of banking supervision or analogous proceedings before an international body. Paragraph 3 of the same section enables co-operation with domestic and foreign regulators by stipulating that provision of the information acquired in connection with discharge of banking supervision by an agency executing supervision over financial institutions or financial markets in the home country or an agency executing supervision over banks, financial institutions or

financial markets in another state is not considered a breach of the obligation of confidentiality, provided that the statutory conditions are observed. Paragraph 4 of the same Section mentions other agencies and persons/entities having their registered office in the Czech Republic and in member states of the European Union to which a provision analogous to paragraph 3 applies. As regards the statutory conditions, there are two: firstly, pursuant to Section 25a paragraph 6, provision of confidential information to another party is possible only on condition that the counter-party, or the respective institution, will be subject to a regime for protection of information to the extent of the domestic Act on Banks at the minimum and, secondly, provision of such information is possible only if the Governor of the Czech National Bank exempts the person from the obligation of confidentiality. For, on parallel lines with the provisions of Section 25a of the Act on Banks, the provision of Section 50 paragraph 1 of the Act on the Czech National Bank is also applied, which stipulates that the staff of the Czech National Bank are obliged to maintain confidentiality in official matters even after the termination of their employment or any other analogous relation. Pursuant to Section 50 paragraph 2 of the Act on Banks the staff of the Czech National Bank may be exempted from this duty by the Governor of the Czech National Bank only on the grounds of the public interest.

Granting of Licences, Ownership Structure of Banks and their Affiliations with Other Entities

Principle 2. The permissible activities of institutions that are licensed and subject to banking supervision as banks must be clearly defined, and the use of the word “bank” in names should be controlled as far as possible.

Comprehensive Assessment:

Compliant.

Essential Criteria

The term “bank” is defined in the Act on Banks. A problem of a kind is represented by the actual enforceability of compliance with the Act on Banks in terms of protection of the name “bank”. The Czech National Bank does not consider this issue a priority as no material problems have occurred so far in practice that would result in any considerable damaging of depositors by an entity that would accept deposits without a licence. Admissible activities of banks have been defined by the Act on Banks. In the interest of achieving a uniform diction of banking licences, works on re-licensing of banks have been commenced in line with the harmonising amended version of the Act on Banks.

Analysis of the Individual Criteria

Essential Criteria

1. The term “bank” is clearly defined in law or regulations.

Compliant.

Laws and Regulations:

The Act on Banks in Section 3 stipulates that the words “bank” or “savings bank”, their translations or words containing those words in their basis may only be used in the business name of a legal entity which has been granted a banking licence, unless it is obvious from the context in which the word “bank” or “savings bank” is used that such entity is not engaged in activities listed in Section 1 paragraph 1 of the Act on Banks. The provision of the quoted Section 3 paragraph 1 does not apply to legal entities, the business name or designation of which are well established or recognised by law or on the basis of an international treaty. The Czech National Bank may impose in accordance with Section 46 ff. of the Act on the Czech National Bank in administrative proceedings a measure aiming at a remedy of the shortcomings ascertained (a change of the proposed business name) or a fine up to the level of CZK 1 mill., depending on the materiality of the shortcoming ascertained. The procedure is initiated on the basis of a proposal or at the Czech National Bank’s own instance. The practice of systematic monitoring (for example of the daily press) has not been introduced for the time being.

Discharge of Supervision:

The powers the Czech National Bank has towards entities using without authorisation the words “bank” or “savings bank” in their business names are in a number of cases ineffective in practice. The first step of the Czech National is usually an invitation to change the business name, addressed to the entity in question. If the company does not do so, the Czech National Bank may impose a fine on it in administrative proceedings. In a number of cases, however, it will turn out that mail sent to the given company is undeliverable. In this connection it is necessary to note that this is a marginal problem, no major difficulties have been registered. The next step is enabled by Section 32 of the Commercial Code, which gives courts or other authorities the right to draw always the attention of the registration court to any discrepancy between the actual legal state and the state of entries in the Commercial Register. If the content of an entry in the Commercial Register is inconsistent with a cogent provision of law, and it is not possible to attain a remedy, the registration court shall invite the person to which the entry refers to remedy the matter. If the person is a legal entity and this entity does not remedy the matter within the stipulated term, the court may, even without a proposal, provided that such procedure is in the interest of protection of third parties, decide on its winding up and liquidation.

2. The permissible activities of institutions that are licensed and subject to supervision as banks are clearly defined either by supervisors, or in laws or regulations.

Compliant.

Laws and Regulations:

The activities a bank may perform are mentioned in Section 1 of the Act on Banks. A bank may not perform other business activities than those permitted to it in its licence, unless stipulated otherwise by law. This does not apply to activities performed for another entity, on condition that they are connected with ensuring the bank's operation and the operation of banks, financial institutions and businesses providing ancillary banking services, over which the Bank exercises control. The inconsistency of the terms used in different acts (for example the Act on Securities and the Act on Banks) sometimes causes problems in granting of a licence.

3. The use of the word “bank” and any derivations such as “banking” in a name are limited to licensed and supervised institutions in all circumstances where the general public otherwise might be misled.

Compliant.

Laws and Regulations:

The prohibition to use the words “bank” or “savings bank”, their translations or words derived from them is stipulated by the Act on Banks in Section 3. Other entities that may accept deposits pursuant to a special act (the Act on Savings and Credit Cooperatives) are not allowed to use the word “bank” and words derived from it in their names. The entities concerned are not regulated by the Czech National Bank.

4. The taking of “proper” deposits from the public is reserved for institutions that are licensed and subject to supervision.

Compliant.

Laws and Regulations:

Deposits may be accepted only by banks - Section 2 paragraph 1 subparagraph a) of the Act on Banks – and further by credit and savings cooperatives, by the latter, however, with the limitations given by the Act on Savings and Credit Cooperatives.

Note:

Apart from the Act on Banks, which governs licensing and business activities of banks, banking supervision and insurance of deposits in banks, yet another act is in effect in the Czech Republic, the Act on Savings and Credit Cooperatives, which provides for the position and activities of savings and credit cooperatives (so-called cooperative savings banks), for insurance of members' deposits in cooperative savings banks and supervision over the activities and economic management of cooperative savings banks. Cooperative savings banks are subject to another regulatory agency, the Office for Supervision over Cooperative Savings Banks, and are registered by this office. The institutions registered pursuant to the Act on Savings and Credit Cooperatives are not allowed to use the word bank and words derived from it in their names.

Principle 3. The licensing authority must have the right to set criteria and reject applications for establishments that do not meet the standards set. The licensing process, at a minimum, should consist of an assessment of the banking organisation's ownership structure, directors and senior management, its operating plan and internal controls, and its projected financial condition, including its capital base; where the proposed owner or parent organisation is a foreign bank, the prior consent of its home country supervisor should be obtained.

Comprehensive Assessment:

Largely compliant.

Essential Criteria

The current provisions on licensing meet standard requirements on entities applying for a banking licence, i.e. the following are considered: ownership structure of the bank and transparency of proprietary and personal relations of the bank's shareholders, capacity of persons with a qualifying holding in the bank to exercise the shareholder's rights at the bank's business, origin of the initial capital, proposed strategy and business plan, quality of the nominated senior management, technical and organisational basis for the bank's operation, including management and control systems of the bank.

Additional Criteria

As a part of the licensing proceedings, also the capacity of owners to bring in additional capital is evaluated. When considering eligibility of managers, the area of their responsibility within the bank is also taken into account. New banks are monitored in the same way as the other banks. The Czech National Bank does not deem it necessary to have any special monitoring procedures for new banks. However, in the course of initial months following the commenced operation of a bank or branch, a more frequent communication between such bank/branch and the Czech National Bank is foreseen.

Analysis of the Individual Criteria

Essential Criteria

1. The licensing authority has the right to set criteria for licensing banks. These may be based on criteria set in law of regulation.

Compliant.

Laws and Regulations:

The basic requirements for granting a banking licence to a bank or a foreign bank branch are stipulated by the Act on Banks in Section 4 (establishment of a bank) and Section 5 (establishment of a foreign bank branch). The requisites of an application for a banking licence are specified in detail in the Decree of the Czech National Bank no. 166/2002 Coll.

2. The criteria for issuing licences are consistent with those applied in ongoing supervision.

Compliant.

Laws and Regulations:

The criteria and procedures for granting a licence are consistent with those applied within the framework of systematic supervision, i.e. they correspond to the requirements which are applied in discharge of supervision and which banks must fulfil in their activities. This means that in licensing and in discharge of supervision practically the same criteria are applied for assessment of persons in the bank's management, for approving the shareholders acquiring a qualifying holding, for evaluation of the bank's regulatory basis, for assessment of the bank's business strategy etc. The minimum amount of initial capital for the establishment of a bank is set down in Section 4 paragraph 1 of the Act on Banks at CZK 500 mill. CZK, and at least to this level the capital must be paid up by pecuniary deposits. Section 12 paragraph 4 of the Act on Banks stipulates that a bank's capital must not drop below this minimum.

3. The licensing authority has the right to reject applications if the criteria are not fulfilled or if the information provided is inadequate.

Compliant.

Laws and Regulations:

The right to reject an application for a banking licence ensues from Section 4 paragraph 3 and Section 5 paragraph 4 of the Act on Banks, in which the conditions are set down that must be fulfilled for the granting of a banking licence. The requisites of an application stipulated in the Decree of the Czech National Bank no. 166/2002 Coll. specify these conditions further; the stipulated requisites represent a set of documents, specific background data and information, which the applicant is obliged to submit and on the basis of which the Czech National Bank shall assesses the fulfilment of the statutory conditions. If the conditions for the issuance of a licence are not fulfilled, it is a reason not to issue a banking licence.

4. The licensing authority determines that the proposed legal and managerial structures of the bank will not hinder effective supervision.

Largely compliant.

Laws and Regulations:

It follows from the Act on Banks that a bank may only have the form of a joint-stock company (Section 1 paragraph 1). The fundamental rules of operation of a joint-stock company are governed by the Commercial Code. A part of an application for a banking licence is the submission of the articles of association. Pursuant to Section 9 paragraph 1 of the Act on Banks the articles of association must set down the structure and organisation of the bank, the powers and responsibilities of the bank's senior managers, the powers and responsibilities of further staff of the head office and branches or, as the case may be, of other organisational units of the bank that are authorised to carry out banking operations and also the organisational safeguarding of the bank's the internal control system. The Decree of the Czech National Bank no. 166/2002 Coll. contains the requirement to submit a commentary on the structure and organisation of the bank being established or, in the case of a branch, the principles of the already existing management and control system, of which the branch will become a part. Towards the close of 2002 the Czech National Bank issued the Provision of the Czech National Bank no. 12/2002, the content of which is the requirements for the internal management and control system of a bank. This provision may be also a kind of instruction for newly arising banking entities that are in the process of creating their internal management and control systems.

5. The licensing authority determines the suitability of major shareholders, transparency of ownership structure and source of initial capital.

Compliant.

Laws and Regulations:

Pursuant to Sections 4 to 5 of the Act on Banks and the Decree of the Czech National Bank no. 166/2002 Coll. assessment of the ability of persons with qualifying holdings in the bank to exercise shareholder's rights in the bank's business activities and assessment of the trustworthiness of a foreign bank is required. A person with a qualifying holding in a bank must submit documents on the origin of the resources which are invested in the bank's initial capital, information on its financial commitments, on persons exercising control over it or persons with which it has concluded a controlling agreement, data on its holdings in excess of 10% of the initial capital of the entity in which the investment was made, and a description of the structure with close links. The structure with close links is the basic starting-point for deeper examination of the transparency of the structure in which the future bank will find itself. Close links within the framework of a group must not hinder discharge of banking supervision.

6. A minimum initial capital amount is stipulated for all banks.

Compliant.

Laws and Regulations:

The minimum level of a bank's capital is stipulated directly in the Act on Banks, in Section 4 paragraph 1, and is CZK 500 mill. This is also the minimum level to which the initial capital must consist of pecuniary deposits.

7. The licensing authority evaluates proposed directors and senior management as to expertise and integrity (fit and proper test). The fit and proper criteria include: (1) skills and experience in relevant financial operations commensurate with the intended activities of the bank, and (2) no record of criminal activities or adverse regulatory judgements that make a person unfit to uphold important positions in a bank.

Largely compliant.

Laws and Regulations:

The Act on Banks in Section 8 paragraph 2 requires that a bank's statutory body (board of directors) should be composed of senior managers of the bank. Section 4 paragraph 3 subparagraph d) and Section 5 paragraph 4 subparagraph c) of the Act on Banks stipulates as a condition for granting a licence the fulfilment of professional competence, trustworthiness and experience of persons who are nominated on the basis of an employment or other contract to executive managerial positions in the bank connected with the powers and responsibilities laid down in the articles of association (the so-called senior managers of the bank) or who are nominated to positions in the management of a foreign bank branch. The Decree of the Czech National Bank no. 166/2002 Coll. then sets down the documents which the nominated persons shall submit to the Czech National Bank with the proviso, that the Czech National Bank may also verify the professional competence of the nominated persons within the framework of an interview with such persons. The Czech National Bank is entitled, by operation of law, to request a copy from the criminal record concerning those natural persons who are founders of a bank or who are nominated to positions of senior managers of a bank. A person convicted lawfully in the past for a wilful criminal act may not act as a senior officer in a bank – see Section 4 paragraph 5 of the Act on Banks. To increase the transparency of its procedures, the Czech National Bank has issued towards the close of 2002 the Official Announcement of the Czech National Bank no. 22 for the assessment of professional competence, trustworthiness and experience of persons nominated to positions of senior managers of banks and positions in the management of foreign bank branches. This Official Announcement sets down the essential criteria and requirements that persons nominated to the top positions in a bank or a foreign bank branch should meet.

Note:

The Czech National Bank assesses the competence, trustworthiness and experience of persons nominated to executive managerial positions in the bank or positions in the management of foreign bank branches. The bank and the foreign bank branch are obliged to inform the Czech National Bank on any proposals for personal changes in the bank's statutory body, in positions of senior managers of the bank and positions in the management of a branch, including submission of the background data that are necessary for the assessment of their professional competence, trustworthiness and experience. The standpoint of the Czech National Bank to personal changes is not a decision in administrative proceedings, but has the character of a recommendation. Banks, however, usually respect this recommendation.

8. The licensing authority reviews the proposed strategic and operating plans of the bank. This includes determining that an appropriate system of corporate governance will be in place.

Largely compliant.

Laws and Regulations:

Strategic intentions and business plans are assessed in accordance with Section 4 paragraph 3 subparagraph f), Section 5 paragraph 4 subparagraph e) of the Act on Banks and the Decree of the Czech National Bank no. 166/2002 Coll. According to the Decree of the Czech National Bank no. 166/2002 Coll. an applicant for a banking licence submits a strategic intention and a business plan for the nearest three years in a detailed break-down, including commentaries on the individual items of the business plan, the starting points on which the plan is built, the envisaged impacts on the profitability of the bank or foreign bank branch, further an analysis of the suitability of carrying out the individual activities with regard to the capital base of the bank or the foreign bank branch, further the structure and organisation of the bank or the foreign bank branch, the powers and responsibilities of senior managers and other staff members (a part of the bank's articles of association). When assessing the suitability and functionality of the bank's system of corporate governance, the Czech National Bank assesses how the basic rights of the shareholders are safeguarded within the framework of the bank's articles of association, how the internal management and control system is set, in which manner information on material facts relating to the company, including its financial condition, efficiency, ownership and management will be provided.

9. The operational structure is required to include, *inter alia*, adequate operational policies and procedures, internal control procedures and appropriate oversight of the bank's various activities. The operational structure is required to reflect the scope and degree of sophistication of the proposed activities of the bank.

Compliant.

Laws and Regulations:

Pursuant to Section 4 paragraph 3 subparagraph e) and Section 5 paragraph 4 subparagraph d) of the Act on Banks a bank or a foreign bank branch is obliged to create technical and organisational prerequisites for performance of the proposed activities and an operational management and control system of the bank, including a risk management system. The Act on Banks further in Section 9 paragraph 1 stipulates the duty of a bank to set down in its articles of association the structure and organisation of the bank, the powers and responsibilities of the bank's senior managers, the powers of other staff members of the head office and branches and the organisational safeguarding of its internal control system. The Decree of the Czech National Bank no. 166/2002 Coll. imposes on applicants for a banking licence the duty to submit a commentary on the organisational structure and organisation of the bank, including the definition of the contents of the individual units, links to the other units, competences and powers of these units, and also a description of the material-technical and personal safeguarding of the individual activities, the principles of the internal management and control system of the bank being established or – in the case of a foreign bank branch – the principles of the management and control system of the foreign bank and the principles for the identification and management of risks.

10. The licensing authority reviews pro forma financial statements and projections for the proposed bank. This includes an assessment of the adequacy of the financial strength to support the proposed strategic plan as well as financial information on the principal owners of the bank.

Compliant.

Laws and Regulations:

The Act on Banks Section 4 paragraph 3 subparagraphs a), c) and f) and Section 5 paragraph 4 subparagraphs a), b, and e) and the Decree of the Czech National Bank no. 166/2002 Coll. Persons with a qualifying holding in a bank and a foreign bank submit as a part of their application for a banking licence their annual reports and financial statements or, as the case may be, consolidated financial statements. These documents are used to assess the adequacy of the financial strength of these persons to safeguard the proposed strategic intentions of the bank or the foreign bank branch.

11. If the licensing authority and the supervisory authority are not the same, the supervisor has the legal right to have its views considered on each specific application.

Not applicable.

12. In the case of foreign banks establishing a branch or subsidiary, prior consent (or a statement of “no objection”) of the home country supervisor is obtained.

Compliant.

Laws and Regulations:

The requirement to submit a statement of the agency discharging supervision over the foreign bank in the country of its registered office, as regards the intention to establish a branch in the Czech Republic, including the agency’s statement that banking supervision will be discharged over the branch, is expressed directly in the Act on Banks - Section 5 paragraph 2. In the case that a foreign bank would establish a subsidiary in the Czech Republic or had a qualifying holding in a bank, it must in accordance with the Decree of the Czech National Bank no. 166/2002 Coll. submit a standpoint of the agency discharging supervision over that foreign bank. The same duty applies to a non-bank foreign entity which is subject to another regulator in the country of the registered office of this entity in the case that this entity acquires a qualifying holding in a bank having its registered office in the Czech Republic. The Czech National Bank assesses the suitability of a bank’s shareholder. In the event of disapproval of the home regulator with the intention to establish a bank in the Czech Republic or to have a holding in it, it is not possible to consider such shareholder to be suitable, which may ultimately lead to the decision not to issue the banking licence.

Discharge of Supervision:

The banking supervision of the Czech National Bank acts in accordance with this criterion, which means that it always requests a statement of the agency that discharges supervision over the foreign bank in the country where it has its registered office.

13. If the licensing, or supervisory, authority determines that the licence was knowingly based on false information, the licence can be revoked.

Compliant.

Laws and Regulations:

This authorisation is provided for in Section 34 paragraph 2 subparagraph b) of the Act on Banks. For the time being, this case has not occurred.

Additional Criteria

1. The assessment of the application includes the ability of the shareholders to supply additional financial support, if needed.

Compliant.

Laws and Regulations:

On the basis of Section 4 paragraph 3 subparagraph c) of the Act on Banks the ability of persons with a qualifying holding in a bank to exercise shareholder’s rights in the bank’s business activities, therefore, also their ability to supply additional financial resources, is assessed. This applies analogously to a foreign bank which establishes its branch in the Czech Republic - Section 5 paragraph 4 subparagraph b) of the Act on Banks.

Discharge of Supervision:

The assessment of the ability of a person with a qualifying holding in a bank to supply further financial resources forms part of the overall assessment of the financial condition of this person within the framework of the licensing proceedings.

2. At least one of the directors must have a sound knowledge of each of the types of financial activities the bank intends to pursue.

Compliant.

Discharge of Supervision:

Within the framework of assessing the ability, trustworthiness and experience of the members of senior management of banks for the purpose of ascertaining their professional and other prerequisites also the future responsibility of the proposed candidate for a position in senior management of a bank is taken into consideration (from the point of view of expertise and ability to identify problem matters relating to the given area).

3. The licensing authority has procedures in place to monitor the progress of new entrants in meeting their business and strategic goals, and to determine that supervisory requirements outlined in the licence approval are being met.

Compliant.

Discharge of Supervision:

A new bank is monitored within the framework of off-site supervision, in particular from the point of view of adherence to its business and strategic goals or, as the case may be, from the point of view of fulfilment of the conditions stipulated in its licence, provided that they have been stipulated. A licence pursuant to the Act on Banks (Section 1 paragraph 7) may contain a stipulation of the conditions a bank or a foreign bank branch is obliged to fulfil before commencing any of its permitted activities. A new bank is also included in the plan of on-site inspections. In discharge of supervision over new banks standard procedures are applied; these procedures are sufficient and appropriate.

Principle 4. Banking supervisors must have the authority to review and reject any proposals to transfer significant ownership or controlling interests in existing banks to other parties.

Comprehensive Assessment:

Largely compliant.

Essential Criteria

The Act on Banks provides that consent of the Czech National Bank is required prior to acquisition or increase of a qualifying holding in a bank (Section 20 paragraph 3). According to the Act on Banks, also any person signing a controlling agreement with a bank or performing any other legal act aimed at control of a bank must obtain consent of the Czech National Bank. The requisites of an application are stipulated by Decree no. 166/2002 Coll. The Czech National Bank has the right to withhold its prior consent if the applicant fails to meet the requirements defined by the Decree of the Czech National Bank no. 166/2002 Coll., or if granting the permission would be in conflict with an international treaty. The Czech National Bank is also authorised to suspend the exercise of certain shareholder's rights in case the shareholder has acquired its stake in the bank without prior consent of the Czech National Bank. This power has not been applied in practice as yet.

Additional Criteria

The requirement of regular identification of persons with a qualifying holding in the bank is observed both through approving of acquisitions or increases of qualifying holdings and through the fact that the Czech National Bank receives a statement of all shareholders and custodians prior to the general meeting. The obligation to obtain the Czech National Bank's consent applies only to the persons that are the actual owners of the bank's shares, not to the so-called beneficial shareholders and custodians.

Analysis of the Individual Criteria

Essential Criteria

1. Law or regulation contains a clear definition of “significant” ownership.

Compliant.

Laws and Regulations:

In accordance with the Directive of the European Parliament and the Council 2000/12/EC, significant ownership is taken to mean a qualifying holding, which is defined in the Act on Banks in Section 17a as a direct or indirect share, or a sum of both, which represents at least 10% of the initial capital of a legal entity or of the voting rights in a legal entity, or a possibility to exercise a significant influence on the management of such legal entity.

2. There are requirements to obtain supervisory approval or provide immediate notification of proposed changes that would result in a change in ownership or the exercise of voting rights over a particular threshold or change in controlling interest.

Compliant.

Laws and Regulations:

The Act on Banks in Section 20 paragraph 3 stipulates the duty of a natural person or legal entity to ask the Czech National Bank for consent prior to acquiring a qualifying holding on the level, or increasing a qualifying holding to the level, of 20%, 33% and more than 50% of the initial capital or the voting rights of a bank. The same duty applies to persons acting in concert. Also a person concluding a controlling agreement with a bank as the controlling person or a person performing any other legal act aimed at control of a bank must ask the Czech National Bank for consent. The requisites of an application are stipulated in the Decree of the Czech National Bank no. 166/2002 Coll. Applicants for acquisition, or increase, of a qualifying holding in a bank are assessed in the same manner as applicants in licensing proceedings, i.e. as persons applying for a banking licence. The Czech National Bank issues on the basis of the application, in accordance with the Code of

Administrative proceedings, a decision in the matter of an application for the acquisition of a qualifying holding in a bank. If a natural person or legal entity decreases its qualifying holding in a bank, it is obliged to inform the Czech National Bank of this fact. Acquisition or increase of a qualifying holding and its decrease contrary to these rules does not result in the invalidity of this legal act.

3. The supervisor has the authority to reject any proposal for a change in significant ownership controlling interest, or prevent the exercise of voting rights in respect of such investments, if they do not meet criteria comparable to those used for approving new banks.

Largely compliant.

Laws and Regulations:

The Czech National Bank has the right to reject proposals for a change in a qualifying holding in a bank if the applicant does not meet the requirements stipulated by the Act on Banks and the Decree of the Czech National Bank no. 166/2002 Coll. If a change in a qualifying holding occurs without consent of the Czech National Bank, the implementation of this legal act does not result in its invalidity. The Czech National Bank may, however, in accordance with Section 20a paragraph 1 of the Act on Banks in administrative proceedings suspend the exercise of the following shareholder's rights:

- a) to participate and vote in the general meeting,
- b) to initiate the convening of an extraordinary general meeting,
- c) to file with a court of law actions demanding the invalidity of the resolutions adopted by the general meeting.

Discharge of Supervision:

The possibilities of the Czech National Bank to enforce observance of the rules for acquisition and losing qualifying holdings have not been as yet tested in practice. Certain aspects of such measure have not been solved yet with final validity from the legal point of view (for example to whom to transfer the voting rights, for how long the shareholder loses his voting rights).

The fulfilment of this principle would require an amendment to the Act on Banks and such amendment is not prepared at present.

Additional Criteria

1. Supervisors obtain from banks, either through periodic reporting or on-site examinations, the names and holdings of all significant shareholders, including, if possible, the identities of beneficial owners of shares being held by custodians.

Largely compliant.

Laws and Regulations:

The Act on Banks in Section 20a imposes on a bank the duty to submit to the Czech National Bank prior to the holding of a general meeting an extract from the register of the issuer of book-entry shares, listing all shareholders and custodians and made on the day which precedes the day of the general meeting by seven days. This excerpt must be delivered to the Czech National Bank six days prior to the holding of the general meeting at the latest. Pursuant to Section 20a paragraph 8 of the Act on Banks the Czech National Bank is also authorised to request at any time an extract from the register of the issuer, if the issuer is a bank. The duty to obtain consent of the Czech National Bank applies only to persons or entities that are the actual owners of the bank's shares, not to so-called beneficial shareholders and custodians. At present the law does not distinguish between actual owners and beneficial shareholders and custodians, for it does not know these terms. A bill on conducting business on the capital markets, which introduces the respective institutes and provides for the respective relations, is currently in the preparatory phase of the legislative process.

Principle 5. Banking supervisors must have the authority to establish criteria for reviewing major acquisitions or investments by a bank and ensuring that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.

Comprehensive Assessment:

Largely compliant.

Essential Criteria

The Act on Banks in Section 17 regulates investments in or acquisitions of non-financial entities in a uniform way, through limits and ban on control of such entities. A bank's qualifying holding in a legal entity that is neither a bank pursuant to the Act on Banks, nor a financial institution or an undertaking providing ancillary banking services may not exceed in a single legal entity 15% of the bank's capital, counted both on an individual and a consolidated basis, in total in respect of all legal entities 60% of the bank's capital, counted both on an individual and a consolidated basis. A bank shall apply for prior consent of the Czech National Bank for a merger of the bank or for conclusion of an agreement on the sale of a business, or a part thereof. A bank shall inform the Czech National Bank of its intention to establish a legal entity abroad or to have a holding therein. Investments in financial institutions and undertakings providing ancillary banking services as well as acquisitions of these subjects are not regulated. However, such entities are subject to consolidated banking supervision under Sections 26c and 26d of the Act on Banks. The Czech National Bank regulates and limits, by its Provision no. 9/2002, ownership relations between banks and businesses and corporate structures. The restrictions on investments and acquisitions in the Act on Banks in the above provision make no difference between investments into domestic and foreign legal entities, so that the restrictions mentioned apply also to legal entities incorporated abroad. The Czech National Bank deems the existing system of regulation of banks' investments and acquisitions to be sufficient and efficient and does not consider it necessary to add further detailed rules and criteria to it at present.

Analysis of the Individual Criteria

Essential Criteria

1. Laws or regulations clearly define what types and amounts (absolute and/or in relation to a bank's capital) of acquisitions and investments need supervisory approval.

Compliant.

Laws and regulations:

Section 17 of the Act on Banks stipulates the rules for acquisition of holdings in other legal entities, with the exception of banks pursuant to the Act on Banks, financial institutions and undertakings providing ancillary banking services, where holdings are not limited, and further stipulates the limits for qualifying holdings of a bank in relation to the bank's capital on the level of 15% in a single legal entity and 60% in the sum of all legal entities, both on an individual and a consolidated basis. The Act on Banks at the same time stipulates exceptions with respect to qualifying holdings arising by virtue of a bank's claim during the period of a recovery operation or financial restructuring or by virtue of issuance of securities and the time limits for these holdings. The Bank is obliged to notify the Czech National Bank without undue delay of the acquisition of a qualifying holding in a legal entity (Section 17 paragraph 5 of the Act on Banks). Further the Act on Banks in Section 12 paragraph 1 prohibits a bank's holding in a limited partnership or an ordinary partnership.

The Provision of the Czech National Bank no. 8/1997, which limited acquisition of certain types of assets, has been replaced with the Provision of the Czech National Bank no. 9/2002, which in its fourth part provides for acquisition of certain types of assets. This provision prohibits a bank to provide credits, or guarantees for credits, designed to finance acquisitions of shares or participation certificates, or subordinate claims. It also prohibits a bank to acquire shares or subordinate claims in legal entities which are affiliated through capital with the bank or with the person having a qualifying holding in the bank, or which act in concert with these persons. At the same time this provision enables to make an exception with respect to shares, if a bank acts as a market-maker for a specific

title, will prove this position and fulfil further conditions stipulated in Section 12 paragraph 2 of the provision. The Czech National Bank considers regulation conceived in this manner as more efficient than approving the individual cases. The Czech National also starts from the fact that the primary interest of banks themselves and also of its senior management is the effectiveness of investments or acquisitions.

In the past the Act on Banks required approving of holdings in excess of a certain level. However, with regard to problems with the assessment of applications the Czech National Bank proposed to revoke this authority. The Czech National Bank may generally apply Section 12 paragraph 1 of the Act on Banks which requires that a bank, when performing its activities, should proceed with prudence, and in particular should perform its business in a manner which is not detrimental to the interests of its depositors from the viewpoint of the return of their deposits and which does not endanger the security and stability of the bank. Related to this is also the conclusion of a controlling agreement, on the basis of which a bank would become the controlling person. The conclusion of this agreement would be contrary to Section 12 paragraph 1 of the Act on Banks, as stipulated in the Official Notification of the Czech National Bank of 31 January 2002 on the issues of concluding controlling agreements by banks.

2. Laws of regulations provide criteria by which to judge individual proposals.

Materially non-compliant.

Laws and Regulations:

The Act on Banks stipulates the conditions and limits for investments in and acquisitions of legal entities, while the Provision of the Czech National Bank no. 9/2002 sets down restrictions for acquisition of certain types of assets. Banks must observe these limits and restrictions when implementing their intentions, which is why potential individual proposals of banks are not assessed and criteria for such assessment are not set down. The existing system of regulation of investments and acquisitions by banks is sufficient and efficient and it is not necessary to add further detailed rules and criteria to it at present.

3. Consistent with the licensing requirements, among the objective criteria that the supervisor uses is that any new acquisitions or investments do not expose the bank to undue risks or hinder effective supervision. The supervisor determines that the bank has, from the outset, adequate financial and organisational resources to handle the acquisition/investment.

Compliant.

Discharge of Supervision:

Investments of banks are limited by the Act on Banks, Section 17. Pursuant to Section 16 of the Act on Banks a bank is obliged to request prior consent of the Czech National Bank for the conclusion of an agreement on the sale of a business or a part thereof, and for a merger of the bank. When deciding on granting its prior consent, the Czech National Bank shall evaluate whether the bank already in the initial phase possesses adequate financial and organisational resources for the acquisition or investment. The CNB shall at the same time assess the impact of the planned acquisition or investment on the financial condition of the bank and on the fulfilment of the respective decrees and provisions that set down the limits and standards of prudential business of banks.

With reference to the text mentioned in connection with the Essential Criterion 2, the criteria for reviewing purchases of property shares or other investments have not been set down. However, a bank's strategy for investing in property shares, including the observance of the prudential criteria in connection with Section 12 of the Act on Banks, is reviewed within the framework of on-site inspections. The Czech National Bank has the right to request at any time a remedy, if it finds any investment or acquisition to be imprudent.

4. Laws or regulations clearly define for which cases notification after the acquisition or investment is sufficient. Such cases should primarily refer to activities closely related to banking and the investment being small relative to the bank's capital.

Compliant.

Laws and Regulations:

Pursuant to the Act on Banks, Section 17 paragraph 5 subsequent notifications apply to all qualifying holdings. Banks submit statements on their capital participations to the Czech National Bank on a quarterly basis.

Prudential Rules and Requirements

Principle 6. Banking supervisors must set minimum capital adequacy requirements for banks that reflect the risks that the bank undertakes, and must define the components of capital, bearing in mind its ability to absorb losses. For internationally active banks, these requirements must not be less than those established in the Basle Capital Accord.

Comprehensive Assessment:

Largely compliant.

Essential Criteria

The Act on Banks and the relating provisions and decree require that banks measure and continuously maintain their capital adequacy on both an individual and consolidated basis. The Act on Banks requires the Czech National Bank to impose a remedial measure in case the capital adequacy drops below a set limit (ratio), which is currently uniform for all banks and represents 8%. The exposure of the financial and institutional environment of banks' business activities has been reflected in regulations covering evaluation of receivables and additions to specific provisions for such receivables, while the amount of such provisions has a secondary impact on the amount of the bank's capital. The experience of discharge of banking supervision suggests that both evaluation of receivables and requirements for additions to provisions represent an efficient tool of banking supervision. Capital adequacy currently is not assessed on the basis of a detailed analysis of the risk profile of individual banks. Evaluation of capital adequacy of a bank based on its individual risk profile is a substantial element of the so-called second pillar of the New Basle Capital Accord. Conceivably, these procedures should be incorporated both in the laws of EU member states and the Czech banking regulation by the end of 2006. The capital adequacy rules are adjusted in line with international standards and are applied uniformly to all banks.

Additional Criteria

The method of determination of capital adequacy is already compliant with the EC law and corresponds also to the current Basle Accord, while it will be fully harmonised as at the date of accession of the Czech Republic to the European Union. The Act on Banks sets the minimum amount of a bank's initial capital at CZK 500 million and a failure to maintain the minimum limit is considered a shortcoming in the bank's performance, authorising the Czech National Bank to impose a remedial measure. Regulation of banks includes also provisions stipulating requirements on liquidity management of banks, their credit risk and market risks, while all that has a substantial effect in terms of evaluating the bank's capital adequacy and its risk profile.

Analysis of the Individual Criteria

Essential Criteria

1. Laws or regulations require banks to calculate and consistently maintain a minimum capital adequacy ratio. At least for internationally active banks, the definition of capital, method of calculation and the ratio required are not lower than those established in the Basle Capital Accord.

Compliant.

Laws and Regulations:

The amount of capital and capital adequacy are dealt with in the Act on Banks, specifically in Section 4 paragraph 3 subparagraph a) and Section 5 paragraph 3 subparagraph a) in connection with granting of a licence. In Section 12 paragraph 3 the Act on Banks expressly imposes on banks the duty to maintain capital adequacy on an individual and consolidated basis. Section 15 of the Act on Banks sets down the authorisation of the Czech National Bank to issue provisions by which it will define to what extent foreign bank branches are subject to the capital adequacy rules (and to further rules of prudential business) and at the same time authorises the Czech National Bank to define in its provision the term capital on an individual and consolidated basis. In Section 26c paragraph 1 of the Act on

Banks the concept of banking supervision on a consolidated basis is defined as monitoring and regulation of risks in consolidated groups, a part of which is a bank, for the purpose of limiting the risks a bank is exposed to in view of its participation in a consolidated group and in paragraph 3 it states that this supervision is discharged by the Czech National Bank. Stipulation of the rules for capital adequacy on a consolidated basis, ascertainment of compliance with these rules and imposition of remedial measures pursuant to Section 26h are – together with other elements – the fundamental components of banking supervision on a consolidated basis. On the basis of the above-mentioned authorisation, the Czech National Bank has issued two legal regulations:

- Provision of the Czech National Bank no. 2/2002 on Capital Adequacy of Banks and Other Rules of Prudential Business on an Individual Basis,
- Decree of the Czech National Bank no. 333/2002 Coll., stipulating the Rules of Prudential Business of Controlling Persons on a Consolidated Basis.

These regulations provide for credit risk and market risks, stipulate the components of capital and the methods of calculation of risk weighting for the purposes of capital adequacy with the proviso, that in the case of market risks banks are allowed to use for the stipulation of the capital requirement also their own models, provided that these have been approved by the Czech National Bank. The minimum limit of capital adequacy amounts to 8%. Both the regulations are as a matter of principle in compliance with the EC law and at the same time correspond to the valid Basle Capital Accord. Full harmonisation of the procedures applied will occur as at the day of accession of the Czech Republic to the European Union.

2. The required capital ratio reflects the risk profile of individual banks, in particular credit risk and market risk. Both on-balance sheet and off-balance sheet risks are included.

Largely compliant.

Laws and Regulations:

The Provision on Capital Adequacy of Banks and Other Rules of Prudential Business on an Individual Basis corresponds to the current international recommendations, i.e. the capital adequacy is a function of credit risk and market risks. Stipulation of the minimum capital adequacy on the basis of a more detailed analysis of the risks an individual bank is exposed to, i.e. according to its risk profile, is not carried out at present. In this connection it is necessary to note that the Czech National Bank by the Provision of the Czech National Bank no. 9/2002 has set down detailed rules for categorisation of the evaluation of receivables and for provisioning.

3. Laws or regulations, or the supervisor, define the components of capital, ensuring that emphasis is given to those elements of capital available to absorb losses.

Compliant.

Laws and Regulations:

The Provision of the Czech National Bank no. 2/2002 on Capital Adequacy of Banks and Other Rules of Prudential Business on an Individual Basis and the above-mentioned Decree of the Czech National Bank no. 333/2002 Coll. on Consolidated Supervision stipulate the capital ratios Tier 1 to Tier 2, or Tier 2 and Tier 3 in accordance with the EC law and with the valid Basle Capital Accord, i.e. Tier 2 must not exceed Tier 1, or the sum of Tier 2 and Tier 3 must not exceed Tier 1).

4. Capital adequacy ratios are calculated and applied on a consolidated bank basis.

Compliant.

The Decree no. 333/2002 Coll., stipulating the Rules of Prudential Business on a Consolidated Basis imposes – starting from 2003 – on banks the duty to determine quarterly capital adequacy on a consolidated basis and report it for the purposes of banking supervision. Also the capital requirement on a consolidated basis is determined with regard to both credit and market risks. The decree has replaced the previous provision, which did not achieve full compliance with the above-mentioned standards (the capital requirement was not determined for market risks on a consolidated basis, it was determined on an individual basis only, there were legislative obstacles which made it difficult to

require observance of the prudential rules or fulfilment of the notification duty, to impose remedial measures in relation to non-bank companies in a consolidated group, data on capital adequacy were reported with annual periodicity only).

5. Laws or regulations clearly give the supervisor authority to take measures, should a bank fall below the minimum capital ratio.

Compliant.

Laws and Regulations:

Act on Banks in Section 26a stipulates that if the ratio of a bank's capital to its risk-weighted assets drops below 2/3 of the ratio laid down by the Czech National Bank, one or more of the following measures shall be imposed on the bank:

- to increase the initial capital so as to reach the ratio laid down by the Czech National Bank,
- to acquire only assets with a risk weighting of less than 100%,
- not to acquire any share in the initial capital and voting rights in any legal entity,
- not to provide any credit to a person with a special relation to the bank,
- not to provide interest rates on deposits exceeding the current usual interest rates on deposits of comparable amounts and with comparable maturities,
- it is also possible to impose, on parallel lines, remedial measures pursuant to Section 26 – see Principle 21.

The Act on Banks in Section 34 stipulates the duty of the Czech National Bank to revoke the banking licence, if the ratio of a bank's capital to its risk-weighted assets is lower than 1/3 of the ratio laid down by the Czech National Bank.

6. Regular (at least semi-annual) reporting by banks to the supervisor is required on capital ratios and their components.

Compliant.

Banks submit statements on capital adequacy on an individual basis to the Czech National Bank monthly, statements on capital adequacy on a consolidated basis quarterly.

Additional Criteria

1. For domestic, as well as internationally active banks, the definition of capital is broadly consistent with the Basle Capital Accord.

Compliant (see above).

2. The supervisor clearly sets out the actions to be taken if capital falls below the minimum standards.

Compliant.

The Act on Banks sets down the procedure in relation to the capital adequacy ratio (not in relation to the capital itself – see above, Essential Criterion 5). The procedure to be followed, if a bank's initial capital falls below the minimum level stipulated by law, is described below.

3. The supervisor determines that banks have an internal process for assessing their overall capital adequacy in relation to their risk profile.

Compliant.

The Czech National Bank has issued provisions stipulating the qualitative requirements for management of risks. Assessment of the overall capital adequacy of a bank with regard to its risk profile is based on these requirements. The provisions in question are the following:

- Provision of the Czech National Bank no. 2/2001 on Liquidity Management Standards of Banks,
- Provision of the Czech National Bank no. 3/2002 on Credit Risk Management in Banks,

- Provision of the Czech National Bank no. 4/2002 on Market Risks Management in Banks,
- Provision of the Czech National Bank no. 12/2002 on the Internal Management and Control System.

Nevertheless, a legal regulation that would set down the requirements for the internal procedures for determination of an individual bank's capital adequacy with regard to its risk profile is not, for the time being, a part of the domestic banking regulation. Such internal procedures belong to the essential building stones of the fundamentally new conception of banking regulation that is expressed in the New Basle Capital Accord and also in the Draft EC Directive, which will incorporate this conception into the EC law. The Czech National Bank has started and continues work on the implementation of the new conception into the domestic banking regulation.

4. Capital adequacy requirements take into account the conditions under which the banking system operates. Consequently, minimum requirements may be higher than the Basle Capital Accord.

Largely compliant.

The minimum capital adequacy ratio has been set down for all banks uniformly at 8%. The level of risk in the environment, both from the viewpoint of macroeconomic shocks and from the viewpoint of specific shocks for individual banks is reflected in the Provision of the Czech National Bank no. 9/2002, stipulating the Rules for Evaluation of Receivables from Financial Activities, Additions to Reserves and Provisions and the Rules for Acquisition of Certain Types of Assets. The importance of this provision is given by the fact that credit risk is the biggest of the risks to which banks and the banking sector as a whole are exposed. Experience has shown that the principle of assessing receivables and provisioning actually do reflect the level of risk in the environment of an economy in transformation and are an effective instrument of banking supervision. As regards the influence of this regulation on capital and capital adequacy see the Essential Criterion 2.

5. Capital adequacy ratios are calculated on both a consolidated and a solo basis for the banking entities within a banking group.

Compliant.

The capital adequacy ratio is calculated on both an individual and a consolidated basis (see Essential Criterion 1).

6. Laws or regulations stipulate a minimum absolute amount of capital for banks.

Compliant.

Pursuant to Section 4 paragraph 1 subparagraph a) of the Act on Banks the minimum amount of initial capital of a bank at its establishment is 500 million CZK and to this level to a bank's capital at its establishment must consist of pecuniary deposits. A decrease in capital below the mentioned CZK 500 million is pursuant to Section 26 paragraph 3 subparagraph g) a shortcoming in the activities of a bank. If, therefore, the Czech National Bank finds that the initial capital of a bank has fallen below the above-mentioned limit, it is authorised to impose a remedial measure pursuant to Section 26 paragraph 1 with the proviso that the specific procedure will depend on consideration of the circumstances of the given case.

Principle 7. An essential part of any supervisory system is the independent evaluation of a bank's policies, practices and procedures related to the granting of loans and making of investments and the ongoing management of the loan and investment portfolios.

Comprehensive evaluation:
Compliant.

Essential Criteria

Measurement, monitoring and control of credit risk represent a substantial element of the overall risk management strategy of a bank and its practical application. The Czech National Bank has issued a regulation stipulating the requirement for credit risk management in banks, with the proviso that a bank shall fulfil the requirements according to its size and method of management, as well as according to the type, nature and complexity of the activities it carries out. The regulatory framework for credit and market risks management is compliant with international standards and creates the prerequisites for efficient discharge of banking supervision, while its observance is a matter of on-site inspections. Standardised procedures are applied according to the manuals and stress is laid on setting down the job content, powers and responsibilities in writing, in order to minimise potential abuse of powers or conflict of interests. The provision of the Czech National Bank on credit risk management in banks has significantly enhanced the efficiency of on-site inspections by stipulating, in the form of a legal regulation, the minimum requirements for credit risk management and facilitating the qualification of the fact that certain elements of the credit risk management system are either missing or non-functional as a shortcoming in the bank's activities under the Act on Banks, Section 26 (b). The Czech National Bank has adequate human resources and technology at its disposal to enable it to assess the credit risk management methods currently used by banks in the Czech Republic.

Additional Criteria

The Czech National Bank verifies during its on-site inspections whether the bank's board of directors decides on large credits and investments, as well as on activities involving a high degree of risk. The Czech National Bank also reviews the functioning of the management information system and the total indebtedness of the bank's debtors.

Analysis of the Individual Criteria

Essential Criteria

1. The supervisor requires, and periodically verifies, that prudent credit-granting and investment criteria, policies, practices, and procedures are approved, implemented and periodically reviewed by bank management and boards of directors.
Compliant.

Laws and Regulations:

The Provision of the Czech National Bank no. 3/2002 on Credit Risk Management in Banks includes the requirement that banks should have an appropriate strategy for credit risk management, that the board of directors should approve the strategy and the other most important internal regulations, including safeguarding of their practical fulfilment, further it includes the requirement for informing the board of directors on the size of the risks undertaken, for the information system of banks, the requirement for the creation and observance of a set of limits and the duty to identify any risks connected with new products and secure the bank against them.

Discharge of Supervision:

Within the framework of on-site inspections it is verified on a regular basis whether banks observe the criteria of prudential business for granting credits and for investments, just as their strategy, principles and procedures in credit and investment policies, including the fact, whether this strategy, principles and procedures are updated as necessary. Until now the Czech National Bank within the framework of off-site supervision regularly evaluated the report on risk management systems of banks, prepared on the basis of the Provision of the Czech National Bank no. 4/1998,

stipulating the Requirements for the Bank Performance Report (this Provision was repealed, in a link-up with the harmonising amendment of the Act on Banks, by the Provision of the Czech National Bank no. 6/2002). In this report a bank, *inter alia*, described its system of credit risk management, including the respective methods, its internal regulations and its system for granting credits. The report also comprised a description of the procedures used when trading securities on the bank's own account and the methods for market risks management, informed of observance of the limits and of the procedures by which prices of securities were set and also of the regularity, preciseness and timeliness of submission of information to the board of directors and the supervisory board. The report was accompanied by a statement of an external auditor. The present state is such that pursuant to Section 22 paragraph 1 of the Act on Banks a bank must ensure that a company of auditors carries out verification of the bank's management and control system, including its risk management system, and submit this report to the Czech National Bank, unless the Czech National Bank exercises its statutory right to waive verification of the management and control system, including the risk management system. The requirements for verification of the management and control systems of banks, including their risk management systems, were set down by the Czech National Bank in its Provision no. 11 of 10 December 2002, stipulating the Requirements for Verification of the Management and Control System of a Bank, including its Risk Management System.

2. The supervisor requires, and periodically verifies, that such policies, practices and procedures include the establishment of an appropriate and properly controlled credit risk environment, including:

- a sound and well-documented credit granting and investment process;
- the maintenance of an appropriate credit administration, measurement and ongoing monitoring/reporting process (including asset grading/classification); and
- ensuring adequate controls over credit risk.

Compliant.

Laws and Regulations:

The Provision of the Czech National Bank no. 3/2002 on Credit Risk Management in Banks stipulates the minimum content of the strategy of management. This includes in particular: the level of risk accepted by the bank, the methods of management, a set of limits for the management of risks, the principles governing the delimitation of the permitted products, countries, regions, market segments and contracting parties in the management of credit risk. The provision also provides for the essential requirements for the organisational structure of the bank from the point of view of risk management, including the definition of the powers, responsibilities and information flows. Apart from this it also contains enumeration of the activities and procedures that must be defined in the bank's regulatory basis.

Discharge of Supervision:

The process of granting credits and its documentation, just as the process of evaluation and monitoring of credits, including assessment of credits and arranging for control over credit risk, is reviewed to the full extent during on-site inspections. Until now, the source of partial information was a report on risk management (a report on the bank's performance). In accordance with the harmonising amendment to the Act on Banks this source of information has been replaced with a report of a company of auditors on the verification of the internal management and control system, including the risk management system.

3. The supervisor requires, and periodically verifies, that banks make credit decisions free of conflicting interests, on an arm's-length basis, and free from inappropriate pressure from outside parties.

Compliant.

Laws and Regulations:

The Provision of the Czech National Bank no. 3/2002 on Credit Risk Management in Banks contains the requirement that a bank has in place a system for carrying out business transactions in

such manner that the subjective aspects of the decision-making process should be minimised. Business transactions with persons having a special relation to the bank must be concluded on the basis of usual conditions. The bank must have information for a detailed assessment of each business transaction with regard to its size and complexity and with regard to the evaluation of creditworthiness of the contracting party. Exposure towards these persons is also limited. One of the very important requirements for management of risks is that the bank when determining the powers and responsibilities of the units or, as the case may be, of the individual staff members, should prevent a conflict of interests, which arises on accumulation of responsibilities and powers with respect to business activities and risk management or, as the case may be, settlement of business transactions. Section 17 of the Act on Banks prohibits banks to exercise control over legal entities that are not a bank, a financial institution or an undertaking providing ancillary banking services. Also the duty to separate credit activities from investment banking has been enacted – Section 19b of the Act on Banks.

Discharge of Supervision:

The process of granting credits (from an application for a credit to its repayment) and adherence to this process are reviewed within the framework of on-site inspections. In this way, indirectly, it is verified whether there have not been any conflicts of interests, non-standard procedures, or inadequate pressures. Comprehensive implementation of this approach in practice is, however, very difficult (demonstrability of the negative phenomena, considerable demands on capacity). In the case of a suspicion that any of the banks is more involved in these negative phenomena, verification of the credit approval process may be one of the primary aspects.

4. The supervisor requires that a bank's credit assessment and granting standards are communicated to, at a minimum, all personnel involved in credit granting activities.

Compliant.

Laws and Regulations:

In accordance with the Provision of the Czech National Bank no. 3/2002 on Credit Risk Management a bank must ensure that all its staff members, whose activities have an influence on credit risk management and who must carry out these activities in accordance with the accepted strategy and the procedures and limits ensuing from it, must be acquainted with the strategy of credit risk management.

Discharge of Supervision:

Within the framework of on-site inspections it is verified, whether lending officers have sufficient qualification for this work and whether they are acquainted with the bank's valid regulatory basis relating to credits.

5. The supervisor has full access to information in the credit and investment portfolios and to the lending officers of the bank.

Largely compliant.

Laws and Regulations:

On the basis of the Act on the Czech National Bank and the Act on State Control, the Czech National Bank has access to all documents of a bank. The Act on the Czech National Bank (Section 41 paragraph 3) provides for the right of the Czech National Bank to set down which information and background materials a bank is obliged to submit to the Czech National Bank on a regular basis. If necessary, the Czech National Bank may adjust the extent of this required information and background data. The legal regulations do not provide sufficiently for the right of the Czech National Bank in discharge of banking supervision to have access to the bank's documents outside discharge of on-site inspections (see Principle 1, Part 1 (3), Essential Criterion 3, Principle 1 Part 1 (4), Essential Criterion 3 and also Principle 19, Essential Criterion 4).

Discharge of Supervision:

Banks submit to the Czech National Bank the requested information in a standardised format, which is stipulated by the Czech National Bank, and with sufficient periodicity.

Additional Criteria

1. The supervisor requires that the credit policy prescribes that major credits or investments, exceeding a certain amount or percentage of the bank's capital, are to be decided at a high managerial level of the bank. The same applies to credits or investments that are especially risky or otherwise not in line with the mainstream of the bank's activities.

Compliant.

Laws and Regulations:

In accordance with the Provision of the Czech National Bank no. 3/2002 on Credit Risk Management in Banks the board of directors must approve the strategy of risk management and re-assess it on a regular basis. The strategy must contain in particular the acceptable level of credit risk, the methods for credit risk management, a set of limits the bank will use, the principles for delimitation of the permitted products, countries, regions, market segments and contracting parties and the essential requirements for the organisational structure of the bank from the point of view of credit risk management, including definitions of the powers, responsibilities and information flows.

Discharge of Supervision:

The Czech National Bank considers this criterion as one of the essential rules of prudential business of a bank and, therefore, it is expected that a bank will have all these rules incorporated in its internal regulations (in most cases credits or investments exceeding a certain level must be approved by the bank's management) and the Czech National Bank reviews within the framework of on-site inspections whether these regulations are adhered to. This is one of the main aspects of the control of a bank's credit policy.

2. The supervisor requires that banks have management information systems that provide essential details on the condition of the loan and investment portfolios.

Compliant.

Laws and Regulations:

According to the Provision of the Czech National Bank no. 3/2002 on Credit Risk Management in Banks a bank is obliged to have in place an appropriate information system for credit risk management. This information system must include information on all business transactions and must provide at least information on the level of the risk undertaken, a comparison of the level of credit risk with the internal and regulatory limits, information on the results of analyses of the credit portfolio and the results of stress tests. Until now a bank described in its report on the risk management systems, whether the information system also includes modules for the support of the decision-making of its senior managers. This report was prepared annually and was accompanied by a statement of the external auditor. (This report will be superseded by a report on verification of the management and control system, including the risk management system, in accordance with Section 22 of the Act on Banks and the Provision of the Czech National Bank no. 11/2002 on Verification of the Management and Control System, including the Risk Management System).

Discharge of Supervision:

The quality of the information the management has at its disposal for managing the bank is reviewed within the framework of on-site inspections; an integral part of this information is the information system for managing risks.

3. The supervisor verifies that bank management monitors the total indebtedness of entities to which they extend credit.

Compliant.

Discharge of supervision:

Verified within the framework of on-site inspections.

Principle 8. Banking supervisors must be satisfied that banks establish and adhere to adequate policies, practices, and procedures for evaluating the quality of assets and the adequacy of loan loss provisions and reserves.

Comprehensive Assessment:
Compliant.

Essential Criteria

Provision no. 9/2002 of the Czech National Bank sets down detailed rules for evaluation of receivables from financing activities and for additions to provisions and reserves. The provision defines the term “receivables from financing activities” as including not only receivables from credits, but also receivables from financial leases, letters of credit etc., as well as selected off-balance sheet items, such as credit commitments, guarantees and sureties provided, etc. The regulation stipulates the procedures for evaluation of receivables (the procedure applies specifically to individual receivables, but evaluation of a complete portfolio of minor receivables is also admissible), lays down the criteria for classification of receivables into individual categories, as well as the rules for calculation of provisions for receivables, including the principles of accounting for the collateral in provisioning. A bank shall submit reports on the above facts to the Czech National Bank. The reports are analysed and the quality of the bank’s assets evaluated as a part of off-site supervision discharge. The bank’s responsibility is to provide entire and correct information in its reports. Once a year, specifically as at 31 December, the reports are reviewed by an external auditor. In accordance with Provision no. 3/2002 of the Czech National Bank on Credit Risk Management in Banks, a bank is required to have a strategy and procedures for credit risk management, while lines of powers and responsibilities in the area shall be clearly defined. A bank is further required to set up a functional and efficient internal control system for credit risk management. The above provision expressly stipulates that a bank must determine its internal procedures for evaluation of receivables from financing activities, for evaluation of collateral for such receivables, for additions to reserves and provisions, as well as for collection of debts, including threatened debts. Compliance with both the provisions is subject to on-site inspections, usually once in 2 or 3 years.

Additional Criteria

Provision no. 9/2002 of the Czech National Bank lays down the criteria for evaluation of credits. In case of a failed regime of the due dates (i.e. debts overdue 30, 90, etc. days) a bank is required to classify individual receivables into the categories of watched or threatened receivables. When analysing receivables by category, the overdue days are considered as well as other criteria, specifically the debtor’s financial condition. Banks are obliged to evaluate larger credits individually. Only in the case of less important credits in terms of their size, i.e. credits up to CZK 5 million or one per mille of the bank’s assets, the bank is allowed instead to evaluate the decrease in the balance value of the total portfolio of receivables, using statistical models.

Analysis of the Individual Criteria

Essential Criteria

1. Either laws or regulations, or the supervisor, sets rules for the periodic review by banks of their individual credits, asset classification and provisioning, or the law/regulations establish a general framework and require banks to formulate specific policies for dealing with problem credits.

Compliant.

Laws and Regulations:

Section 7 paragraph 1 of the Act on Accounting states that accounting units are obliged to keep their accounting records in a complete manner, conclusively and correctly, so that they fairly present the facts which are the subject of accounting. Linked up with this Act is a Decree of the Ministry of Finance of the Czech Republic and a Provision of the Ministry of Finance of the Czech Republic which sets down the accounting procedures for banks. These procedures, however – as

opposed to the International Accounting Standards – contain only general principles of provisioning and use of provisions. Detailed rules for the evaluation of receivables from financing activities, additions to provisions and reserves are set down in the Provision of the Czech National Bank no. 9/2002. The Provision defines the term “receivables from financing activities” in such a way that it includes not only receivables from credits, but also receivables from financial leasing, receivables from deposits, receivables from guarantees, receivables from letters of credit, receivables from factoring, receivables relating to securities transactions with maturities in excess of 30 days, etc., as well as selected off-balance sheet items, for example credit commitments provided, guarantees and sureties provided. The provision stipulates the methods which may be used when ascertaining whether the value of receivables has decreased, either for individual receivables, or for a portfolio of receivables, sets down the criteria for evaluation of receivables, just as the rules for calculation of provisions for receivables, including the principles for taking account of the collateral in the provisioning. A bank submits monthly to the Czech National Bank a “Report on Receivables by their Classification” and quarterly a “Report on Changes in the State of Credits“. These reports contain information on the classification of receivables, on provisioning and additions to reserves for classified receivables and on migration of receivables from the point of view of their classification. A bank is obliged to verify the completeness and correctness of the data contained in these reports. The reports are analysed and the quality of banks’ assets is evaluated within the framework of off-site supervision.

Note:

The historically first provision of the Czech National Bank on classification of receivables from credits and additions to reserves and provisions for these receivables was issued in 1994 and substituted for the Principles for Additions to Reserves and Provisions for Risk Assets of Banks, issued previously by the State Bank of Czechoslovakia. The provision that is effective at present has substituted for the previous Provision no. 193/1998 Coll., stipulating the Principles for Classifying Receivables from Credits and Provisioning for these Receivables.

2. The classification and provisioning policies of a bank and their implementation are regularly reviewed by the supervisor or external auditors.

Compliant.

Discharge of Supervision:

Pursuant to the Provision of the Czech National Bank no. 3/2002 on Credit Risk Management in Banks, a bank is obliged to have a strategy and procedures for credit risk management, lines of powers and responsibilities in this area must be clearly defined and the bank is also obliged to create a functional and efficient internal control system for credit risk management. The above provision in Section 5, subparagraphs n), o) and p) expressly imposes on the bank the duty to lay down its internal procedures for the evaluation of receivables from financing activities, for collateralisation of these receivables and also for additions to reserves and provisions. Adherence to this provision and to the above-mentioned provision (see Essential Criterion 1) is the subject of on-site inspections. On the basis of the provision of Section 22 of the Act on Banks a Bank is obliged to have its accounting statements and also some reports which it submits to the Czech National Bank once a year, i.e. as at 31 December, verified by an external auditor.

3. The system for classification and provisioning includes off-balance sheet exposures.

Compliant.

Laws and regulations:

The Provision of the Czech National Bank no. 9/2002 specifies selected off-balance sheet items, for example credit commitments provided, guarantees and sureties provided, with respect to which a bank is obliged to review the need for reserves more frequently than at the terms of preparation of the financial statements. A bank is obliged to review the adequacy and rightfulness of reserves at least with a quarterly frequency (see also above, Principle 8, Essential Criterion 1).

4. The supervisor determines that banks have appropriate policies and procedures to ensure that loan loss provisions and write-offs reflect realistic repayment expectations.

Compliant.

Laws and regulations:

Pursuant to the Provision of the Czech National Bank no. 3/2002 on Credit Risk Management in Banks a bank must reflect its policies and its procedures in provisioning and write-offs with respect to receivables from financial activities in an internal regulation. In provisioning, banks may account for the value of collateral for the receivable (see Essential Principle 8, Criterion 2).

5. The supervisor determines that banks have appropriate procedures and organisational resources for the ongoing oversight of problem credits and for collecting past due loans.

Compliant.

Laws and regulations:

Pursuant to Section 3 paragraph 4 of the Provision of the Czech National Bank no. 3/2002 on Credit Risk Management in Banks a bank's board of directors is responsible for the creation and operation of such organisational and management structure of the bank that will enable to implement effectively and efficiently the strategy of credit risk management. This structure must ensure that the respective members of the bank's senior management are immediately involved in the process of credit risk management and at the same time must take account of the requirements for separation of incompatible functions. Section 3 paragraph 7 of the Provision of the Czech National Bank no. 3/2002 stipulates that a bank should have in place and operate an information system which effectively supports operation of the above-mentioned organisational structure and employment of the organisational tools. Section 5 stipulates in detail that a bank should have a regulatory basis which defines the procedures for credit risks management; the procedures for collection of debts under credits are dealt with in subparagraph m). Section 10 paragraph 3 relates directly in particular to reviewing of problem credits; it requires a bank, *inter alia*, to have such system of measuring and monitoring of the credit risk ensuing from the business transactions concluded as will ensure monitoring of the financial and economic condition of the contracting party with regard to the type of business transactions concluded with that contracting party, monitoring of fulfilment of the conditions of the contract by the contracting party, monitoring of appraisal of the value of the collateral, monitoring of the actual problems that require immediate remedial measures.

Discharge of supervision:

Compliance with the above-mentioned requirements of the Provision is the subject of on-site inspections.

6. The supervisor has the authority to require a bank to strengthen its lending practices, credit-granting standards, level of provisions and reserves, and overall financial strength if it deems the level of problem assets to be of concern.

Compliant.

Laws and Regulations:

The procedure introduced by this principle stems from the authorisation given to the Czech National Bank by the respective provisions of the Act on Banks, especially its Section 26. Within the framework of remedial measures the Czech National Bank may require removal of the shortcomings, revision of the procedures for granting credits or it may restrict the granting of credits, require a review of the quality of the system by an auditor, require an increase in provisions and reserves, if their level does not correspond with the risk of an increase in capital in the case that it has dropped below the statutory limit, i.e. below 8%, *et alia*.

Discharge of Supervision:

The Czech National Bank employs these powers as necessary.

7. The supervisor is informed on a periodic basis, and in relevant detail, concerning the classification of credits and assets and of provisioning.

Compliant.

Discharge of Supervision:

A bank submits to the Czech National Bank for the purposes of discharge of banking supervision a “Report on Receivables by their Classification” and a “Report on Changes in the State of Credits”, which contain information on categorisation of receivables, on provisions and reserves created for watched and threatened receivables and also on migration of receivables from the point of view of their categorisation. The bank is obliged to verify completeness and correctness of the data contained in these reports. The reports are evaluated within the framework of off-site supervision (see also Principle 8, Essential Criterion 1). December reports are also the subject of examination by auditors.

8. The supervisor requires banks to have mechanisms in place for continually assessing the strength of guarantees and appraising the worth of collateral.

Compliant.

Laws and Regulations:

Pursuant to Section 5 subparagraph p) of the Provision of the Czech National Bank no. 3/2002 on Credit Risk Management in Banks, a bank is obliged to set down in its internal regulations the procedures for the appraisal of collateral and for subsequent adjustments to this appraisal. Section 6 paragraph 2 subparagraph c) of the mentioned provision imposes on banks the duty to carry out the appraisal of collateral independently of their business units. The provision mentioned also applies to guarantees, for pursuant to Section 9 paragraph 1 of the Provision of the Czech National Bank no. 9 a guarantee is a type, or a kind, of collateral.

Discharge of Supervision:

Adherence to the above-mentioned requirements of the Provision is the subject of on-site inspections.

9. Loans are required to be identified as impaired when there is reason to believe that all amounts due (both principal and interest) will not be collected in accordance with the contractual terms of the loan agreement.

Compliant.

Laws and Regulations:

Section 5 of the Provision of the Czech National Bank no. 9/2002 stipulates the criteria for evaluation of credits. If a receivable from a credit (or any other financial receivable) corresponds to these criteria (which are unfavourable for the profitability of the bank) and if there is a reason to assume that the receivable will not be duly repaid in accordance with the credit contract, the Provision requires the Bank to categorise such receivable as a watched one, or classify it into an even more risky category. The principle of evaluation by client, not by receivable, is applied: if the bank has more receivables from the same debtor, it classifies them into the same category, according to the receivable which has the worst evaluation. The bank need not apply this principle only in the case of certain enumerated receivables. The bank is obliged to provision for watched and threatened receivables on the level which is stipulated in Section 7 of the mentioned provision. Provisions are also created for portfolios of credits that are not categorised on an individual basis. In this case, provisioning is carried out with the use statistical models, not on the basis of an individual evaluation of each receivable.

10. The valuation of collateral is required to reflect the net realisable value.

Compliant.

Laws and Regulations:

Pursuant to Section 9 paragraph 1 subparagraph a) of the Provision of the Czech National Bank no. 9/2002, a bank, when determining the level of provisions for receivables, may take account of the respective collateral, however, only on condition that the conditions and restrictions mentioned in other parts of the provision are complied with. Paragraph 1 subparagraph c) of the provision in question stipulates that a bank will take account of collateral at the most at its net realisable value, i.e. only on the level which does not serve to secure other of the bank's assets or assets of third parties, if these are entitled to be satisfied before the bank, and at the most, up to the level of valuation of the receivable in the accounting.

Additional Criteria

1. Loans are required to be classified when payments are contractually a minimum number of days in arrears (e.g. 30, 60, 90 days). Refinancing of loans that would otherwise fall into arrears does not lead to improved classifications for such loans.

Compliant.

Laws and Regulations:

The criteria for evaluation of credits are stipulated by the Provision of the Czech National Bank no. 9/2002, stipulating the Rules for Evaluation of Receivables from Financial Activities, Additions to Provisions and Reserves and the Rules for Acquisition of Certain Types of Assets, specifically by Section 5 of this provision. In case of a failed regime of the due dates (i.e. debts overdue 30, 90, etc. days) the bank is required to classify the individual receivables. It is necessary to mention that when classifying receivables into categories, account is taken not only of the overdue days, but also of other criteria, which are mentioned in Section 5 paragraph 3, for example the debtor's financial condition. Section 6 paragraph 1 of the Provision stipulates that the bank – instead of classifying individual credits into categories (standard, watched, non-standard, doubtful, loss) – may use statistical models for determining the balance-sheet value of portfolios of receivables. It may, however, do so only provided that the evaluation of each of the receivables included in the portfolio does not exceed as at the moment of realization of the accounting event the lower of the following two values – CZK five million or one pro mille of the total net amount of the balance-sheet value of the bank's assets. As regards refinancing in the form of granting a new credit: pursuant to Section 1 subparagraph g) of the provision this is one of the ways of restructuring a credit and Section 5 paragraph 12 of the provision stipulates that a bank shall classify a restructured receivable at the moment of restructuring in the same category as that into which it was classified before the restructuring with the proviso, that if the bank is able to demonstrate that the level of the risk of default of the receivable has decreased in comparison with the state before the restructuring, it may classify such receivable in a better category.

2. The supervisor requires that valuation, classification and provisioning for large credits are conducted on an individual item basis.

Compliant.

Laws and Regulations:

Pursuant to the Provision of the Czech National Bank no. 9/2002 banks are obliged to evaluate larger credits on an individual basis. Only in case of minor credits in terms of size, i.e. credits up to CZK 5 million or one per mille of the bank's assets, is the bank allowed instead to assess the decrease in the balance-sheet value of an entire portfolio of receivables with the use of statistical models (see also Principle 8, Essential Criterion 1).

Principle 9. Banking supervisors must be satisfied that banks have management information systems that enable management to identify concentrations within the portfolio and supervisors must set prudential limits to restrict bank exposures to single borrowers or groups of related borrowers.

Comprehensive Assessment:

Largely compliant.

Essential Criteria

The regulatory framework that came into effect as at 1 January 2003 is harmonised with the EC law. A bank is obliged to divide all its financial instruments into a banking portfolio and a trading portfolio, in accordance with the strategy adopted by its statutory body. The principle is applied both on an individual and a consolidated basis. The relevant decree and relevant provision of the Czech National Bank define the terms gross and net credit exposure of the banking portfolio and set down the respective limits. The limits are applied both on an individual and a consolidated basis and are applicable to both an individual person and an economically related group of persons. The definition of the “economically related group of persons” is sufficiently firm and at the same time gives the Czech National Bank the necessary amount of freedom in making decisions when approving regulated consolidated groups. The Provision no. 3/2002 of the Czech National Bank on Credit Risk Management in Banks requires banks to have their strategy of management of this risk approved by their statutory body and to have an adequate credit risk management system that includes, *inter alia*, also the credit exposure limits with the proviso, that these limits must not be in conflict with the limits set down by the decree and provision of the Czech National Bank. A part of the credit risk management system is a management information system, which submits information that is essential for control of the observance of the bank’s strategy in the credit risk management area to the statutory body. The form of the regulatory framework, therefore, corresponds with the accepted international standards and with the needs of regulation of the Czech banking sector and, from this perspective, the requirements set down in this principle have been observed. The fact remains, however, that experience with the application of the new regulation of capital adequacy and exposure on a consolidated basis will be gathered in discharge of supervision only in 2003, which is why observance of this criterion has been assessed one degree below the maximum.

Additional Criteria

The maximum credit exposure limits are set at 25% of the bank’s capital towards a single person, or on the level 20% towards a person with a special relation to the bank and certain other persons. The total net exposures of the banking portfolio towards persons whose net exposure has reached 10% or more of the bank’s capital must not exceed 800% of the bank’s capital reduced by the utilised Tier 3. The limits also apply to economically related groups of persons and are applied both on an individual basis and on the basis of a regulated consolidated group.

Analysis of the Individual Criteria

Essential Criteria

1. A “closely related group” is explicitly defined to reflect actual risk exposure. The supervisor has discretion, which may be prescribed by law, in interpreting this definition on a case-by-case basis.

Compliant.

Laws and Regulations:

The term “a closely related group”, i.e. in the diction of Czech banking regulation, “an economically related group of persons” is defined in the Decree of the Czech National Bank no. 333/2002 Coll., stipulating the Rules of Prudential Business of Controlling Persons on a Consolidated Basis (Section 21). A part of the scope of this term is delimited in Section 21 paragraph 1 by the classic definition, in which the conceptual feature is the “exercise of control” pursuant to Section 17a

of the Act on Banks. In Section 21 of the mentioned Decree, however, the scope of the term “an economically related group of persons” is at the same time broadened, so that it includes any group of persons whose mutual relations are of such nature, that financial difficulties of one of the persons may cause payment difficulties to at least one of the other ones, while the features that characterize such group of persons are mentioned in the form of enumeration of examples. In Section 21 paragraph 2 of the Decree the term mentioned is broadened to include investment companies and investment funds. The definition of the term, therefore, gives the Czech National Bank sufficient freedom in decision-making on whether in the specific case an economically related group of persons is involved or not, and at the same time gives the regulated persons information on the criteria according to which the Czech National Bank proceeds when assessing the relations between the respective persons.

2. Laws or regulations, or the supervisor, set prudent limits on large exposures to a single borrower or closely related group of borrowers. “Exposures” include all claims and transactions, on-balance sheet as well as off-balance sheet.

Compliant.

Laws and Regulations:

Section 9 paragraph 1 of the Decree of the Czech National Bank no. 333/2002 Coll., stipulating the Rules of Prudential Business of Controlling Persons on a Consolidated Basis determines that a bank, provided it is the controlling person of a regulated consolidated group, is obliged to have a strategy for dividing all financial instruments into a banking portfolio and a trading portfolio and also that this strategy must be approved by the bank’s statutory body. This provision forms the basis for calculation of adherence to the credit exposure limits of the banking portfolio on a consolidated basis. Gross exposure of the banking portfolio for a regulated consolidated group is defined in Section 20 paragraph 1 to 4 and includes both balance-sheet and off-balance sheet items of the banking portfolio. The same Section, paragraphs 5 and 6, defines net credit exposure of the banking portfolio. Section 22 paragraph 1 sets the limit of net credit exposure towards a single person or an economically related group of persons at 25% of the bank’s capital with the proviso, that for persons mentioned in paragraph 2 (i.e. persons with a special relation to the bank and certain other persons) the stipulated limit is lower, specifically 20% of the bank’s capital. Paragraph 3 sets the limit for total net exposure represented by the sum of exposures equal to or larger than 10% of the capital of the regulated consolidated group reduced by the utilised Tier 3 capital at 800% – the exact definition is given in the mentioned paragraph 3. The Decree in Section 71 paragraph 5 and in paragraph 6 stipulates that a bank that is the controlling person shall create within the framework of its risk management such system of its own limits as will ensure consistent adherence to the limits stipulated by this Decree and also that the bank must, at request of the Czech National Bank, prove adherence to the limits in a creditworthy manner. Pursuant to Section 4 of the Provision of the Czech National Bank no. 2/2002, on Capital Adequacy of Banks and Other Rules of Prudent Business on an Individual Basis, limits of credit exposure of a bank are stipulated. The limits in question apply to the banking portfolio of a bank. This provision in Section 1 paragraph 2 also stipulates that banks in setting these limits shall proceed in accordance with the above-mentioned decree, unless stipulated otherwise in the provision. This means, *inter alia*, that both balance-sheet and off-balance sheet items of the banking portfolio are included in the credit exposure of a bank on an individual basis and also that the above-mentioned limits and qualitative requirements apply both in relation to individual persons and in relation to economically related groups of persons.

3. The supervisor verifies that banks have management information systems that enable management to identify on a timely basis concentrations (including large individual exposures) within the portfolio on a solo and consolidated basis.

Compliant.

Laws and Regulations:

Pursuant to Section 3 paragraph 7 of the Provision of the Czech National Bank no. 3/2002, on Credit Risk Management in Banks, a bank arranges for operation of an information system that provides sufficient support for credit risk management. The information system must in particular

provide information that is essential for credit risk management to the board of directors, the respective members of senior management, the units responsible for risk management and business units. In Section 7 of the provision mentioned the requirements for the information system are elaborated in greater detail. Among the requirements for the information system is that it should provide information on exposure on both an individual and a consolidated basis and should enable management of these exposures, including adherence to the internal limits set by the bank itself and the limits stipulated by the rules of prudential business, which were stipulated by the Czech National Bank in the respective decree and the respective provision (see above, Principle 9, Essential Criterion 1 and Essential Criterion 2).

Discharge of Supervision:

The existence, structure and functionality of the management information system are the subject of on-site inspections. The Provision of the Czech National Bank no. 3/2002 on Credit Risk Management in Banks enhances the effectiveness of on-site inspections by defining clear requirements for the management information system.

4. The supervisor verifies that bank management monitors these limits and that they are not exceeded on a solo and consolidated basis.

Compliant.

Laws and Regulations:

The Provision of the Czech National Bank no. 3/2002 on Credit Risk Management in Banks stipulates the minimum qualitative requirements on the system of management of credit risk. These cover all main aspects of credit risk management and include, *inter alia*, the requirement that a bank's board of directors and the other responsible senior managers of the bank should monitor adherence to the exposure limits on a regular basis. The duties of the board of directors as the statutory body of the bank are expressly provided for in the provision (Section 3 above mentioned Provision).

Discharge of Supervision:

The activities of the board of directors and the other responsible senior managers of the bank in the area of credit risk management generally and setting the limits for credit exposure and control over adherence to these limits specifically are the subject of on-site inspections. The Provision of the Czech National Bank no. 3/2002 on Credit Risk Management in Banks 3/2002 enhances the effectiveness of on-site inspections by defining clear requirements for the main aspects of the system of managing exposure and credit risk in general.

5. The supervisor regularly obtains information that enables concentrations within a bank's credit portfolio, including sectoral and geographic exposures, to be reviewed.

Largely compliant.

Discharge of Supervision:

Banks submit reports on their exposure on an individual basis monthly – Report BD(ČNB)3-12. They also report with monthly periodicity on their exposure towards individual countries; the report concerned is BD(ČNB)16-12. Their reports on exposure of a regulated group are submitted to the CNB quarterly, in this case the report is BD(ČNB) 13-04. The information contained in these reports is analysed periodically within the framework of off-site supervision. As at 31 December every year the reports mentioned are verified by an external auditor. Observance of the methodology and the objective accuracy of these reports are also the subject of on-site inspections. Information on exposure towards individual sectors is available to the Czech National Bank through reports which banks submit for the purposes of the monetary policy; the staff of banking supervision however, do not work with these reports systematically.

Additional Criteria

1. Banks are required to adhere to the following definitions:

- **10 percent or more of a bank's capital is defined as a large exposure;**
Compliant.

Pursuant to Section 22 paragraph 3 of the Decree of the Czech National Bank no. 333/2002 Coll. a large exposure is taken to mean in principle a net exposure which is equal to or larger than 10% of a bank's capital; the exact definition is given in the mentioned paragraph 3. The same conception of regulation of large exposures is also applied on an individual basis.

- **25 percent of a bank's capital is the limit for an individual large exposure to a private sector non-bank borrower or a closely related group of borrowers.**
Compliant.

This is stipulated by the Provision of the Czech National Bank no. 2/2002, on Capital Adequacy and Other Rules of Prudential Business on an Individual Basis, which includes market risk. Section 22 paragraph 1 of the Decree of the Czech National Bank no. 333/2002 Coll. sets the limit of a net exposure towards one person or an economically related group of persons at 25% of a bank's capital with the proviso, that a lower limit, specifically 20% of a bank's capital, is set for persons mentioned in paragraph 2 (i.e. for persons with a special relation to the bank or certain other persons). The limit is stipulated in relation to the bank's capital, decreased by the utilised Tier 3, and is applied both on an individual basis and for a regulated consolidated group. Section 3 of the Decree sets the limit of a total net exposure, which is represented by the sum of large exposures, at 800%.

Minor deviations from these limits may be acceptable, especially if explicitly temporary or related to very small or specialised banks.

A bank is obliged to observe the credit exposure limits; in the event of exceeding them it must notify the Czech National Bank thereof without delay and devise a procedure to remedy this situation.

Principle 10. In order to prevent abuses arising from connected lending, banking supervisors must have in place requirements that banks lend to related companies and individuals on an arm's-length basis, that such extensions of credit are effectively monitored, and that other appropriate steps are taken to control or mitigate the risks.

Comprehensive Assessment:

Largely compliant.

Essential Criteria

“A person with a special relation to the bank” is defined, in the form of enumeration, in the Act on Banks. The Czech National Bank consequently has no discretion to decide in individual cases that do not precisely meet the definition. Extension of credits to such persons under special conditions is prohibited by the Act. The Act also requires that credits and guarantees extended to such persons should be approved by the board of directors. The Czech National Bank also reviews whether banks use the procedures preventing any unjust personal enrichment of the individuals who prepare supporting documentation for credits, as well as the individuals who decide on extension of a credit. The Czech National Bank will initiate a change of the respective provisions of the Act on Banks (this also applies to the Additional Criteria – see below).

Additional Criteria

The definition of “a person with a special relation to the bank” in the Act on Banks is narrower in scope as compared to the definition mentioned in the Core Principles for Effective Banking Supervision. Additional Criterion 2 has been observed, since the bank exposure limit with regard to a person with a special relation to the bank has been set at 20% of the bank’s capital, while it is higher for the other persons and has been set at 25% of the bank’s capital.

Analysis of the Individual Criteria.

Essential Criteria

1. A comprehensive definition of “connected or related parties” exists in law and/or regulation. The supervisor has discretion, which may be prescribed in law, to make judgments about the existence of connections between the bank and other parties.

Largely compliant.

Laws and Regulations:

Section 19 of the Act on Banks defines persons with a special relation to the bank, which are: a) members of the statutory body and senior managers of the bank; b) members of the supervisory board of the bank, c) legal entities exercising control over the bank, persons with a qualifying holding in these entities and members of the management of these entities; d) persons close to members of the statutory body, supervisory board, senior managers of the bank and persons exercising control over the bank; e) legal entities in which some of the persons listed in subparagraphs a), b), c) has a qualifying holding; f) persons with a qualifying holding in the bank and any legal entity under their control; g) members of the Bank Board of the Czech National Bank; h) legal entities controlled by the bank. From the point of view of the Additional Criterion 1, however, this definition is not complete. The Czech National Bank does not have the right to consider persons other than those stipulated in the Act on Banks as “persons with a special relation to the bank”. The Czech National Bank will initiate a change of the respective provisions of the Act on Banks.

2. Laws and regulations exist that exposures to connected or related parties may not be extended on more favourable terms (i.e., for credit assessment, tenor, interest rates, amortisation schedules, requirements for collateral) than corresponding to loans to non-related counterparties.

Compliant.

Laws and Regulations:

Section 18 of the Act on Banks stipulates that a bank must not carry out with persons having a special relation to the bank business transactions which otherwise, due to their nature, purpose or risk, would not be carried out with other clients. A bank may extend credits to persons with a special relation to the bank and guarantee their commitments only if its statutory body decides so on the basis of an analysis of the respective banking transaction and the applicant's financial condition. The issues of extending credits to "persons with a special relation to the bank" are dealt with in the Provision of the Czech National Bank no. 3/2002 on Credit Risk Management in Banks, which in Section 9 stipulates that business transactions with persons having a special relation to the bank (both private individuals and legal entities) shall be concluded by the bank under the usual conditions.

3. The supervisor requires that transactions with connected or related parties exceeding specified amounts or otherwise posing special risks are subject to approval by the bank's board of directors.

Largely compliant.

Laws and Regulations:

With respect to credits, i.e. to temporarily extended funds in any form, or to guarantees for commitments, this criterion is fulfilled by the provision of Section 18 of the Act on Banks (see also above, Essential Criterion 2). The criterion, however, is not fulfilled with respect to other business transactions. The Czech National Bank will initiate a change of the respective provision of the Act on Banks (approval by the board of directors also of other than credit transactions with persons having a special relation to the bank).

4. The supervisor requires that banks have procedures in place to prevent persons benefiting from the loan being part of the preparation of the loan assessment or of the decision itself.

Compliant.

Laws and Regulations:

The Provision of the Czech National Bank no. 3/2002 on Credit Risk Management in Banks stipulates that the board of directors is responsible for the creation and operation of such organisational and managerial structure of the bank that will, *inter alia*, respect the requirements for separation of incompatible functions. It is important for credit risk management that a bank in determining the powers and responsibilities of its units or, as the case may be, individual staff members, should prevent a conflict of interests, which may arise on accumulation of responsibilities and powers with respect to business activities and risk management or, as the case may be, also to settlement of business transactions. The limits, therefore, must be approved independently of the business units. The same applies to approving of the systems and methods for appraisal of collateral. The separation of incompatible functions also applies to disbursing of the extended funds and creation of quantitative and qualitative information on credit risk for members of the senior management and the board of directors. The units which are responsible for credit risk management must not be subordinated to those members of the board of directors to whom the business units are subordinated.

Discharge of Supervision:

Within the framework of on-site inspection it is reviewed whether the bank has in place such organisation of the entire credit process that reduces to the maximum extent possible the risk of abuse of powers in extending credits. The review focuses especially on adequate separation of powers and on the system of limits in approving credits.

5. Laws or regulations set, or the supervisor has the mandate to set, on a general or case-by – case basis, limits for loans to connected and related parties, to deduct such lending from capital when assessing capital adequacy or to require collateralisation of such loans.

Compliant.

Laws and Regulations:

Exposure towards persons with a special relation to the bank is not deducted from capital. In accordance with Section 26a of the Act on Banks the Czech National Bank is authorised to bar a bank from extending a credit to any person with a special relation to the bank in the case that the bank's capital adequacy ratio on an individual basis is less than two thirds of the ratio stipulated by the Czech National Bank. It is true that neither the Act on Banks, nor any other legal regulation entitles the Czech National Bank to make special demands on collateralisation of a credit extended to a person with a special relation to the bank. These credits are evaluated in the same manner as other credits and the rules for evaluation of receivables from financial activities and additions to provisions and reserves as well as the rules for credit risk management mentioned in connection with Principle 8 apply to them to the full. This regulation is sufficient.

6. The supervisor requires banks to have information systems to identify individual loans to connected and related parties as well as the total amount of such loans, and to monitor them through an independent credit administration process.

Compliant.

Laws and Regulations:

The Provision of the Czech National Bank no. 3/2002 on Credit Risk Management in Banks stipulates the requirements for an information system for credit risk management. The requirement for identification of the individual credits extended to persons with a special relation to the bank and for ascertaining their total volume is not stipulated in this provision. Nevertheless, banking supervision of the Czech National Bank may request this information from the bank, if necessary.

Discharge of Supervision:

Compliance of the bank's activities with this criterion is reviewed within the framework of on-site inspections.

7. The supervisor obtains and reviews information on aggregate lending to connected or related parties.

Largely compliant.

Discharge of supervision:

As regards off-site supervision, the Czech National Bank does not require banks to prepare a special report on credits extended to persons with a special relation to the bank. If such credit exceeds 10% of the bank's capital, it is recorded in the monthly report on credit exposure on an individual basis, or in the quarterly report on credit exposure of a consolidated group. Observance of the criterion is reviewed during on-site inspections (see Essential Criterion 6).

Additional Criteria

1. The definition of "connected or related parties" established in law and/or regulation is broad and, generally, includes affiliated companies, significant shareholders, board members, senior management, key staff as well as close family members, corresponding persons in affiliated companies, and companies controlled by insiders and shareholders.

Materially non-compliant.

Laws and Regulations:

The term "person with a special relation to the bank" is defined in the form of enumeration in the Act on Banks. Nevertheless, this definition does not include significant capital participations of the bank (only companies under the bank's control are listed), key staff of the bank (only members of the board of directors, senior management of the bank and members of the supervisory board are mentioned in Section 19 of the Act on Banks). Nor does the definition mention family members of key staff and persons with corresponding positions in the affiliated companies of the bank. From among insiders only members of the Bank Board of the Czech National Bank are mentioned in it. The Czech

National Bank will initiate a change of the respective provisions of the Act on Bank (i.e. a modification of the definition of “connected or related parties”).

3. There are limits on aggregate exposures to connected and related parties that are at least as strict as those for single borrowers, groups or related borrowers.

Compliant.

Laws and Regulations:

For all persons with a special relation to the bank the exposure limit is 20% of the bank’s capital and is, therefore, lower than the limit for other persons (25% of the bank’s capital). See also Essential Criterion 1.

Principle 11. Banking supervisors must be satisfied that banks have adequate policies and procedures for identifying, monitoring and controlling country risk and transfer risk in their international lending and investment activities, and for maintaining appropriate reserves against such risks.

Comprehensive Assessment:

Compliant.

Essential Criteria

Country risk and transfer risk are regulated by the Provision of the Czech National Bank no. 3/2002 on Credit Risk Management in Banks. This provision lays down the requirements for all key aspects of credit risk management. The requirements apply fully also to country risk and transfer risk that both represent special instances of credit risk. The Provision of the Czech National Bank no. 9/2002 sets down the detailed rules for evaluation of receivables from financial activities and for additions to provisions and reserves. The rules are described and assessed above, in connection with Principle 8, and apply in full also to receivables from financial activities from non-residents and, therefore, also to country risk and transfer risk. Beginning from 2000, a monthly report has been introduced to monitor banks' exposures by country. The report is analysed and evaluated within the framework of off-site supervision. During on-site inspections, country risk management is evaluated as a part of credit risk and the system of its management within the bank. Failures in functioning of the risk management system with regard to country risk or transfer risk are considered a breach of prudence.

Analysis of the Individual Criteria

Essential Criteria

1. The supervisor determines that a bank's policies and procedures give due regard to the identification, monitoring and control of country risk and transfer risk. Exposures are identified and monitored on an individual country basis (in addition to the end-borrower/end-counterparty basis). Banks are required to monitor and evaluate developments in country risk and in transfer risk and apply appropriate counter-measures.

Compliant.

Laws and Regulations:

Country risk and transfer risk are regulated by the Provision of the Czech National Bank no. 3/2002 on Credit Risk Management in Banks. The provision includes in particular the requirement that banks should have an appropriate strategy for credit risk management, that a bank's board of directors should approve the strategy and the other most important internal regulations for extending and administration of credits and that it should consistently control observance of these regulations in practice. The provision also lays down the requirements for a system for measuring and monitoring credit risk and imposes on the bank the duty to arrange for the operation of an information system providing sufficient support for credit risk management with the proviso, that the information system must provide in particular the information that is essential for the management of credit risk to the board of directors, to the respective members of the bank's senior management, to the units responsible for risk management and to business units. Among further requirements is that a bank should lay down and observe such set of limits as is adequate with regard to the bank's size, complexity, methods of management and capital adequacy. In dependence on these factors, the provision in Section 11 requires a bank to set down limits, for example for individual contracting parties, individual states and geographical areas or for individual activities. All of these and still other requirements stipulated by the Provision apply in full also to country risk and transfer risk, which are specific types of credit risk.

Discharge of Supervision:

Beginning from 2000, a monthly report – BD(ČNB)16-12 – has been introduced, which monitors exposures by country and the structure of exposures by type of assets. This report is analysed

and evaluated within the framework of off-site supervision. During on-site inspections, country risk management is evaluated as a part of credit risk and the system of its management within the bank. Failures in functioning of the risk management system with regard to country risk or transfer risk are considered a breach of prudence.

2. The supervisor verifies that banks have information systems, risk management systems and internal control systems to comply with their policies.

Compliant.

Discharge of Supervision:

Reviewed within the framework of on-site inspections as a part of the evaluation of credit risk and the system of its management within the bank.

3. There is supervisory oversight of the setting of appropriate provisions against country risk and transfer risk. There are different international practices which are all acceptable, as long as they lead to reasonable, risk-related, results. These include, *inter alia*:

- **The supervisor (or some other official authority) decides on appropriate minimum provisioning by setting fixed percentages for exposures to each country.**
- **The supervisor (or some other official authority) sets percentage intervals for each country and the banks may decide, within these intervals, which provisioning to apply for the individual exposures.**
- **The bank itself (or some other body such as the national bankers' association) sets percentages or guidelines or even decides for each individual loan on the appropriate provisioning. The provisioning will then be judged by the external auditor and/or by the supervisor.**

Compliant.

Laws and Regulations:

Detailed rules for evaluation of receivables from financing activities and additions to provisions and reserves are set down by the Provision of the Czech National Bank no. 9/2002. These rules are described and assessed in connection with Principle 8 and apply to the full also to receivables from financing activities from non-residents and, therefore, also to country risk and transfer risk. The procedure used is, in principle, the one mentioned in the third indentation. Czech regulation, however, is based on a higher standard of prudence than this procedure, because it applies to receivables from financing activities, i.e. not only to credits, but to a wider range of items.

4. The supervisor obtains and reviews sufficient information on a timely basis on the country risk/transfer risk of individual banks.

Compliant.

Discharge of Supervision:

Beginning from 2000, a monthly report – BD(ČNB)16-12 – has been introduced, which monitors exposure by country and structure of exposure by type of assets. This report is analysed and evaluated within the framework of off-site supervision. During on-site inspections, country risk management is evaluated as a part of credit risk and the system of its management within the bank. Failures in functioning of the risk management system with regard to country risk or transfer risk are considered a breach of prudence.

Principle 12. Banking supervisors must be satisfied that banks have in place systems that accurately measure, monitor and adequately control market risks; supervisors should have powers to impose specific limits and/or a specific capital charge on market risk exposures, if warranted.

Comprehensive Assessment:

Largely compliant.

Essential Criteria

Measurement, monitoring and control of market risks are substantial elements of a bank's overall risk management strategy and its application in practice. The Provision of the Czech National Bank no. 4/2002 on Market Risks Management in Banks sets down the requirements for market risks management, specifying that a bank shall adhere to the requirements with respect to its size and method of management, type, nature and complexity of the activities it performs. The key requirement is that a bank has its market risk management strategy that is based on the principle that market risk management is a day-to-day process. The strategy specifically determines an acceptable amount of market risks, the methods for market risks management, including measuring and monitoring of market risks, stress testing, as well as a system of limits, the rules for defining the approved products, currencies and markets, etc. The strategy and its changes are approved by the board of directors. The strategy is followed up with the procedures and methods for market risk management that the bank must reflect in its internal regulations. The board of directors is responsible also for the creation and operation of such organisational and management structure of the bank that will enable to implement effectively and efficiently the market risk management strategy. The structure must ensure that relevant members of the bank's senior management are directly involved in the process of market risk management. The structure must also reflect the requirements for separation of incompatible functions. The provision further requires that all staff members of the bank whose activities have an impact on market risk management be familiarised with the strategy and the related procedures.

The market risk management system is subject to on-site inspections. Standardised procedures are used in accordance with the manuals and an emphasis is laid on setting down in writing all job descriptions, powers and responsibilities so that any possible abuse of powers and conflict of interests be minimised. The provision on market risks management in banks significantly enhances the efficiency of on-site inspections in that it determines, in the form of a legal regulation, the minimum requirements for market risk management and facilitates qualification of the fact that certain elements of the risk management system are either missing or non-functional as a shortcoming in the bank's activities under the Act on Banks, Section 26 paragraph 3 subparagraph b).

The regulatory framework of market risk management is compliant with international standards and creates a basis for efficient discharge of banking supervision. However, as the Czech National Bank has so far gathered only a limited practical experience of the process of approving market risk models, we have assessed observance of Principle 12 one degree below the maximum. The other reason is that the laws do not authorise the Czech National Bank to set down specific capital requirements for individual institutions. The truth, however, is that this supervision tool is to a considerable degree substituted for by the possibility of imposing remedial measures in accordance with Section 26 paragraph 1 subparagraph a) of the Act on Banks and that introduction of this tool in the EC law has been projected for as late as the end of 2006, in connection with harmonising the EC law with the New Basle Accord.

Additional Criteria

The Czech National Bank has provided for an extensive training programme for its specialists in the control of market risks management systems in banks. The knowledge potential of the Czech National Bank in the area of supervision over market risks management is being further reinforced as the banking supervision of the Czech National Bank has been gaining more and more experience from its on-site inspections. The experience is analysed and incorporated in manuals for the discharge of supervision. The piled-up knowledge has enabled the Czech National Bank to develop its own methodology for approving market risk management models of banks.

Analysis of the Individual Criteria

Essential Criteria

1. The supervisor determines that a bank has suitable policies and procedures related to the identification, measuring, monitoring and control of market risk.

Compliant.

Laws and Regulations:

Section 9 of the Provision of the Czech National Bank no. 4/2002 on Market Risks Management sets down the requirements for measuring and monitoring of market risks. The basic requirements are that measuring and monitoring of these risks should form a comprehensive system giving an undistorted picture of the amount of risks undertaken and that all transactions and exposures involving any market risk should be identified and correctly assessed. In a link-up with these basic requirements the provision in Section 9 paragraph 2 subparagraphs b) to f) stipulates specific requirements for the procedures and methods of measuring and monitoring of market risks.

Discharge of Supervision:

The system of market risks management is the subject of on-site inspections. During on-site inspections this system is assessed in connection with the bank's information system and its internal control system. The basic aim of on-site inspections in the area of market risks is mapping of all states and processes within the bank which relate in some manner to market risks, liquidity risk and the risks connected with trading on the financial markets, detecting of any shortcomings in these processes including those which might have an impact on the deterioration of the bank's financial condition only in the future. A substantial part of the control is also assessment of the system of management of market risks. During the control, standard procedures are applied which are described in the manual "Methodology for the Control of Market Risks Management during On-site Inspections".

2. The supervisor determines that the bank has set appropriate limits for various market risks, including their foreign exchange business.

Compliant.

Laws and regulations.

The Provision of the Czech National Bank no. 4/2002 on Market Risks Management in Banks in Section 4, paragraph 2 subparagraph c) stipulates that a part of a bank's strategy for market risks management must be also a set of limits the bank uses.

Discharge of Supervision:

During on-site inspections, within the framework of assessment of the bank's risk management, it is also examined whether the bank has set limits for positions involving market risks, on the basis of what principles these limits were set and whether they are observed.

3. The supervisor has the power to impose a specific capital charge and/or specific limits on market risk exposures, including their foreign exchange business.

Materially non-compliant.

Laws and Regulations:

The Provision of the Czech National Bank no. 333/2002 Coll., stipulating the Rules of Prudential Business of Controlling Persons on a Consolidated Basis and the Provision of the Czech National Bank no. 2/2002 on Capital Adequacy of Banks and Further Rules of Prudential Business on an Individual Basis stipulate the procedure for calculation of capital to cover market risks and also the uniform 8% minimum limit of capital adequacy. The laws do not authorise the Czech National Bank to stipulate specific capital requirements for individual banks. Assessment of a bank's capital

adequacy by its individual risk profile is a fundamental part of the second pillar of the New Capital Accord (NBCA). It is envisaged that towards the end of 2006 these procedures will be incorporated into the EC law and also into the Czech banking regulation. Nevertheless, the Czech National Bank is currently authorised, pursuant to Section 26 paragraph 1 subparagraph a) of the Act on Banks to require, on the basis of findings of the banking supervision, the bank to curb or terminate such business operations as the Czech National Bank in discharge of banking supervision has qualified in accordance with the Act on Banks, Section 12 paragraph 1 as imprudent. This remedial measure may influence the bank's capital adequacy and it is assumed that decision on its imposition will be made on the basis of assessment of the amount of risk of certain transactions or exposures of the respective bank or the quality of its system for the management of risks (credit risk or market risks). It, therefore, corresponds to a considerable degree with the procedures that form part of the second pillar of the New Capital Adequacy Concept.

4. The supervisor verifies that banks have information systems, risk management systems and internal control systems to comply with those policies, and verifies that any limits (either internal or imposed by the supervisor) are adhered to.

Compliant.

Laws and Regulations:

Section 7 of the Provision of the Czech National Bank no. 4/2002 on Market Risks Management in Banks imposes on the bank the duty to have an appropriate information system providing information that is essential for the management of market risks and stipulates specifically the essential requirements this information system must fulfil. In Section 4 paragraph 2 subparagraph e) it requires a bank to set down, as a part of its risk management strategy, the basic requirements for the organisational structure of the bank from the point of view of management of market risks, including the setting down of the powers, responsibilities and information flows and in Section 5 subparagraph a) imposes on the bank the duty to incorporate these requirements into its internal regulations which will define such organisational structure as will provide for efficient implementation of the strategy of market risk management and will also comprise unequivocally defined powers and responsibilities of the individual units, staff members or committees in managing market risks. The Provision of the Czech National Bank on Market Risks Management in Banks stipulates in Section 4 paragraph 2 subparagraph c) that a part of the bank's strategy for market risks management must also be a set of limits which the bank uses (see also above, Essential Criterion 2).

Discharge of Supervision:

Within the framework of on-site inspections the adequacy and reliability of information systems, just as the organisation of the risk management, the timeliness and reality of capturing of all transactions and exposures are reviewed.

5. The supervisor satisfies itself that there are systems and controls in place to ensure that all transactions are captured on a timely basis and that the banks' positions are revalued frequently, using reliable and prudent market data.

Compliant.

Laws and Regulations:

The Decree of the Czech National Bank no. 333/2002 Coll., stipulating the Rules of Prudent Business of Controlling Persons on a Consolidated Basis in Section 9 paragraph 1 and the Provision of the Czech National Bank no. 2/2002 on Capital Adequacy of Banks and Other Rules of Prudent Business on an Individual Basis in Section 2 stipulate that a bank shall categorise all its financial instruments into a trading portfolio or a banking portfolio in accordance with the strategy approved by its statutory body and according to the accounting procedures which are set down by the Decree of the Ministry of Finance no. 501/2002, implementing Some Provisions of the Act no. 563/1991 Coll., on Accounting, in the wording of subsequent regulations, for accounting units that are banks and other financial institutions, and the Provision of the Ministry of Finance of the Czech Republic Ref. no.:

282/73390/2001 of 15 November 2001, stipulating the Chart of Accounts and the Accounting Procedures for Banks and Some Financial Institutions. The instruments of the trading portfolio are valued daily on the basis of actual values. Section 7 paragraph 2 of the Provision of the Czech National Bank no. 4/2002 on Market Risks Management in Banks requires a bank to include in its information system information on all transactions, due to which the bank is exposed to market risks, and to input this information and update it with appropriate periodicity with regard to the nature of the risk undertaken.

Discharge of Supervision:

Within the framework of on-site inspections the system and control of timely capturing of transactions is reviewed, just as whether the positions of banks are revalued on a regular basis and whether reliable data are used.

6. The supervisor determines that banks perform scenario analysis, stress testing and contingency planning, as appropriate, and periodic validation or testing of the systems used to measure market risk.

Compliant.

Laws and Regulations:

Section 11 paragraph 1 of the Provision of the Czech National Bank no. 4/2002 on Market Risks Management in Banks requires banks to carry out stress testing to assess the impacts of extremely unfavourable market conditions on the bank, to take the results of these stress tests into account when setting down the procedures and limits for market risks management, in order that any losses the bank may incur owing to abrupt adverse changes in market conditions should not cause insolvency of the bank or decrease its capital adequacy below the minimum level stipulated by the respective legal regulations. Stress testing is carried out on the basis of stress scenarios. Pursuant to Section 11 paragraph 3 a bank is obliged to carry out stress testing on a regular basis, once in three months at the minimum, and to submit the results of the stress tests to those members of the bank's senior management who are responsible for the management of market risks. Pursuant to Section 7 paragraph 5 a bank draws up contingency plans and plans for the event of breakdowns of its information system. These plans are periodically tested in order to ensure their functionality. Validation and testing of the systems for managing market risks constitute a substantial element of the internal control system. The duty to carry out within the framework of internal audit and internal control independent verification of the risk management system, i.e. of the system for managing market risks, including validations and testing, is expressly imposed by the Provision of the Czech National Bank no. 12/2002 on the Internal Management and Control System of a Bank in Section 6 and Section 7 (this Provision becomes effective on 1 July 2003).

Discharge of Supervision:

The stipulated requirements for stress testing, creation of scenarios, contingent planning and independent verification of the market risk management system, including validation and reconciliation, are the subject of on-site inspections. During these inspections standardised procedures contained in the manuals are used and emphasis is placed on stipulating the job descriptions, powers and responsibilities in written form and in such manner as to minimise the possibility of abuse of powers and conflicts of interests.

7. The supervisor has the expertise needed to monitor the actual level of complexity in the market activities of banks.

Largely compliant.

Discharge of Supervision:

The individual staff members in the review teams for the execution of on-site inspections specialise in the individual specialised areas in order that a review team should be able to cover all

significant areas of the activities of banks. The areas involved are in particular the following: credit activities, market risks management, information systems and internal management and control systems. The Czech National Bank has arranged for an extensive training programme for its specialists in control of market risk management systems in banks. In 1999 several training courses relating to market risks took place (the standard method, VAR), in 2000 further training courses were implemented, *inter alia* within the framework of the Phare Twinning Project (internal models, VAR, financial tools). Two staff members completed long-term internships with a foreign regulator (the British FSA, the Austrian Central Bank). The staff of the Czech National Bank have gathered considerable experience directly in the course of on-site inspections. The growth of knowledge of the Czech National Bank enabled it to create its own methodology – the methodology of the Czech National Bank for approving models for market risks management to be submitted by banks to the Czech National Bank.

Additional Criteria

1. Either through on-site work, or through internal or independent external experts, the supervisor determines that senior management understands the market risks inherent in the business lines/products traded and that it regularly reviews and understands the implications (and limitations) of the risk management information they receive.

Compliant.

Laws and Regulations:

Section 9 paragraph 3 of the Provision of the Czech National Bank no. 4/2002 on Market Risks Management in Banks requires a bank to ensure that the staff of the units responsible for market risks management and the respective members of the bank's senior management understand the assumptions from which the system of measuring and monitoring market risks stems. It also requires that the assumptions mentioned should be adequately documented.

Discharge of Supervision:

The knowledge possessed by a bank's senior management is reviewed within the framework of interviews with the individual members of the bank's senior management on their joining the bank. Observance of the duty imposed in Section 9 paragraph 3 of the Provision of the Czech National Bank no. 4/2002 on Market Risks Management in Banks is the subject of control within the framework of on-site inspections. During these inspections standardised procedures are used. No external experts are engaged for these purposes.

2. The supervisor reviews the quality of management information and forms an opinion on whether the management information is sufficient to reflect properly the banks' position and exposure to market risk. In particular, the supervisor reviews the assumptions management has used in their stress testing scenarios, and the bank's contingency plans for dealing with such conditions.

Largely compliant.

See Essential Criterion 5 and Essential Criterion 6.

3. The supervisor who does not have access to the adequate skills and capacity does not allow banks to determine their regulatory capital requirements based on sophisticated models, such as VAR.

Largely compliant.

See Essential Criterion 7.

Principle 13. Banking supervisors must be satisfied that banks have in place a comprehensive risk management process (including appropriate board and senior management oversight) to identify, measure, monitor and control all other material risks and, when appropriate, to hold capital against these risks.

Comprehensive Assessment:

Largely compliant.

Essential Criteria

The principle has been reflected with regard to credit risk, market risks and liquidity risk. In July 2001 the Provision of the Czech National Bank no. 2/2001 on Liquidity Management Standards of Banks came into force. This provision sets down the key principles of management of liquidity in banks. The Provision of the Czech National Bank no. 3/2002 on Credit Risk Management in Banks and the Provision of the Czech National Bank no. 4/2002 on Market Risks Management in Banks stipulate the minimum prudential requirements to be observed by banks in the respective area. Both provisions came into force as at 1 January 2003. These provisions should be followed up with other provisions stipulating the minimum requirements also in other areas of risk management pursuant to the New Basle Capital Accord (for example the operational risk).

The three already published provisions of the Czech National Bank lay down the minimum prudential requirements for management of credit risk and market risks and for management of liquidity of banks. Banks are required to adjust them further according to their size and method of management, as well as the type, nature and complexity of the activities they carry out.

The criteria for some other significant types of risk are set down in a partial manner in other provisions (e.g. for operational risk in the Provision on Credit Risk Management and in the Provision on Market Risks Management). However, the Czech National Bank reviews, as a part of its on-site inspections, whether the banks have in place a system of management of operational risk and a system of management of other risks and the quality of managing in practice the risks connected with the bank's business. A new provision on risk management is currently underway that should cover the requirements for management of all material risks, i.e. also of operational risk. As a result, all requirements set out in the recommendations of the Basle Committee on Banking Supervision should be fulfilled. A new phenomenon that needs to be paid attention, above all during on-site inspections, is the shift of risk management from a domestic bank, which is a subsidiary bank of a foreign bank, to its parent bank. This means in practice that a significant proportion of the risks management system of a domestic subsidiary bank gets concentrated within the foreign head office. The Czech National Bank has been considering issuance of a regulation which would set down the minimum requirements for information that in such case the domestic bank must submit to the banking supervision of the Czech National Bank in order to demonstrate that risk management is carried out with prudence and does not involve a higher amount of risk for the bank than if the bank carried out such management by itself.

Additional Criteria

The Act on Banks, as well as the decrees and provisions of the Czech National Bank require that banks hold capital to cover credit risk and market risks, both on an individual basis and by virtue of their inclusion within a consolidated group. There is no specific capital requirement relating to other risks (for example to operational risk) and the Czech National Bank has never applied such requirement to any bank in practice. The New Basle Capital Accord draft, however, has expressly included the requirement for capital to be brought in to cover operational risk and banks will have to get ready for fulfilment of this requirement within the framework of their preparations for the implementation of the New Basle Capital Accord. As regards disclosure of information on management of the risks to which banks are exposed, the Provision of the Czech National Bank no. 1/2002, stipulating the Minimum Requirements for Disclosure of Information by Banks and Foreign Bank Branches requires banks to disclose material information on risk management already in their financial statements for 2002. This provision came into effect as at 1 January 2003. According to this provision a bank shall disclose substantive qualitative information on its risk management (in

particular on its risk management strategy and objectives and its principles and procedures of monitoring, managing and controlling risk) in the event of any changes in the information during the calendar quarter compared with the information disclosed in the last annual report or in the financial statements for the last ended accounting period. The Czech National Bank is planning to issue a comprehensive provision on risks management with the aim to be fully compliant with the required criteria. This provision should sum-up the general principles of managing risks in banks, mentioning the differences for the individual types of risk.

Analysis of the Individual Criteria

Essential Criteria

1. The supervisor requires individual banks to have in place comprehensive risk management processes to identify, monitor and control material risks. These processes are adequate for the size and nature of the activities of the bank and are periodically adjusted in light of the changing risk profile of the bank and external market developments. These processes include appropriate board and senior management oversight.

Compliant.

Laws and Regulations:

The Provision of the Czech National Bank no. 2/2001 on Liquidity Management Standards of Banks, Provision of the Czech National Bank no. 3/2002 on Credit Risk Management in Banks and the Provision of the Czech National Bank no. 4/2002 on Market Risks Management in Banks.

Discharge of Supervision:

Reviewed within the framework of on-site inspections.

2. The supervisor determines that the risk management processes address liquidity risk, interest rate risk, and operational risk as well as all other risks, including those risks covered in other Principles (e.g., credit and market risk). These would include:

- **Liquidity: good management information systems, central liquidity control, analysis of net funding requirements under alternative scenarios, diversification of funding sources, stress testing and contingency planning. Liquidity management should separately address domestic and foreign currencies.**
- **Interest rate risk: good management information systems and stress testing.**
- **Operational risk: internal audit, procedures to counter fraud, sound business resumption plans, procedures covering major system modifications and preparation for significant changes in the business environment.**

Compliant.

Laws and Regulations:

The Provision of the Czech National Bank no. 2/2001 on Liquidity Management Standards of Banks stipulates the key principles for prudent management of liquidity, including the requirements for diversification of the sources of financing, for drawing up of a business resumption plan, for an information system for liquidity management and for independent management of liquidity in individual currencies. The Provision of the Czech National Bank no. 3/2002 on Credit Risk Management in Banks sets down the requirements for an information system for managing credit risk and requires banks to carry out a regular analysis of their credit portfolios. The Provision of the Czech National Bank no. 4/2002 on Market Risks Management in Banks stipulates the requirements for an information system for managing market risks, which also applies to interest rate risk, and imposes on banks the duty to arrange for:

- a) regular execution of stress testing, once in three months at the minimum;
- b) regular reviewing of validity of the assumptions of their stress scenarios with regard to the changing conditions on the market or within the bank. Changes of the assumptions are an impetus for an adjustment of the scenarios and subsequent execution of stress tests;

c) submitting of the results of stress tests to those members of the bank's senior management who are responsible for the management of market risks.

The requirements for internal audit and the control of effectiveness of internal audit are evaluated under Principle 16, Additional Criterion 4. The legal regulations do not as yet provide for operational risk in a comprehensive manner.

Discharge of Supervision:

A report on liquidity is reviewed as a part of off-site supervision. This report, however, does not distinguish between domestic currency and foreign currencies. Liquidity management is reviewed within the framework of on-site inspections as an integral part of management of the bank's risks. During on-site inspections it is ascertained in which manner the bank within the framework of its risk management system manages interest rate risk. For this purpose the bank's management information system is reviewed. Within the framework of on-site inspections it is also ascertained whether the bank uses stress testing.

3. The supervisor issues standards related to such topics as liquidity risk, interest rate risk, foreign exchange risk and operational risk.

Largely compliant.

Laws and Regulations:

The Czech National Bank has issued the Provision of the Czech National Bank no. 2/2001 on Liquidity Standards of Banks, the Provision of the Czech National Bank no. 3/2002 on Credit Risk Management in Banks and the Provision of the Czech National Bank no. 4/2002 on Market Risks Management in Banks. These three Provisions set down the key principles for prudential management of the respective risks.

4. The supervisor sets liquidity guidelines for banks, which include allowing only truly liquid assets to be treated as such, and takes into consideration undrawn commitments and other off-balance sheet liabilities, as well as existing on-balance sheet liabilities.

Compliant.

Laws and Regulations:

The Provision of the Czech National Bank no. 2/2001 on Liquidity Management Standards of Banks requires banks to include in their information systems assets, off-balance sheet assets, liabilities and off-balance sheet liabilities; i.e. to have a liquidity management system which also takes account of off-balance sheet items. The provision also includes the definition of quick assets – cash, funds in current accounts maintained with banks, short-term deposits with banks with maturities under 7 days, treasury bills, short-term notes of central banks and other similar values, free reserves with the Czech National Bank.

5. The supervisor determines that limits and procedures are communicated to the appropriate personnel and primary responsibility for adhering to limits and procedures is placed within the relevant business units.

Compliant.

Laws and Regulations:

In the case liquidity, this is required in Section 3 paragraph 3 of the Provision of the Czech National Bank no. 2/2001 on Liquidity Standards of Banks. In the case of credit risk, this is required in Section 11 of the Provision of the Czech National Bank no. 3/2002 on Credit Risk Management in Banks and in the case of market risk in Section 10 of the Provision of the Czech National Bank no. 4/2002 on Market Risks Management in Banks.

Discharge of Supervision:

Fulfilment of the requirements contained in the above-mentioned Provisions is reviewed within the framework of on-site inspections.

6. The supervisor periodically verifies that these risk management processes, capital requirements, liquidity guidelines and qualitative standards are being adhered to in practice.

Compliant.

Discharge of Supervision:

The systems and procedures for managing risks, for determining capital requirements, for managing liquidity and observance of the other qualitative standards are the subject of on-site inspections. The Provisions of the Czech National Bank mentioned in connection with Essential Criterion 2 materially support the efficiency of on-site inspections by stipulating, in the form of a legal regulation, the minimum standards facilitating qualification of the fact that a bank's activity does not meet these standards as a shortcoming in the activities of the bank pursuant to Section § 26 of the Act on Banks.

Additional Criteria

1. The supervisor has the authority to require a bank to hold capital against risks in addition to credit and market risk.

Non-compliant.

Laws and Regulations:

The Act on Banks and the decrees and provisions of the Czech National Bank require that banks should hold capital to cover credit risk and market risks, both on an individual basis and by virtue of their inclusion in a consolidated group. The possibility to determine a specific capital requirement in relation to other risks is not admitted in the legal regulations and the Czech National Bank has never applied such requirement to any specific bank. In the event that the banking supervision ascertains shortcomings in the activities of a bank, the Czech National Bank shall employ those remedial measures it is authorised to impose on the basis of the Act on Banks (see Principle 22). The criterion will be fulfilled by the end of 2006 by implementation of the EC Directive based on the principles of the New Basle Capital Accord.

2. The supervisor encourages banks to include a statement on their risk management policies and procedures in their publicly available accounts.

Compliant.

Laws and Regulations:

The Provision of the Czech National Bank no. 3/2002, stipulating the Minimum Requirements on Disclosure of Information by Banks and Foreign Bank Branches imposes on banks and foreign bank branches the duty to disclose, with quarterly periodicity, material information on the management of risks (information on the strategy and objectives of risks management, on the principles and procedures of monitoring, management and control of risks management). Banks are obliged to disclose analogous information also in their annual reports.

3. Supervisors obtain sufficient information to enable them to identify those institutions carrying out significant foreign currency liquidity transformations.

Compliant.

Discharge of Supervision:

This information is contained in the reports submitted by banks to the Czech National Bank. By analysing these reports it is possible to identify banks that carry out large liquidity transformations in foreign currency.

4. The supervisor determines that, where a bank conducts its business in multiple currencies, management understands and addresses the particular issues this involves. Foreign currency liquidity strategy is separately stress-tested and the results of such tests are a factor in determining the appropriateness of mismatches.

Compliant.

Laws and Regulations:

These requirements are imposed by the Provision of the Czech National Bank no. 2/2001 on Liquidity Standards of Banks.

Discharge of Supervision:

Fulfilment of this criterion is reviewed within the framework of on-site inspections. The review also includes strategy in the currency area and the systems of re-valuation and observance of foreign exchange positions.

Principle 14. Banking supervisors must determine that banks have in place internal controls that are adequate for the nature and scale of their business. These should include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding its assets; and appropriate independent internal or external audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.

Comprehensive assessment

Largely compliant.

Essential Criteria

The Commercial Code specifies the key duties of the board of directors of a joint-stock company. The Act on Banks stipulates further requirements the board of directors and its members must meet. A bank is required to set down the powers and responsibilities of its board of directors and supervisory board and the powers and responsibilities of its senior managers in its articles of association. The requirement for separation of incompatible functions is contained in the Provision of the Czech National Bank on Risk Management and in the Provision of the Czech National Bank on the Internal Management and Control System. A bank is required to arrange in its articles of association also for the organisational safeguarding of its internal control system. The Act on Banks requires a bank to establish its internal audit unit. The Czech National Bank reviews, whether the internal audit unit has an independent position in the bank, whether it has sufficient resources and whether it has developed a methodology to detect the key risks within the bank.

Additional Criteria

From the point of view of the Czech legal order these additional criteria are not relevant to the Czech National Bank.

Analysis of the Individual Criteria

Essential Criteria

1. Corporate or banking laws identify the responsibilities of the board of directors with respect to corporate governance principles to ensure that there is effective control over every aspect of risk management.

Compliant.

Laws and Regulations:

The responsibilities of the board of directors are given above all by the provisions of Sections 191 to 196a of the Commercial Code. Section 8 of the Act on Banks further requires that the powers of the board of directors and the supervisory board of a bank should be stipulated in the bank's articles of association, further that the statutory body (the board of directors) must have at least three members and must be composed of senior managers of the bank. A member of the statutory body of a bank may not be simultaneously a statutory body or a member of a statutory body or a member of a supervisory board of another legal entity which is a business. The Act on Banks at the same time stipulates that the powers entrusted by the Commercial Code to the board of directors of a joint-stock company may not be transferred to the supervisory body of a bank. In accordance with Section 8a of the Act on Banks members of the statutory body who have breached their duties as members of the statutory body of a bank ensuing for them from the legal regulations or from the articles of association are liable, jointly and severally, for any damage the creditors of the bank may incur owing to the fact that the bank is unable to meet its due commitments as a result of the breach of duties by these members of the statutory body. Pursuant to Section 9 paragraph 1 of the Act on Banks a bank is obliged to specify in its articles of association also the powers and responsibilities of senior managers of the bank and its internal control system. The Provision of the Czech National Bank no. 12/2002 on the Internal Management and Control System, the Provision of the Czech National Bank no. 3/2002 on Credit Risk

Management in Banks, the Provision of the Czech National Bank no. 4/2002 on Market Risks Management in Banks and the Provision of the Czech National Bank no. 2/2001 on Liquidity Management Standards of Banks elaborate further the duties of the board of directors and senior management in the areas of management of the bank's risks. The Provision no. 12/2002 stipulates directly the responsibility of the board of directors for the creation, maintenance and evaluation of an effective and efficient management and control system of a bank, an integral part of which is the management of risks by the bank.

2. The supervisor determines that banks have in place internal controls that are adequate for the nature and scale of their business. These controls are the responsibility of the board of directors and deal with organisational structure, accounting procedures, checks and balances and the safeguarding of assets and investments. More specifically, these address:

- **organisational structure: definitions of duties and responsibilities including clear delegation of authority (for example, clear loan approval limits), decision-making procedures, separation of critical functions (for example, business origination, payments, reconciliation, risk management, accounting, audit and compliance),**
- **accounting procedures: reconciliation of accounts, control lists, information for management),**
- **checks and balances (or “four eyes principle”): segregation of duties, cross-checking, dual control of assets, double signatures,**
- **safeguarding assets and investments: including physical control.**

Largely compliant.

Laws and Regulations:

Section 9 of the Act on Banks stipulates the duty of banks to specify in their articles of association their internal control system. The requirement for the introduction of internal control mechanisms pervades the individual provisions of the Czech National Bank (the Provision of the Czech National Bank no. 12/2002 on the Internal Management and Control System, the Provision of the Czech National Bank no. 3/2002 on Credit Risk Management in Banks and the Provision of the Czech National Bank no. 4/2002 on Market Risks Management in Banks), which set down the requirements for management of risks and management of the bank, including the requirement for creating the appropriate control mechanisms. A bank is obliged to fulfil these requirements with regard to its size and method of management, type, nature and complexity of the activities it carries out.

- The organisational structure is reviewed within the framework of the licensing proceedings in accordance with Sections 4 and 5 of the Act on Banks and the Decree of the Czech National Bank no. 166/2002 Coll., stipulating the Requisites of an Application for a Banking Licence, the Requisites of an Application for Consent of the Czech National Bank to the Acquisition or Increase of a Qualifying Holding in a Bank, to the Person Concluding a Controlling Agreement with a Bank or to the Person Performing a Legal Act Aimed at Control of a Bank and the Requisites of a Notification of a Decrease in a Qualifying Holding in a Bank. Pursuant to Section 9 of the Act on Banks the organisational structure must be defined in the bank's articles of association. The Czech National Bank should have at its disposal a valid version of the articles of association, i.e. including the valid organisational structure. The board of directors of a bank is responsible for approval of a functional organisational structure, which, *inter alia*, clearly defines the responsibilities and the powers, arranges for the separation of incompatible functions and enables efficient communication on all levels of the bank. The board of directors is responsible for regular evaluation of functionality of the organisational structure.
- The accounting procedures are stipulated by the Act on Accounting and the related legal regulations (the Provisions of the Ministry of Finance of the CR).
- The four eyes principle can be – even though only partially – derived from the Act on Banks, which requires that the board of directors must consist of three members at the minimum. The requirement for separation of incompatible functions is set down in the provisions of the Czech

National Bank on the internal management and control system, on market risks management in banks and credit risk management in banks.

- The safeguarding of assets (currency in the vault regime, equipment, buildings, but also rights of access to the information system etc.), including tangible fixed assets and physical control of these assets, is a part of internal controls. The regulation that relates in general terms to this aspect of banks' activities is the Provision of the Czech National Bank no. 12 of 11 December 2002 on the Internal Management and Control System of a Bank (effectiveness from 1 July 2003). The safeguarding of assets will be regulated by the Provision of the Czech National Bank on Operational Risk (see Principle 14, Essential Criterion 1), which is currently under preparation.

Discharge of Supervision:

The organisational structure and its functionality are reviewed within the framework of on-site inspections. The application of the "four eyes principle" and cross-checking is reviewed during on-site inspections.

3. To achieve a strong control environment, the supervisor requires that the board of directors and senior management of a bank understand the underlying risks in their business and are both committed to, and legally responsible for, the control environment. Consequently, the supervisor evaluates the composition of the board of directors and senior management to determine that they have the necessary skills for the size and nature of the activities of the bank and can address the changing risk profile of the bank and external market developments. The supervisor has the legal authority to require changes in the composition of the board and management in order to satisfy these criteria.

Compliant.

Laws and Regulations:

Pursuant to Section 12 paragraph 1 of the Act on Banks a bank, when performing its activities, is obliged to proceed with prudence, in particular to conduct its business in a manner which is not detrimental to the interests of its depositors from the point of view of the return of their deposits and which does not endanger the security and stability of the bank. The powers and responsibilities of senior managers of a bank must be defined in the articles of association – Section 9 paragraph 1 of the Act on Banks (senior managers of a bank are, pursuant to Section 4 paragraph 3 subparagraph d) persons who are nominated on the basis of an employment or other contract to executive managerial positions in the bank connected with the powers and responsibilities laid down in the articles of association). The board of directors must be composed of senior managers of the bank. Pursuant to Section 191 of the Commercial Code the board of directors is a statutory body that manages the activities of the company and acts on its behalf, decides all matters of the company, unless these according to the Commercial Code fall within the competence of the general meeting or the supervisory board. Pursuant to the Act on Banks Section 8 paragraph 5 the powers entrusted by the Commercial Code to the board of directors of a joint-stock company may not be delegated to the supervisory board. The Provision of the Czech National Bank no. 3/2002 on Credit Risk Management in Banks, the Provision of the Czech National Bank no. 4/2002 on Market Risks Management in Banks and the Provision of the Czech National Bank no. 12/2002 on the Internal Management and Control System lay down the requirements for the duties and responsibilities of the board of directors and senior management when managing the company and managing risks, i.e. they contain the requirement that the board of directors must understand the risks the bank is taking on, is responsible for the creation and operation of such organisational and managing structure of the bank as will enable to implement effectively and efficiently the strategy of risks management and will ensure that control activities are an integral part of the everyday activities of the bank. The professional competence, trustworthiness and experience of the bank's senior staff, including the board of directors, are assessed within the framework of the licensing proceedings. Later on the bank is obliged to notify the CNB of any proposed personnel changes in its board of directors and in the positions of its senior managers, including the submission of background documents that are necessary for assessment of their professional competence, trustworthiness and experience (Section 16 paragraph 2 subparagraph b) of

the Act on Banks). Even though the CNB does not approve these later changes, it is authorised, in accordance with Section 26 paragraph 1 of the Act on Banks, to demand that a bank or a foreign bank branch should replace persons in the management of the bank or the foreign bank branch, if any shortcomings have been detected in the activities of the bank, one of which is management of a bank or a foreign bank branch by persons who do not possess sufficient professional competence or are not trustworthy. On the grounds of detection of a shortcoming in the bank's activities the Czech National Bank is authorised to require also replacement of members of the supervisory board. Towards the close of 2002 the Czech National Bank has issued an official notification on assessment of the professional competence, trustworthiness and experience of persons nominated for positions of senior managers of banks and positions in the management of foreign bank branches. This official notification sets down the key criteria and requirements that persons nominated for positions in senior management of a bank or a foreign bank branch should fulfil.

Discharge of Supervision:

The fulfilment of the content of the criterion is monitored within the framework of the licensing proceedings and within the framework of assessment of the competence, trustworthiness and experience of persons nominated for positions of senior managers of banks. Attention is also paid to the competence of senior managers of a bank within the framework of on-site inspections and further during meetings with the bank's board of directors and senior management and during information visits to the bank.

4. The supervisor determines that there is an appropriate balance in the skills and resources of the back office and control functions relative to the front office/business origination.

Compliant.

Laws and Regulations:

The Provision of the Czech National Bank no. 3/2002 on Credit Risk Management in Banks, the Provision of the Czech National Bank no. 4/2002 on Market Risks Management in Banks and the Provision of the Czech National Bank no. 12/2002 on the Internal Management and Control System stipulate the requirement for the separation of incompatible functions.

Discharge of Supervision:

This principle forms a part of the review of risks management and distribution of responsibilities within the framework of the licensing proceedings and also within the framework of on-site inspections. The Czech National Bank should be also notified of inadequate organisation and distribution of responsibilities and powers between the front office and the back office by the auditor within the framework of his report on the verification of the management and control system.

5. The supervisor determines that banks have an appropriate audit function charged with a) ensuring that policies and procedures are complied with and b) reviewing whether the existing policies, practises and controls remain sufficient and appropriate for the bank's business. The supervisor determines that the audit function:

- has unfettered access to all the bank's business lines and support departments;
- has appropriate independence, including reporting lines to the board of directors and status within the bank to ensure that senior management reacts to and acts upon its recommendations;
- has sufficient resources, and staff that are suitably trained and have relevant experience to understand and evaluate the business they are auditing;
- employs a methodology that identifies the key risks run by the bank and allocates its resources accordingly.

Largely compliant.

Laws and Regulations:

Section 9 of the Act on Banks requires a bank to specify in its articles of association its internal control system. Apart from this Section 8 paragraph 6 of the Act on Banks explicitly imposes on a bank the duty to establish an internal audit unit which examines and evaluates in particular the functionality and effectiveness of the bank's management and control system and its risks management system and also compliance with the principles of prudential business of a bank. Submission of a bank's articles of associations constitutes a part of the licensing proceedings. A bank is obliged to inform the Czech National Bank of any changes in its articles of association. In order to prevent a conflict of interests, a member of the bank's statutory body or a member of its supervisory body may not be the head of its internal audit unit. Upon notifying the bank's statutory body of the facts ascertained, the head of the internal audit unit is obliged to inform of these facts the supervisory body and in the case of findings which might have an adverse impact on the bank's economic management, he is obliged to initiate an extraordinary meeting of the supervisory board. The requirements that the internal audit unit should have adequate independence, sufficient resources, well-trained personnel and the appropriate methodology which detects the key risks in the bank ensue from the Provision of the Czech National Bank no. 12/2002 on the Internal Management and Control System (in effect from 1 July 2003). This Provision further stipulates that the nomination and recalling of the head of the internal audit unit is possible only upon prior consent of the bank's supervisory board. It also stipulates that the internal audit unit:

- must perform its activities independently of all executive activities of the bank,
- must be provided access to all documents of the bank,
- must regularly inform the supervisory board and the audit committee, provided it has been established, of its findings.

The principles of remuneration of the head of internal audit unit are set down by the supervisory board, unless this is within the powers of the general meeting.

Discharge of Supervision:

The above-mentioned requirements are reviewed during on-site inspections. The internal audit system is described within the framework of the report on risks management. The internal audit and the internal control system as a whole are reviewed in their entirety during on-site inspections.

6. The supervisor has access to the reports of the audit function.

Compliant.

Laws and Regulations:

Pursuant to Section 22 paragraph 1 of the Act on Banks a report on verification of the financial statements and verification of the management and control system, including the risks management system is submitted to the Czech National Bank within the stipulated deadlines. The Czech National Bank has issued the Provision of the Czech National Bank on Verification of the Management and Control System, Including the Risks Management System, and further the Official Notification on Certain Parts of the Provision of the Czech National Bank on Verification of the Management and Control System, including the Risks Management System.

Discharge of Supervision:

The auditor's reports are examined during on-site inspections, when the internal control system of the bank is controlled. Pursuant to the Act on Banks the banking supervision has at its disposal reports on the verification of the internal control system, including the risks management system.

Additional Criteria

1. In those countries with a unicameral board structure (as opposed to a bicameral structure with a supervisory board and a management board), the supervisor requires the board of directors to include a number of experienced non-executive directors.

Not applicable.

On the basis of Section 8 of the Act on Banks the board of directors must consist of at least three members and must be composed of senior managers of the bank. This approach was selected on the basis of previous experience with management of banks.

2. The supervisor requires the internal audit function to report to an audit committee.

Not applicable.

The existence of an audit committee is not explicitly required; the establishment of an audit committee is within the competence of the bank; the possibility of its establishment is dealt with in a standard of the Banking Association, but also in the Provision of the Czech National Bank no. 12/2002 on the Internal Management and Control System of a Bank. In the case that the audit committee does not exist, the internal auditor submits his reports to the statutory body and the supervisory board.

3. In those countries with a unicameral board structure the supervisor requires the audit committee to include experienced non-executive directors.

Not applicable.

See items 1 and 2 of the Additional Criteria.

Principle 15. Banking supervisors must determine that banks have adequate policies, practices and procedures in place, including strict “know-your-customer” rules, that promote high ethical and professional standards in the financial sector and prevent the bank being used, intentionally or unintentionally, by criminal elements.

Comprehensive Assessment:

Largely compliant.

Essential Criteria

The area of “money laundering” has been provided for by the Act no. 61/1996 Coll., on Certain Measures against Legalisation of Proceeds of Criminal Activities. The act is sponsored by the Ministry of Finance of the Czech Republic. The Czech National Bank has been empowered under the act to control adherence to certain provisions of the act, specifically those of Section 2 (the identification duty), Section 3 (the duty to retain specified data) and Section 9 (the duty to prepare and apply a system of internal rules). An amended version of the act, which should further reinforce the position of the Czech National Bank, is currently under preparation.

In terms of the legal framework, money laundering has been fairly well addressed. Still missing are, however, legal requirements regarding other closely related areas, specifically application of the “know-your-customer” rule (the issue will be covered by the currently prepared provision of the Czech National Bank on prevention of abuse of banks for legalisation of proceeds of criminal activities), ethical and professional standards of bank staff members (the duty of adherence to these standards is stipulated by the Provision of the Czech National Bank no. 12/2002 on the Internal Management and Control System, which will become effective as at 1 July 2003), rules aimed against fraud *et alia*. Still missing is also the duty of banks to report any detected instances to the Czech National Bank.

Additional Criteria

The Act on Certain Measures against Legalisation of Proceeds of Criminal Activities implements international standards applicable to money laundering, specifically the standards contained in 40 FATF Recommendations. The requirement for regular training of bank staff members is expressly included in the Act (Section 9). The Czech National Bank will include those of the requirements set out under Principle 15 that exceed the scope of the Money Laundering Act in its provision that will cover the key standards of prudential business of banks.

Analysis of the Individual Criteria

Essential Criteria

1. The supervisor determines that banks have in place adequate policies, practices and procedures that promote high ethical and professional standards and prevent the bank from being used, intentionally or unintentionally, by criminal elements. This includes the prevention and detection of criminal activity or fraud, and reporting of such suspected activities to the appropriate authorities.

Largely compliant.

The act provides for the “money laundering” area only. There are no acts or other legal regulations that would require banks to set down a policy, procedures and methods for the application of the “know-your-customer” principle and would prevent abuse of a bank by criminal elements (except for the above-mentioned rules against “money laundering”). Nevertheless, a provision of the Czech National Bank is currently under preparation, which will regulate this area. One of the possibilities appears to be application of a regulation pursuant to Section 167 of the Criminal Code, which provides for the facts of the criminal offence of “failure to act to prevent a crime“, or Section 252a of the Criminal Code which defines the criminal offence of legalisation of proceeds of a criminal activity, or, as the case may be, the criminal offence of accessoryship pursuant to Section 252 paragraph 2 of the Criminal Code. Pursuant to Section 167 of the Criminal Code any persons who get to know in a trustworthy manner that another person is preparing or committing a criminal offence that

is included in the enumeration in this section, are obliged to thwart such crime, with the proviso that notifying a public prosecutor or a police authority of such fact is also considered as thwarting the offence. The criminal offence of legalisation of proceeds of a criminal activity is committed not only by the person who covers up the origin of a thing or a property benefit gained as a result of a criminal activity, but also by the person who enables another person to cover up this origin. Pursuant to Section 252 paragraph 2 it is also punishable if a person by its negligence enables some other person to cover up the origin or the detection of the origin of a thing gained by a criminal activity. Section 4 of paragraph 8 of the Provision of the Czech National Bank No. 12/2002 on the Internal Management and Control System also mentions the ethical and professional standards of the correct ethical behaviour and conduct of a bank (even though these standards are not defined anywhere, the duty to adhere to them is imposed on the banks in this sense – with effect from 1 July 2003).

“Money Laundering”

Laws and Regulations:

The Act on Certain Measures against Legalisation of Proceeds of Criminal Activities stipulates the above-mentioned requirements: Section 2 requires identification of persons who conclude a business transaction amounting to CZK 500 thous. at the minimum (see also Essential Criterion 2) – the Act on Banks lowers this limit to the amount of CZK 100 thous.; Section 4 requires a financial institution (i.e. also a bank), if it in the course of its activities detects a suspicious transaction, to notify of it the respective organisational unit, which is the Financial Analytical Unit of the Ministry of Finance of the Czech Republic, and to do so within 5 days of the day of conclusion of the transaction at the latest; on the basis of Section 9 financial institutions are obliged to elaborate and apply a system of internal principles, procedures and control measures to prevent legalisation of proceeds of criminal activities through their mediation. A part of the system is also nomination of a specific person which will arrange for on-going contacts with the Ministry of Finance of the Czech Republic under this act, unless this will be arranged for directly by the statutory body. In accordance with Section 2 paragraph 2, the transactions considered as transactions with which the duty of a financial institution to identify its participants is connected, are in particular the following:

- a) any banking operation, the value of which exceeds the amount of CZK 500,000,
- b) purchase, sale or exchange of any sort of securities and any sort of derivatives of different issuers by the same contracting parties, if the price at which the securities or derivatives are purchased or sold, or their value stipulated pursuant to a special regulation, exceeds CZK 500,000,
- c) payout of an amount in excess of CZK 500,000 by a betting shop, gambling room or a casino,
- d) payout of indemnifications, the value of which exceeds the amount of CZK 500 000.

Pursuant to Section 2 paragraph 3 of Act no. 61/1996 Coll., a financial institution is always obliged to identify the participants in a business transaction, if the transaction concerned is

- a) a suspicious transaction,
- b) conclusion of an agreement on a current or deposit account, or on a deposit in a deposit book, or on a certificate of deposit, or arrangement of any other form of deposit,
- c) conclusion of an agreement on lease of a safe-deposit box or an agreement on safe-keeping in the bank's vault,
- d) a business transaction which is otherwise subject to the identification duty (business transactions exceeding the amount of CZK 500 thous.), business transactions pursuant to subparagraphs a), b) and c), if at its conclusion the client is represented by another person on the basis of a power of attorney.

The provisions of Section 8 of the same Act stipulate that a financial institution, the definition of which for the purposes of this Act is broader than that contained in the Act on Banks, is obliged to disclose to the Ministry of Finance of the Czech Republic on request within the deadline stipulated by the Ministry data on business transactions to which the identification duty applies and with regard to which the Ministry of Finance of the Czech Republic conducts an investigation, to submit documents relating to these business transactions, or to provide entrusted staff members of the Ministry of Finance of the Czech Republic access to these documents when verifying notifications or carrying out control activities and to provide information about persons who participated in any manner in such

business transactions. It is true, the requirement for creation of a bank's policy with respect to its fight against money laundering is missing in the Act. This requirement, however, will be included in the provision of the Czech National Bank against abuse of banks for legalisation of proceeds of criminal activities.

Discharge of Supervision:

The Czech National Bank checks in accordance with Section 8 paragraph 3 subparagraph a) of the Act on Certain Measures Against Legalisation of Proceeds of Criminal Activities, whether banks fulfil their duties stipulated by this act and whether legalisation of proceeds through their mediation does not occur. It also checks compliance with other acts in banks.

“Ethical and Professional Standards and the Rules Against Abuse of a Bank by Criminal Elements in General“

Laws and Regulations:

Pursuant to Section 4 paragraph 8 of the Provision on the Internal Management and Control System a bank's board of directors is responsible for systematic assertion of a high standard of ethics and moral integrity of the bank's staff. For this purpose it defines the ethical principles and the expected models of correct ethical behaviour and conduct of the bank's staff. As regards the ethical and professional standards, they are mentioned in a partial manner in the Act on Securities. Pursuant to Section 81 of this act a person which by virtue of its job, profession, position, share in the initial capital or in the voting rights of the issuer or by virtue of its function or in connection with the fulfilment of its duties has access to confidential information and obtains such information, may not employ this information for its benefit or for the benefit of any other person, in particular it may not acquire or misappropriate the instrument of the capital market to which such information relates. The Criminal Code also provides for such conduct and establishes the facts of the offence of abuse of information in business relations. The duty of the board of directors to set down the rules for ethical codices is stipulated by the Provision of the Czech National Bank on the Internal Management and Control System.

Discharge of Supervision:

The ethical code is the subject of interest of the Czech National Bank within the framework of execution of on-site inspections; job descriptions with regard to the individual positions in the bank are requested on the one hand as a part of control of the internal management and control system, on the other as a part of control focused on money laundering.

2. The supervisor determines that banks have documented and enforced policies for identification of customers and those acting on their behalf as part of their anti-money-laundering program. There are clear rules on what records must be kept on customer identification and individual transactions and the retention period.

Compliant.

Laws and Regulations:

Section 37 of the Act on Banks stipulates that a bank is obliged to request identification of a client in the case of any business transaction, the value of which exceeds CZK 100 thous. The Act on Banks, therefore, stipulates a lower limit than the Act on Certain Measures Against Legalisation of Proceeds of Criminal Activities, which requires identification of a person concluding a business transaction in the amount of CZK 500 thous. at the minimum. The Act no. 61/1996 Coll. provides for the duty to record the identification data obtained and to retain them for the period of ten years after the termination of the business transaction. This Act also defines what is understood by the identification of a client.

3. The supervisor determines that banks have formal procedures to recognise potentially suspicious transactions. These might include additional authorisation for large cash (or similar) deposits or withdrawals and special procedures for unusual transactions.

Compliant.

Laws and Regulations:

See Essential Criterion 1. Pursuant to Section 9 of the Act on Certain Measures Against Legalisation of Proceeds of Criminal Activities a bank or a financial institution must create and have in place a system of internal principles, procedures and control measures to prevent legalisation of such proceeds and must report any suspicious business transaction, regardless of its volume. A definition of a suspicious business transaction is given in Section 1 of the Act on Certain Measures Against Legalisation of Proceeds of Criminal Activities.

Discharge of Supervision:

The Czech National Bank performs checks on the above-mentioned principles, procedures and measures according to its own internal methodology.

4. The supervisor determines that banks appoint a senior officer with explicit responsibility for ensuring that the bank's policies and procedures are, at a minimum, in accordance with local statutory and regulatory anti-money laundering requirements.

Compliant.

Laws and Regulations:

The Act on Certain Measures Against Legalisation of Proceeds of Criminal Activities does not require this. A bank is obliged to appoint a person which provides for the on-going contact with the Ministry of Finance of the Czech Republic and the fulfilment of the notification duty. This person does not bear the responsibility that is stipulated in the criterion. In some cases these duties are fulfilled directly by the statutory body. Let us add that the board of directors of a bank that is always responsible for adherence to the duties stipulated by the laws and regulations.

Discharge of Supervision:

The responsibility for adherence to the provisions of Act no. 61/1996 Coll. is borne by the bank's board of directors, in the case of a foreign bank branch by its statutory body in the Czech Republic. This statutory body is the head of the organisational unit of the foreign bank. In some banks a practice is spreading to delegate the administrative work relating to adherence to the provisions of the Act Against Legalisation of Proceeds of Criminal Activities to an appointed staff member, usually the one who holds the position called "Compliance Officer".

5. The supervisor determines that banks have clear procedures, communicated to all personnel, for staff to report suspicious transactions to the dedicated senior officer responsible for anti-money laundering compliance.

Compliant.

Laws and Regulations:

The Act on Certain Measures Against Legalisation of Proceeds of Criminal Activities stipulates on the one hand the duty to create a system of internal principles, procedures and control measures to prevent legalisation of such proceeds and further the duty to train every year persons who might come across suspicious business transactions. The Czech National Bank does not have the authority to set down this requirement, for it ensues directly from the Act on Certain Measures Against Legalisation of Proceeds of Criminal Activities. It is, however, authorised to perform checks on how banks fulfil these duties.

Discharge of Supervision:

The Czech National Bank verifies during its on-site inspections, whether the process of reporting suspicious transactions within the bank (i.e. the entire decision-making process starting with

the staff member working at the counter to the person responsible for reporting suspicious business transactions to the Financial Analytical Unit of the Ministry of Finance of the Czech Republic) is provided for in the bank's regulations. The Czech National Bank reviews whether the staff members are acquainted with these principles and also whether the given procedures are adhered to.

6. The supervisor determines that banks have established lines of communication both to management and to an internal security (guardian) function for reporting problems.

Largely compliant.

Laws and Regulations:

The laws do not explicitly provide for this duty. The Czech National Bank is preparing a provision which will set down the principles of the identification of clients for the purposes of suppressing legalisation of proceeds of criminal activities and which in connection with the Provision of the CNB on the Internal Management and Control System will contribute to the fulfilment of this criterion.

7. In addition to reporting to the appropriate criminal authorities, banks report to the supervisor suspicious activities and incidents of fraud material to the safety, soundness or reputation of the bank.

Materially non-compliant.

Laws and Regulations:

Any threat to safety, or to financial soundness, within the meaning of a decrease in capital adequacy below 2/3 and 1/3 of the required minimum level must be notified by the bank to the Czech National Bank. The notification duty, however, does not apply to various individual incidents of fraud which have afflicted the bank. Nevertheless, the Criminal Code stipulates the duty to thwart such criminal offences, if their preparation or execution is detected, with the proviso that also their reporting to the investigative, prosecuting and adjudicating bodies, in the competence of which the investigation of the respective criminal activities falls, is considered as thwarting.

8. Laws, regulations and/or banks' policies ensure that a member of staff who reports suspicious transactions in good faith to the dedicated senior officer, internal security function, or directly to the relevant authority cannot be held liable.

Compliant.

Laws and Regulations:

The Act on Certain Measures Against Legalisation of Proceeds of Criminal Activities explicitly stipulates that fulfilment of the notification duty is not a breach of the statutory duty of confidentiality, imposed under a special Act. Also the Act on Banks stipulates that fulfilment of the notification duty pursuant to the Act on Certain Measures Against Legalisation of Proceeds of Criminal Activities does not constitute a breach of the bank secret (Section 38 paragraph 2 of the Act on Banks).

Section 6 of the Act on Certain Measures Against Legalisation of Proceeds of Criminal Activities stipulates that a financial institution may not fulfil a client's order relating to a suspicious business transaction sooner than after the lapse of 24 hours from the receipt of a notification by the Ministry of Finance of the Czech Republic, if a danger threatens that by immediate fulfilment of such order the securing of the proceeds of the respective transaction might be thwarted or made considerably more difficult. On the basis of Section 14 of this Act, fulfilment of this duty does not give rise to liability of the person which did so to compensate for the damage or loss arising in connection with these actions; liability for such damage or loss is borne by the state.

9. The supervisor periodically checks that banks' money laundering controls and their systems for preventing, identifying and reporting fraud are sufficient. The supervisor has adequate enforcement powers (regulatory and/or criminal prosecution) to take action against a bank that does not comply with its anti-money laundering obligations.

Compliant.

Discharge of Supervision:

The Czech National Bank performs checks according to its internal methodology by agreement with the Ministry of Finance of the Czech Republic. On detecting any shortcomings it is possible to apply remedial measures according to Section 26 of the Act on Banks.

10. The supervisor is able, directly or indirectly, to share with domestic and foreign financial sector supervisory authorities information related to suspected or actual criminal activities.

Compliant.

Laws and Regulations:

Section 38 of the Act on Banks stipulates that providing information to the Ministry of Finance of the Czech Republic or the Securities Commission for the purposes of discharge of state supervision is not considered as a breach of the bank secret. The issue of co-operation with these regulators is elaborated in detail in the Agreement on Co-Operation between the Czech National Bank, the Securities Commission and the Ministry of Finance of the Czech Republic in Discharge of Banking Supervision and State Supervision. Section 38 of the Act on Banks also enables an exchange of information with foreign banking supervisors.

11. The supervisor determines that banks have a policy statement on ethics and professional behaviour that is clearly communicated to all staff.

Compliant.

Laws and Regulations:

The Czech National Bank does not stipulate this requirement. Within the framework of supervision it, however, requires consistent compliance with the ethical and professional principles in all activities of banks. Banks possessing a licence of the Securities Commission for trading in securities are also subject to Section 47b of the Act on Securities, which contains the rules of conduct of the securities trader towards his clients; this provision requires adoption of an ethical and professional attitude towards clients. The Provision no. 12/2002 on the Internal Management and Control System in Section 4 stipulates that the board of directors is responsible for consistent assertion of a high standard of ethics and moral integrity of the bank's staff. For this purpose the board of directors sets down rules, which formulate unequivocally the ethical principles and the expected models of correct ethical behaviour and conduct of the bank's staff. The board of directors shall further ensure that all members of the bank's staff understand their role in the internal management and control system and involve themselves actively in it.

Additional Criteria

1. The laws and/or regulations embody international sound practices, such as compliance with the relevant forty Financial Action Task Force Recommendations issued in 1990 (revised 1996).

Compliant.

In the opinion of the Ministry of Finance of the Czech Republic (the Financial Analytical Unit) the FATF 40 Recommendations have been fully reflected in our legal framework.

2. The supervisor determines that bank staff is adequately trained on money laundering detection and prevention.

Compliant.

See Essential Criterion 5.

3. The supervisor has the legal obligation to inform the relevant criminal authorities of any suspicious transactions.

Materially non-compliant.

Laws and Regulations:

Pursuant to Section 8 paragraph 1 of the Code of Criminal Procedure the state authorities are obliged to notify the public prosecutor or the police authorities without delay of any facts suggesting that a criminal offence has been committed. Fulfilment of this obligation, however, is not absolute and can be rejected, *inter alia*, with reference to the obligation of confidentiality imposed or recognised by the state.

As follows from Section 1 paragraph 3 of the Act on the Czech National Bank, the Czech National Bank has been entrusted with the competences of an administrative authority to the extent stipulated by this Act and special legal regulations. It can be, therefore, deduced that the Czech National Bank in discharge of banking supervision has the position of a state authority.

Pursuant to Section 25a paragraph 1 of the Act on Banks, however, the duty of confidentiality is imposed on all persons discharging banking supervision. This confidentiality applies to all data acquired by such persons in connection with the performance of their profession, employment or function. Nevertheless, pursuant to Section 50 paragraph 2 of the Act on the Czech National Bank members of the staff of the Czech National Bank and members of its advisory bodies may be exempted from the duty of confidentiality by the Governor on the grounds of the public interest. As follows from Section 1 of the Criminal Code, the purpose of this act is to protect the interests of the society, the constitutional system of the Czech Republic, the rights and legitimate interests of private individuals and legal entities. It can be undoubtedly inferred from this that an interest protected by the Criminal Code is the public interest. The provision of Section 25a paragraph 4 of the Act on Banks enables (upon exemption from the duty of confidentiality) to provide information to the investigative, prosecuting and adjudicating bodies, if this information is provided for the fulfilment of their function. The function of the investigative, prosecuting and adjudicating bodies is appropriate ascertainment of criminal offences and punishment of offenders according to the law.

If, therefore, the Czech National Bank in discharge of banking supervision detects any facts suggesting that a criminal offence has been committed, it is obliged (with regard to Section 8 of the Criminal Code and upon exemption from the duty of confidentiality by the Governor) to notify of such facts the investigative, prosecuting and adjudicating bodies within the competence of which investigation of criminal offences falls.

Pursuant to Section 24 of Act on State Control, the control authorities (the range of which is defined in Section 2 of this Act) notify the investigative, prosecuting and adjudicating bodies of any suspicion of a criminal activity ascertained in the course of control. With regard to Section 45 of Act on the Czech National Bank, Section 24 of the Act on State Control also applies to the Czech National Bank (supervision in the form of on-site inspection).

The notification duty should be observed above all by the bank itself - in the case of a suspicious business transaction such business transaction notification must be addressed to the ministry, in the case of a credit fraud, for example, the fraud is to be reported to the investigative, prosecuting and adjudicating bodies. The issues relating to notifying of the commission of a criminal offence and not thwarting a criminal offence are governed by the Criminal Code and the Code of Criminal Procedure. The Czech National Bank is obliged, pursuant to Section 8 paragraph 1 of the Criminal Code, in the wording of subsequent regulations, to notify the investigative, prosecuting and adjudicating bodies of any facts suggesting commission of a criminal offence.

4. The supervisor is able, directly or indirectly, to share with relevant judicial authorities information related to suspected or actual criminal activities.

Compliant.

Laws and Regulations:

Information may be provided under the statutory conditions (Section 38, Section 38a paragraph 4 and Section 25a of the Act on Banks) and if the respective staff members are exempted

from the duty of confidentiality by the Governor on the basis of the public interest (Section 50 paragraph 2 of the Act on the Czech National Bank).

5. If not performed by another agency, the supervisor has in-house resources with specialist expertise on financial fraud and anti-money laundering obligations.

Compliant.

Discharge of Supervision:

Within the framework of the Czech National Bank the fight against “money laundering” in the banking sector is the subject of activities of the Department of On-Site Inspections 1, specifically its Internal Control System Section, and the Department of Licenses and Permissions, specifically its Non-standard Activities Section. The staff members take part in a number of special training courses. The key responsibility for this area is borne, however, by the Ministry of Finance of the Czech Republic.

Methods of Execution of Banking Supervision

Principle 16. An effective banking supervisory system should consist of some form of both on- and off-site supervision.

Comprehensive Assessment:

Largely compliant.

Essential Criteria

Discharge of supervision includes off-site supervision and on-site inspections performed directly in banks. In discharge of supervision the Czech National Bank uses a comprehensive set of methods and tools, which it has been gradually developing and improving. Nevertheless, not always can shortcomings in the activities of banks be sufficiently identified and duly documented. Reports by external auditors represent a complementary tool of supervision.

Additional Criteria

The Czech National Bank has established a team that prepares internal assessments of the activities of the Czech National Bank in discharge of banking supervision and its decision-making. The Czech National Bank in discharge of supervision uses standardised procedures that are included in manuals and methodologies for off- and on-site supervision. In discharge of supervision also findings of banks' internal audit functions are used, in addition to the other sources of information. The Czech National Bank, however, takes a discerning approach to those findings, and the internal audit activity itself is the subject of on-site inspections.

Analysis of the Individual Criteria

Essential Criteria

1. Banking supervision requires an in-depth understanding, periodic analysis and evaluation of individual banks, focussing of safety and soundness, based on meetings with management and a combination of both on-site and off-site supervision. The supervisor has a framework that (1) uses on-site work (conducted either by own staff or through the work of external auditors) as a primary tool to:

- **provide independent verification that adequate corporate governance (including risk management and internal control systems) exists at individual banks;**
- **determine that information provided by banks is reliable;**
- **obtain additional information needed to assess the condition of the bank.**

Largely compliant.

Discharge of supervision

The Czech National Bank endeavours to have in discharge of banking supervision as deep an understanding as possible of the activities of the individual banks. To attain this aim it applies:

- off-site supervision,
- on-site inspection in the form of controls carried out directly in banks,
- deliverables by auditors.

Off-site supervision is based on the one hand on issuing licenses and permissions. Activities in this case involve in particular assessment of entry of new shareholders into the banking sector, on the other hand on monitoring and analysis of the activities of banks, i.e. on analysis and evaluation of the financial statements and the so-called prudential reports submitted to the Czech National Bank by banks and foreign bank branches.

Another tool of supervision is information visits to banks or foreign bank branches (hereinafter only the "bank"). These visits can be characterized as an intermediate stage between off-site supervision and in-site inspections. From the legal point of view they differ substantially from on-site inspections in that they are not based on authorisation under the Act on State Control. Information visits are not explicitly mentioned in the Act on the Czech National Bank and in the Act on Banks. The objective of information visits is to get acquainted in greater detail with the key aspects of the

bank's activities and to achieve this through meetings which are held on various levels of the bank's management and, as the case may be, also with its regular staff members. The duration of an information visit depends on a number of circumstances and ranges from several hours to several days. Information visits are held in large and medium-sized bank at least once a year.

Material risks are checked once in one to three years, in the case of problem banks at shorter intervals. Comprehensive inspections are focused above all on reviewing the quality of assets, the system of market risks management, the internal control system and the information systems and technologies of the bank. Comprehensive assessment of the bank's activities from the point of view of the principles of corporate governance is not carried out. The Czech National Bank, however, forms an opinion on the overall quality of management of a bank on the basis of the results of control of the above-mentioned areas and key aspects of the bank's activities. During on-site inspections also correctness of the information provided by the bank within the framework of off-site supervision is verified and complementary information for the bank's assessment is obtained. On-site inspections are implemented by specialised teams, which consist of appointed members of the staff of the Czech National Bank. One of the members of the team is always the inspector who carries out off-site supervision of the respective bank.

The effectiveness of on-site inspections and also of off-site supervision (reliability of the information contained in the reports submitted regularly to the Czech National Bank for the purposes of banking supervision) is enhanced by those provisions of the Czech National Bank which stipulate, in a legally binding form, the minimum requirements for the risks management system and for the internal control system in banks. The provisions in question are the following:

- Provision of the Czech National Bank no. 12/2002 on the Internal Management and Control System of a Bank (effectiveness from 1 July 2003),
- Provision of the Czech National Bank no. 11/2002, stipulating the Requirements for Verification of the Management and Control System of a Bank, including its Risks Management System,
- Provision of the Czech National Bank no. 4/2002 on Market Risks Management in Banks,
- Provision of the Czech National Bank no. 3/2002 on Credit Risk Management in Banks,
- Provision of the Czech National Bank no. 2/2001 on the Standards of Liquidity Management of Banks.

These provisions (as well as the other relevant legal regulations) are an important tool for discharge of banking supervision, because the requirements included in them specify the criteria for qualification of contingent shortcomings in the activities of a bank, thus reinforcing the legal basis for contingent imposition of remedial measures and sanctions. Deliverables of external audit are a complementary tool of supervision and include in particular verification of the correctness of prudential reports, including the assessment of whether the system for elaboration of the reports is set-on correctly and whether the data as at 31 December are correct. Also an audit of the bank's annual financial statements is important for discharge of banking supervision.

2. and (2) uses off-site work as a primary tool to:

- **review and analyse the financial condition of individual banks using prudential reports, statistical returns and other appropriate information, including publicly available information;**
- **monitor trends and developments for the banking sector as a whole.**

Compliant.

Discharge of Supervision:

The Czech National Bank monitors the key parameters of the financial condition (soundness) of banks. Further, it elaborates regular analyses and assessments of individual banks within the framework of off-site supervision, as a rule with quarterly periodicity. The Czech National Bank employs for these purposes prudential and other reports submitted by the banks. In addition to this, further information on the bank, including publicly available information, is analysed within the framework of off-site supervision. The Czech National Bank elaborates, half-yearly, comprehensive

analyses of the banking sector, in which the state of the banking sector is analysed and the key trends in its development are delineated.

3. The supervisor checks for compliance with prudential regulations and other legal requirements through on-site and off-site work.

Compliant.

See Essential Criteria 1 and 2.

4. The appropriate mix of on-site and off-site supervision is determined by the particular conditions and circumstances of the country. In any event, the framework integrates the two functions so as to maximise the synergy and avoid supervisory gaps.

Compliant.

Discharge of Supervision:

The Czech National Bank discharges banking supervision both in the form of off-site supervision and in the form of on-site inspections. The knowledge acquired in the course of on-site inspections is employed by inspectors in their work within the framework of off-site supervision and vice versa the knowledge acquired in the course of off-site supervision is employed for the preparation of on-site inspections in the respective bank.

Additional Criteria

1. The supervisor has procedures in place to assess the effectiveness of on-site and off-site functions, and to address any weaknesses that are identified.

Materially non-compliant.

Discharge of Supervision:

There is no standardised procedure for assessment of the effectiveness of off-site and on-site supervision. The Czech National Bank has established within the framework of its banking supervision a team which prepares an internal assessment of the activities of banking supervision and its decision-making. A number of foreign regulators have teams like this, the so-called Quality Assurance Units. See Principle 1 Part 1(5).

2. The supervisor has the right to access copies of reports submitted to the board by both internal and external auditors.

Compliant.

Discharge of Supervision:

Reports of the external auditor are regularly requested within the framework of on-site inspections.

3. The supervisor has a methodology for determining and assessing the nature, importance and scope of the risks to which individual banks are exposed, including the business focus, the risk profile and the internal control environment. Off-site and on-site work is prioritised based on the results of that assessment.

Largely compliant.

Discharge of Supervision:

The methodology for defining and assessment of the nature, importance and scope of the risks to which individual banks are exposed is contained in the following internal documents of the Czech National Bank:

- Manual for Discharge of Off-Site Banking Supervision,
- Methodology for Determination of a Bank's Rating,

- Manual for Administrative Proceedings, Containing the Procedures Applied in Licensing and Imposition of Remedial Measures,
- Methodology for Control of Credit Risk Management during On-Site Inspections,
- Methodology for Control of Market Risks Management during On-Site Inspections,
- Methodology for Control of the Internal Control System and Internal Audit during On-Site Inspections,
- Methodology for Control of the Information System and Information Technologies during On-Site Inspections.

These internal documents define the standard procedures that are applied in discharge of supervision. They are updated as necessary and on the basis of the experience gained in discharge of supervision.

4. The supervisor is legally required to treat as confidential information received as part of the supervisory process. However, the supervisor is given powers under the law to disclose information in certain defined circumstances. The law prevents disclosure of confidential information unless the supervisor is satisfied that it will be held confidential by the recipient, or unless disclosure is otherwise required by law.

Compliant.

See Principle 1, Part 1(6).

5. The supervisor is able to reasonably place reliance on internal audit work that has been competently and independently performed.

Largely compliant.

Laws and Regulations:

Pursuant to Section 8 of the Act on Banks a bank is obliged to establish an internal audit unit which examines and assesses in particular the functionality and effectiveness of the bank's management and control system and its risks management system and adherence to the rules of prudential business of banks. In order to prevent a conflict of interest, the head of the internal audit unit may not be a member of the bank's statutory body, or a member of its supervisory board. After notifying the statutory body of the bank, the head of the internal audit unit is obliged to inform also the supervisory board of the facts detected and in the case of findings which may have an adverse impact on the bank's economic management, he is obliged to initiate an extraordinary session of the supervisory board. In a link-up with the Act on Banks, the Provision of the Czech National Bank no. 12/2002 on the Internal Management and Control System of a Bank (effectiveness from 1 July 2003) in Section 8 paragraph 3 stipulates that appointment and removal of the head of the internal audit unit is only possible upon prior consent of the supervisory board of the bank and that the internal audit unit:

- must perform its activities independently of all executive activities of the bank,
- must be provided access to all documents of the bank,
- must regularly inform the supervisory board and the audit committee, provided it has been established, of its findings.

In March 2003 the Czech National Bank issued the Official Notification relating to the Provision of Section 22 paragraph 3 of Act no. 21/1992 Coll., which contains the reason for a rejection of the auditing company, which bank had notified to the Czech National Bank.

Discharge of Supervision:

The knowledge gained by banks' internal audit units is employed in discharge of supervision. The Czech National Bank considers the knowledge of internal audit units a significant source of information, above all for the preparation of on-site inspections. The Czech National Bank does not take an undiscerning approach to the knowledge of internal audit units. The activities of internal audit units as one of the key components of the internal control system are reviewed within the framework of on-site inspections. Internal audit function in banks has been improving in recent years.

Principle 17. Banking supervisors must have regular contact with bank management and a thorough understanding of the institution's operations.

Comprehensive assessment.

Largely compliant.

Essential Criteria

Information visits in a bank constitute an essential part of discharge of banking supervision. The aim of these visits is to get acquainted in greater detail with of the key aspects of the bank's activities, which is achieved through meetings held at various levels of the bank's senior management and, as the case may be, also with its regular staff members. Information visits take place as a rule at least once a year, and are implemented in large and medium-sized banks. The Czech National Bank assesses the quality of senior management of banks both within the framework of the licensing process and during on-site inspections in already existent banks. The amount of knowledge the Czech National Bank banking supervision staff have gathered of specific activities of banks has been growing. Banks usually notify of substantial changes in their activities, although they are not obliged to do so under the Act on Banks, and it is largely at their discretion which procedure they will follow in a particular situation. The above would require an amendment to the Act on Banks (a matter of a longer period of time).

Analysis of the Individual Criteria

Essential Criteria

1. Based on the risk profile of individual banks, the supervisor has a programme of regular meetings with senior and middle management (including the board, non-executive directors and heads of individual units) to discuss operational matters such as strategy, group structure, corporate governance, performance, capital adequacy, liquidity, asset quality, risk management systems etc.

Largely compliant.

Discharge of Supervision:

Meetings with senior management of banks are held regularly, on the basis of a schedule which forms a part of the plan of the Czech National Bank in the area of discharge of banking supervision, specifically of the plan of its banking supervision section, or as currently needed. Information visits or meetings with a bank's management are employed for example in the cases when it is necessary to clarify a certain special problem, to ascertain or verify certain relevant pieces of information, to explain the strategy and the business plan of the bank, to analyse the economic results of the bank, to evaluate the management system of the bank, (corporate governance) and to discuss other issues that are the subject of mutual interest and are topical. Information visits are employed by banking supervision also when it is necessary to solve speedily some problematic situation and also in many other matters, when banking supervision considers it necessary or appropriate.

The Czech National Bank is currently preparing a methodology for assessment of the risk profile of a bank.

2. The supervisor has a thorough understanding of the activities of its banks. This is accomplished through a combination of off-site surveillance, on-site reviews and regular meetings.

Largely compliant.

Discharge of Supervision:

The Czech National Bank endeavours to attain the necessary level of knowledge of a bank's activities and to create such model of supervision that combines effectively off-site supervision, on-site inspections and information visits and meetings with senior management of banks with the use of reports and knowledge of external and internal auditors. The key factor for the fulfilment of this

criterion is the potential of knowledge and abilities of the Czech National Bank staff members who work in the area of banking supervision.

From the institutional point of view it is possible to state that supervision over the individual areas of a bank's activities became more effective due to the amendment to the Act on Banks, which authorises the Czech National Bank to require a bank to verify specific areas of risks management. For this purpose the Czech National Bank issued the Provision of the Czech National Bank no. 11/2002, stipulating the Requirements for Verification of a Bank's Management and Control System, including its Risk Management System. The Czech National Bank is authorised by operation of law to waive verification of the management and control system of a bank, including its risk management system, or to confine this requirement to some of parts of these systems only.

3. The supervisor requires banks to notify it of any substantive changes in their activities or any material adverse developments, including breach of legal and prudential requirements.

Largely compliant.

Laws and Regulations:

Pursuant to Section 1 paragraph 4 of the Act on Banks a bank may not perform other business activities than those permitted to it in its licence. If a bank intends to carry out activities beyond the framework of its licence, it is obliged in accordance with the legal regulations to ask for a change of its licence. The range of potential activities a bank may perform is, however, limited by law. The Act on Banks does not require a bank to fulfil its notification duty when changes occur in the activities which are in accordance with the licence issued to it, for example on introduction of a new product within the framework of a permitted activity. Nevertheless, banks as a rule notify the Czech National Bank of such basic facts, for example at its meetings with their senior management, or publish them in their annual reports. Section 26b of the Act on Banks stipulates the duty to notify the Czech National Bank without delay in the event that the statutory body or the supervisory board finds out that the bank is or will become insolvent or that the bank has incurred or probably will incur losses which have caused, or may cause, a decrease in the bank's capital adequacy on an individual basis below 2/3 of the ratio stipulated by the Czech National Bank. However, there is no other explicit requirement which would require a bank or, as the case may be, its bodies, to notify of any deterioration in its activities, including any breaches of the law and the rules of prudential business (this is, however, without prejudice to the duty to submit to the Czech National Bank the necessary information pursuant to Section 41 paragraphs 2 and 3 of the Act on the Czech National Bank). Within the framework of remedial measures the Czech National Bank may impose on the bank the duty to notify it of any deterioration of certain activities or indicators. The Czech National Bank may also require the bank to submit to it regularly detailed analyses of the bank's financial condition. Infringements of the stipulated limits and some further information characterising the bank's situation are also evident from the content of the regularly submitted statements. In order to meet this criterion to the full, the Czech National Bank will initiate a modification of the respective provisions of the Act on Banks.

4. As part of the licensing process, and on an on-going basis during routine supervision, the supervisor considers the quality of management.

Compliant.

Discharge of Supervision:

A part of the licensing process is assessment of the professional competence, trustworthiness and experience of persons nominated to the top positions in a bank or to the management of a foreign bank branch in accordance with Section 4 paragraph 3 subparagraph d) and Section 5 paragraph 4 subparagraph c) of the Act on Banks. The Decree of the Czech National Bank no. 166/2002 Coll. then stipulates the documents which the nominated persons shall submit to the Czech National Bank with the proviso, that the Czech National Bank may verify the professional competence of the nominated persons also within the framework of an interview with such persons. The Czech National Bank is authorised by operation of law to request a copy of the criminal record concerning the natural persons who are founders of a bank or are nominated to positions of senior managers of a bank, whose powers and responsibilities are defined in the articles of association (see § 4 paragraph 5 of the Act on

Banks). To increase the transparency of the criteria which are applied in this area, the Czech National Bank has issued towards the close of 2002 the Official Notification of the Czech National Bank no. 22 on Assessing the Professional Competence, Trustworthiness and Experience of Persons Nominated to Positions of Senior Managers of Banks and Positions in the Management of Foreign Bank Branches, which contains the essential criteria and requirements that persons nominated to top positions in a bank or a foreign bank branch should fulfil. The quality of senior management and line management is assessed above all within the framework of on-site inspections. If the Czech National Bank finds that any of the managing officers is not competent to perform his function, it will discuss this fact with the senior management of the bank. In addition, pursuant to Section 26 paragraph 1 subparagraph a) of the Act on Banks the Czech National Bank is authorised, in the event that it detects shortcomings in the activities of a bank or a foreign bank branch, to require replacement of a person in the management of the bank or the foreign bank branch. (See also Principle 3, Essential Criterion 7).

Principle 18. Banking supervisors must have a means of collecting, reviewing and analysing prudential reports and statistical returns from banks on a solo and consolidated basis.

Comprehensive Assessment:
Compliant.

Essential Criteria

The Czech National Bank has the right to request information on the financial condition of banks. The banks regularly submit a series of reports/statements that provide information on their assets, liabilities, costs and revenues on an individual basis and there are no serious problems in this area in terms of methodology or accuracy of data. The Czech National Bank does not expect occurrence of major problems in reporting on a consolidated either. Consolidated statements are submitted quarterly since 2003 and capital adequacy on a consolidated basis includes, since 2002, both credit and market risks. For the purposes of discharge of supervision on a consolidated basis the Czech National Bank has imposed, as a part of the prudential rules, the obligation to report assets and liabilities in the International Accounting Standards format. Accordingly, the CNB has imposed for the consolidation of data both the full and the proportional consolidation method, in line with the IAS.

Analysis of the Individual Criteria

Essential Criteria

1. The supervisor has the legal authority to require banking organisations to submit information, on both a solo and consolidated basis, on their financial condition and performance, at regular intervals. These reports provide data on matters such as on- and off-balance sheet assets and liabilities, profit and loss, capital adequacy, liquidity, large exposures, loan loss provisioning, market risk and deposit sources.

Compliant.

Discharge of supervision

The Czech National Bank has all the above-mentioned statements on an individual basis at its disposal. The statements on a consolidated basis (the balance sheet, the capital adequacy and the credit exposure) were submitted from 1999 onwards on an annual basis. Since 2002 the consolidated statements have been extended to include also the profit and loss statement and the information on qualifying holdings and capital adequacy already included market risk. Since 2003 a quarterly notification duty has been introduced with respect to the consolidated statements.

2. Laws and regulations establish, or the supervisor has the authority to establish, the principles and norms regarding the consolidation of accounts as well as the accounting techniques to be used.

Compliant.

Laws and Regulations:

Accounting procedures for consolidated groups for the purposes of accounting are issued by the Ministry of Finance of the Czech Republic. Banks have an option to use, starting with the consolidated financial statements for 2002, instead of these procedures the International Accounting Standards. The Czech National Bank prescribes for the purposes of supervision on a consolidated basis within the framework of the prudential rules the duty to report assets and liabilities with the use of the International Accounting Standards. It also prescribes for the consolidation of data the full and the proportional consolidation method in accordance with the International Accounting Standards.

3. The supervisor has a means of enforcing compliance with the requirements that the information be submitted on a timely and accurate basis. The supervisor determines that the appropriate level of senior management is responsible for the accuracy of supervisory returns, can impose penalties for deliberate mis-reporting and persistent errors, and can require that inaccurate information be amended.

Compliant.

Laws and Regulations:

Pursuant to Section 41 paragraph 2 of the Act on the Czech National Bank the Czech National Bank is authorised to demand from banks (and other persons engaged in activities under special acts) information and background data. The Czech National Bank sets down the methodology and the conditions for submission of the information and background data requested. The Act on Banks, Section 24 paragraph 1 links up to this. The act states that banks and branches of foreign banks are obliged to prepare and submit to the Czech National Bank information and background data, the content, format, break-down, terms and manner of submission of which are set down by the Czech National Bank. When a bank does not submit the data, or does not comply with the deadlines, or submits inaccurate and false reports, this is considered as a shortcoming in the activities of the bank, which means that remedial measures and sanctions may be imposed on it pursuant to Section 26 of the Act on Banks (see also Principle 22). If the Czech National Bank finds that a report submitted to it contains erroneous data, it requires that the data be corrected. The Czech National Bank, however, may take specific steps (for example impose a fine, *et alia*) against the bank, yet not against individual members of the bank's senior management, except for the requirement to replace a person in the senior management (Section 26 of the Act on Banks).

4. The information that is required to be submitted includes standardised prudential and statistical reports, and detailed balance sheets and income statements, as well as supporting schedules that provide details concerning on- and off- balance sheet activities and on reserves included in capital. Inclusion of data on loan classification and provisioning is also required.

Compliant.

Discharge of Supervision:

The balance sheet, the profit and loss statement, the statements on capital adequacy, on exposure, classification of credits and provisioning, liquidity and exposures towards countries are required on a monthly basis, while the consolidated balance sheet, the consolidated profit and loss statement, the statement on consolidated capital adequacy and exposure and the statement on qualifying holdings of the consolidated group have been submitted quarterly since 2003.

5. The supervisor has the authority to request and receive any relevant information from banks, as well as any of their related companies, irrespective of their activities, where the supervisor believes that it is material to the financial situation of the bank or the assessment of the risks of the bank.

Compliant.

Laws and Regulations:

See also Principle 1 part 1(4). The Czech National Bank is authorised to request information from non-bank entities which have a relation to a bank (subsidiaries, affiliates or, as the case may be, other organisations) pursuant to Section 26f paragraph 2 of the Act on Banks. The companies in question form part of the consolidated group of the bank (see also Principle 20).

6. The supervisor has an analytical framework that uses the statistical and prudential information for the ongoing monitoring of the condition and performance of individual banks. The results are also used as a component of on-site supervision planning. This requires that the supervisor has an adequate information system.

Compliant.

Discharge of Supervision:

The Czech National Bank has at its disposal the prudential and the financial statements. Within the framework of the central database of the Czech National Bank an information system of the Czech National Bank for the area of discharge of banking supervision has been built, the outputs of which are the following analytical tasks enabling an analysis of a bank:

- a uniform system of an economic assessment of a bank,
- a system of monitoring of currency positions,
- a system of monitoring fulfilment of the limits for (large) exposures,
- signal information,
- rating of banks.

The reports/statements and the analytical outputs of the information centre are also used for the preparation of on-site inspections.

7. In order to make meaningful comparisons between banking organisations, the supervisor collects data from all banks and all other relevant entities within a banking organisation on a comparable basis and related to the same dates (stock data) and periods (flow data).

Compliant.

Discharge of supervision

The reports/statements of banks are submitted in a standardised format and as at firmly set terms. The Czech National Bank is authorised to require information from non-bank entities that are members of a consolidated group (see Essential Criterion 5). The Czech National Bank gathers information above all through the mediation of a bank (the controlling bank or, as the case may be, a bank which forms a part of a financial or a mixed holding group) and the data involved are primarily consolidated data, not unconsolidated data of the individual companies.

8. The supervisor collects data from banks at a frequency (e.g. monthly, quarterly and annually) commensurate with the nature of the information requested, and the size, activities and risk profile of the individual bank.

Compliant.

Discharge of supervision

See Essential Criteria 4 and 5. The reports/statements are obligatory for all companies that are included in a consolidated group of a bank. The reports/statements are not submitted only in the case that the bank does not constitute a consolidated group or its subsidiaries or affiliates are irrelevant.

Principle 19. Banking supervisors must have a means of independent validation of supervisory information either through on-site examinations or use of external auditors.

Comprehensive Assessment:

Largely compliant.

Essential Criteria

On-site inspections (see Principle 16) are discharged according to the annual plan that is based on the medium-term conception of the banking supervision section of the Czech National Bank. The frequency of information visits and on-site inspections has been set down on the basis of classification of banks and foreign bank branches into categories (hereinafter, within Principle 19, only “banks”), carried out according to their importance from the point of view of stability of the banking sector and according to the structure of their balance sheet and off-balance sheet. Account is also taken of the findings previously noted in the respective bank by the banking supervision of the Czech National Bank. Every on-site inspection is carried out according to a plan and is implemented by a review team, in which each of the team members is assigned clearly set objectives and work tasks. The inspectors in their control activities during on-site inspections widely utilise standardised procedures. These procedures are incorporated in manuals for discharge of on-site inspection. However, the manuals have not been completed yet. The Czech National Bank uses the services of external auditors for the purposes of assessment of the risk management and verification of selected prudential reports yearly as at 31 December. The Czech National Bank has the right to reject the auditing company appointed by the bank. According to the Act on Banks a bank shall ensure that a legal entity performing audit activities will carry out verification of the financial statements and verification of the bank’s management and control system, including its risk management system. The Czech National Bank may, by operation of law, waive verification of the systems or confine the requirement to some of their components only. Towards the close of 2002 the Czech National Bank issued a provision that regulates the requirements for verification of a bank’s management and control system, including its risk management system.

Additional Criteria

The Czech National Bank discusses the results of the audit with the bank’s management and meets auditors regularly in order to discuss matters of common interest.

Analysis of the Individual Criteria

Essential Criteria

1. The supervisor has in place a coherent process for planning and executing on-site visits, using either in-house examiners, or making use of the work of external auditors, as appropriate. There are policies and procedures in place to ensure that examinations are conducted on a thorough and consistent basis with clear responsibilities, objectives and outputs. The supervisor holds meetings with banks and their auditors to discuss the results of work by the external auditors and to agree on the responsibilities for corrective work.

Largely compliant.

Discharge of Supervision:

On-site inspections are discharged by inspectors of the banking supervision section who are authorised to do so under the Act on State Control and are organised in teams. The off-site supervision inspector who is in charge of the supervised bank also participates in on-site inspections. In case of need, the team for on-site inspection is reinforced by further entrusted employees from both the banking supervision sections. In addition, the control team may avail itself of the wide professional background of the other units of the Czech National Bank for consultations on special or extraordinarily complex issues it may come across during the on-site inspection. On-site inspections (see Principle 16) are implemented according to the annual plan which derives from the medium-term conception of the banking supervision section of the Czech National Bank. The frequency of on-site inspections is set down on the basis of the classification of banks and foreign bank branches into

categories, carried out according to their importance from the point of view of stability of the banking sector and according to the structure of their assets, liabilities and off-balance sheet items. Account is also taken of the findings previously noted in the respective bank by the banking supervision of the Czech National Bank. Every on-site inspection is carried out according to a plan of the on-site inspection. This plan determines *inter alia* the schedule of the implementation of the on-site inspection and the composition of the team which will discharge the on-site inspection. The plan also defines the tasks of the inspectors, the forms of their co-operation and communication. The inspection focuses on those units, activities, systems and on those portfolios of financial instruments which are of key importance for the financial soundness and stability of the bank or in the case of which it can be expected that major shortcomings in the activities of the bank would be reflected in them. A plan of an on-site inspection is drawn up on the basis of an analysis of the bank, carried out before starting the on-site inspection. The plan of an on-site inspection, therefore, organises the work of inspectors in such a way as to ensure that they within the framework of the team would act with unequivocally defined responsibilities, objectives and outputs, including the terms of fulfilment. In case of need, a plan of an on-site inspection will be adjusted to account for any unexpected circumstances, for example by reinforcing the capacity for control of a certain portfolio.

When preparing a plan of an on-site inspection and also during the inspection itself, standardised procedures are used, which have been verified in the past and are incorporated into manuals or methodologies for discharge of on-site inspections. The manuals concerned are the following:

- methodology for the control of credit risk management during on-site inspections,
- methodology for the control of market risks management during on-site inspections,
- methodology for the control of the internal management and control system and internal audit during on-site inspections,
- methodology for the control of the information system and information technologies during on-site inspections.

The methodologies mentioned define the standard procedures that are applied during every on-site inspection. The methodologies contain:

- definitions of the issues (i.e. the line of the area under review), a glossary of terms from the respective area, references to appropriate literature, recommended procedures and laws,
- basic definition of the objectives of the control,
- description of the sources of information for the preparation of the control and of the requirements for the content of the analysis of the bank in the respective area, carried out on the basis of the data available to the Czech National Bank and on the basis of the background data the banking supervision of the Czech National Bank will request prior to starting the inspection by a letter, in which it will also announce the bank that it will carry out an inspection in it (the so-called first-day-letter),
- quantitative, but mainly qualitative limit parameters, the so-called benchmarks, which the Czech National Bank considers as the standard of prudential approach to managing the given type of risk; the qualitative parameters relate in particular to the organisational structure, information flows and purposes of the risk management systems,
- questionnaires which serve as a guidelines during on-site inspections.

Also the procedures and formats for compiling a record of the on-site inspection are standardised. If the Czech National Bank on the basis of findings from an on-site inspection decides to impose on the bank a fine, to change its licence, to order an extraordinary audit, to introduce conservatorship, to decrease the bank's initial capital, to prohibit or limit the execution of certain operations, it proceeds according to the instructions of the Czech National Bank for administrative proceedings, which are based on the Code of Administrative proceedings. This is, however, as a rule preceded by an invitation to the bank to redress the matter. The above-mentioned methodologies, or the manual for the administrative proceedings, however, do not cover all material details and procedures and it is, therefore, necessary to complement them. As regards co-operation with external auditors, trilateral meetings of the banking supervision staff with the external auditors and the bank are held after an on-site inspection or, as the case may be, further meetings, for example if the bank has problems. Also bilateral meetings between the Czech National Bank and external auditors are held in matters of common interest, not, however, with respect to individual banks. Once a year a meeting

with representatives of the Chamber of Auditors takes place, in which also representatives of the individual auditing firms participate.

2. The supervisor has the authority to monitor the quality of work done by external auditors for supervisory purposes. The supervisor has the authority to directly appoint external auditors for conducting supervisory tasks or oppose the appointment of an external auditor that is deemed to have inappropriate expertise and/or independence.

Compliant.

The Czech National Bank does not use external auditors as the only tool of verification of the state on site. Nevertheless, the regulatory rules require that the financial statements submitted to the banking supervision of the Czech National Bank that reflect the state as at the end of a calendar year, i.e. as at 31 December, are verified by an external auditor.

Laws and Regulations:

The Czech National Bank is not authorised under the law to verify and influence the auditing procedures used by auditors (an auditor is independent, he adheres to a special Act and the auditing guidelines). As regards the work of an auditor in banks, a bank is obliged pursuant to Section 22 of the Act on Banks to notify the Czech National Bank of its external auditor. The Czech National Bank does not directly appoint the auditor, but it may reject the auditor within 30 days of the bank's notification. The Czech National Bank avails itself of this right in practice. The Czech National Bank has issued an official notification which relates to the assessment of external auditors. Within 15 days of the rejection, the bank is obliged to notify the Czech National Bank of a new auditor. Persons with a special relation to the bank may not be its auditors. The relations between banking supervision and external auditors are governed by the Guideline of the Chamber of Auditors no. 51, which is binding only on auditors, not on the Czech National Bank. A bank is obliged by operation of law to carry out verification of its management and control system through an external auditor. The Czech National Bank may waive this verification or confine it to some of its parts only. The requirements for verification of the management and control of the bank, including its risk management system, have been stipulated by a provision of the Czech National Bank.

Discharge of supervision

The banking supervision of the Czech National Bank compares the results of the work of an external auditor with its own findings obtained in the course and within the framework of on-site inspections. This comparison is carried out not only for the purpose of audit of the mentioned reporting, but also for the purpose of the statutory audit, i.e. from the point of view of assessment of the overall financial condition of the bank, in particular the quality of its assets (the amount of provisions). In the case of significantly differing opinions, the Czech National Bank discusses these differences with the auditors. The present situation is satisfactory with regard to the fact that the statutory tasks of external auditors towards the Czech National Bank are limited (see Principle 16 – discharge of on-site inspections).

3. The supervisor can also make use of external auditors to examine specific aspects of banks' operations, provided there is a well-developed, professionally independent auditing and accounting profession with skills to undertake the work required. The respective roles and responsibilities for the supervisor and the auditors in these circumstances are clearly defined by the supervisor.

Compliant.

The Czech National Bank is authorised pursuant to Section 26 of the Act on Banks to order execution of an extraordinary audit at the bank's expense and on the basis of Section 22 of the Act on Banks to order verification of the control and management systems of the bank. The Czech National Bank considers the present situation as satisfactory with regard to the fact that the Czech National Bank has sufficient human resources for discharge of supervision according to its medium-term conceptions and annual plans.

4. The supervisor has the legal right of full access to all bank records for the furtherance of supervisory work. The supervisor also has similar access to the board, senior management and staff, when required.

Compliant.

According to the Act on State Control the Czech National Bank, when discharging on-site inspection, has free access to all documents, or records, of the bank and also access to the board of directors and the senior managers and regular staff members of the bank controlled (compare Principle 1 part 1(4), Essential Criterion 3 and also Principle 7, Essential Criterion 5).

5. The supervisor has a programme for the periodic examination of supervisory returns by examiners or through the work of external auditors. There is a requirement that certain key supervisory returns, such as that for capital adequacy, be examined at least annually by the auditors and a report submitted to the supervisor.

Compliant.

Laws and Regulations:

The Provision of the Czech National Bank which links up with the Decree of the Czech National Bank no. 333/2002 Coll. or, as the case may be, other provisions of the Czech National Bank stipulate for example that the reports/statements should be verified once a year by an external auditor who should elaborate a report on whether the system for elaboration of these reports is set up correctly and whether the data as at 31 December are correct.

Discharge of Supervision:

The Czech National Bank evaluates the outputs and the activities of an external auditor once a year. Verification of the system of the prudential reports is also reviewed within the framework of on-site inspections.

Additional Criteria

1. The supervisor meets with management and the board of directors each year to discuss the results of the supervisory examination or the external audit. Such visits should allow for the supervisor to meet separately with the independent board members.

Compliant.

Discharge of Supervision:

Upon termination of an on-site inspection, the record of the on-site inspection, which contains its results, is always discussed with the bank's management. The results of the statutory audit are discussed with the bank's management in case of need, taking account of the results of this audit, of the situation in which the bank finds itself and of its importance for the stability of the banking sector.

Note:

The position of independent executive managers in banks does not exist in the Czech Republic, with regard to the fact that the Act on Banks requires that the board of directors should consist of members of the bank's senior management.

2. The supervisor meets periodically with external audit firms to discuss issues of common interest relating to bank operations.

Compliant.

Representatives of the Czech National Bank for the area of discharge of banking supervision meet external auditors once or twice a year to discuss matters of common interest.

Principle 20. An essential element of banking supervision is the ability of the supervisors to supervise the banking group on a consolidated basis.

Comprehensive assessment.

Largely compliant.

Essential Criteria

Part eight (Sections 26c-26h) was incorporated into the Act on Banks based on its so-called Harmonisation Amendment no. 126/2002 Coll., effective as at 1 May 2002 (except for the provision of Section 26e paragraph 2 which comes into effect from the date of accession of the Czech Republic to the EU). In a link-up with the Act no. 442/2000 Coll., by which the Act on the Czech National Bank was amended, the Harmonisation Amendment has expanded the so-far authorisation of the Czech National Bank for discharge of banking supervision over activities of banks and foreign bank branches (the so-called supervision on an individual basis) by discharge of banking supervision on a consolidated basis. Prior to the Harmonisation Amendment, the Czech National Bank carried out banking supervision on a consolidated basis only within a limited scope, as permitted by the then valid legislation, specifically over groups controlled by a bank, in accordance with the Provision of the Czech National Bank no. 2/1999, stipulating the Terms and Conditions for Discharge of Supervision on a Consolidated Basis, while the Czech National Bank had practically no authority over non-bank members of such groups. A detailed definition of the scope and content of banking supervision on a consolidated basis is included in the Decree of the Czech National Bank no. 333/2002 Coll., stipulating the Rules of Prudential Business of Controlling Persons on a Consolidated Basis.

Pursuant to Section 26f of the Act on Banks and the Decree of the Czech National Bank no. 333/2002 Coll., the Czech National Bank obtains information on all members of a consolidated group and their mutual relations. The controlling bank and the financial holding company are obliged to observe capital adequacy and exposure rules on a consolidated basis. Banks and financial holding companies submit the consolidated statements to the Czech National Bank on a quarterly basis.

The Czech National Bank may, for the purpose of discharge of banking supervision on a consolidated basis, oversee also the activities carried out by the branches and subsidiaries of the bank, its controlling persons or other persons included within the consolidated group. The Czech National Bank may carry out, for the purpose of discharge of banking supervision on a consolidated basis, on-site inspections in the persons included in the consolidated group (including the subsidiaries of the bank) or request the relevant supervisory body to carry out such inspections.

As a part of its discharge of consolidated supervision the Czech national Bank is authorised by operation of law to co-operate and exchange information with both domestic regulators (the Agreement on Co-operation between the Czech National Bank, the Securities Commission and the Ministry of Finance of the Czech Republic) and the foreign ones, as a rule on the basis of co-operation agreements with foreign regulators (the so-called Memoranda of Understanding) in some cases also informally (see also Principles 24 and 25).

If the Czech National Bank detects any shortcomings in the activities of an entity included in a consolidated group that is not a bank, it may by operation of law require such entity to remedy the situation within a specified term, or may order that an extraordinary audit be arranged in the entity which forms part of the consolidated group, at the expense of the controlling entity, or impose a fine of up to CZK 50 mill. on this entity, or prohibit or restrict execution of transactions with entities which are parts of the same consolidated group.

Additional Criteria

The Czech national Bank is authorised to review the activities of parent companies and businesses related to the parent companies. The Czech National Bank may prohibit or restrict a bank (both controlling and controlled) and a financial holding company to carry out transactions with entities that are included in the same consolidated group (in the case of a bank also with persons related to it by a close connection or persons with a special relation to it). The Czech National Bank has no authorisation to assess members of the senior management of the parent company in terms of their integrity and professional capacity, i.e. to assess whether they are “fit and proper”.

Essential Criteria

1. The supervisor is aware of the overall structure of banking organisations (i.e., the bank and its subsidiaries) or groups and has an understanding of the activities of all material parts of these groups, including those that are supervised directly by other agencies.

Largely compliant.

Discharge of Supervision:

On the basis of Section 26f of the Act on Banks and the Decree of the Czech National Bank no. 333/2002 Coll. the Czech National Bank acquires comprehensive information on all members of a consolidated group, i.e. on the controlled entities and affiliates of the parent bank, financial holding company or mixed-activity holding company, and on the relations between them, including a chart showing of the structure of the group, at least once a year and always without undue delay on any change in the information provided. A certain source of acquisition, and mainly of verification, of information is the other domestic, or as the case may be, foreign regulators (see further).

2. The supervisor has a supervisory framework that evaluates the risks that non-banking activities conducted by a bank or banking group may pose to the bank or banking group.

Largely compliant.

Laws and Regulations:

The Act on Banks limits generally and to a certain extent the risks ensuing from non-banking activities. A bank may carry out only those activities that are mentioned in its licence. This does not hold true for activities performed for someone else, provided that they are connected with arranging for its operation and the operation of other banks, financial institutions and undertakings of ancillary banking services, over which the bank exercises control. Acquisition of holdings in non-bank and non-financial entities is also significantly restricted (see Principle 5). Founding of financial institutions, including insurance companies and pension funds, is not, however, from the point of view of the Act on Banks subject to approval of the Czech National Bank; the licence is issued by the state supervision agency for insurance companies or, as the case may be, pension funds. A number of financial institutions is not regulated at all (for example leasing companies). Within the framework of consolidated supervision the Czech National Bank acquires information on the activities actually performed by members of a consolidated group and on transactions within the framework of the consolidated group. The controlling bank or financial holding company is obliged to observe the rules concerning capital adequacy and exposure on a consolidated basis, i.e. basically taking account of the activities of the relevant subsidiaries and jointly managed companies.

Discharge of Supervision:

An internal manual on consolidated supervision is in process of preparation. Works on the manual continue and account will be also taken of the practical experience the Czech National Bank will gather in discharge of supervision over consolidated groups.

3. The supervisor has the legal authority to review the overall activities of a bank, whether the activities are conducted directly (including those conducted at overseas offices), or indirectly, through subsidiaries and affiliates of the bank.

Largely compliant.

See also Principle 23.

Laws and Regulations:

The Czech National Bank pursuant to Section 25 paragraph 2 and Section 26c paragraph 4 may exercise supervision over the activities performed by branches and subsidiaries of a bank or other persons included in a consolidated group, provided there are no statutory restrictions in the host country (the respective foreign regulator will enable to exercise supervision as a rule on the basis of reciprocity).

Discharge of Supervision:

Discharge of supervision on a consolidated basis to the full extent is only beginning to be implemented in practice. An internal manual for discharge of banking supervision on a consolidated basis is under preparation (it is necessary to include in it also the practical experience and data gained on the basis of the notification duty.)

4. There are no impediments to the direct or indirect supervision of all affiliates and subsidiaries of a banking organisation.

Compliant.

Laws and regulations

Direct supervision over branches and representative offices is possible, because these are integral parts of the bank. A foreign regulator will as a rule enable to carry out controls abroad on the basis of reciprocity or will carry them out itself on the basis of a request. The Czech National Bank may carry out for the purpose of discharge of banking supervision on a consolidated basis on-site inspections in the entities included in the consolidated group (including the subsidiaries of the bank) or may ask the respective supervisory body to carry out such inspection. The necessary information may be obtained also through the controlling person. Basically, it is not possible to carry out an on-site inspection in a foreign entity which is not regulated (without its consent). The Czech National Bank presumes that no regulator in the world has such authority that interferes in the jurisdiction of another state and neither do the Core Principles for Effective Banking Supervision envisage it.

5. Laws and regulations establish, or the supervisor has the authority to impose, prudential standards on a consolidated basis for the banking organisation. The supervisor uses its authority to establish prudential standards on a consolidated basis to cover such areas as capital adequacy, large exposures and lending limits.

Compliant.

Laws and regulations

The Act on Banks, Section 26f, authorises the Czech National Bank to issue a decree stipulating the rules of prudential business of controlling persons on a consolidated basis (especially with respect to capital adequacy and exposure). Such decree is the Decree of the Czech National Bank no. 333/2002 Coll.

6. The supervisor collects consolidated financial information for each banking organisation.

Compliant.

Discharge of Supervision:

Banks and financial holding companies submit the consolidated statements to the Czech National Bank quarterly in accordance with the Decree of the Czech National Bank no. 333/2002 Coll.

7. The supervisor has arrangements with functional regulators of individual business vehicles within the banking organisation group, if material, to receive information on the financial condition and adequacy of risk management and controls of such business vehicles.

Largely compliant.

Discharge of Supervision:

A new agreement on co-operation was concluded with the domestic regulators (the Czech National Bank, the Securities Commission and the Ministry of Finance of the Czech Republic), which should fully reflect the needs of the regulator discharging consolidated supervision (as yet, there is no experience with its application in practise). Regular transmission of information on the adequacy of risk management or on the financial condition of the individual affiliations is not carried out between the regulators or, rather, this information is provided at request only. On the basis of this agreement work teams will be established consisting of the staff members of the individual regulators for every

consolidated group in existence. As regards cross-border consolidated groups, the Czech National Bank has concluded the necessary Memoranda of Understanding with the banking regulators of:

- Slovakia,
- France,
- Austria,
- Federal Republic of Germany,
- USA (the New York State) and
- Belgium.

Memoranda of understanding with the Netherlands and Italy are under preparation.

Regular transmission of information on the adequacy of risk management or on the financial condition of the individual affiliations is not carried out between regulators (neither domestic nor foreign), or rather such information is provided only at request.

8. The supervisor has the authority to limit or circumscribe the range of activities the consolidated banking group may conduct and the overseas locations in which activities can be conducted; the supervisor uses this authority to determine that the activities are properly supervised and that the safety and soundness of the banking organisation is not compromised.
Largely compliant.

Laws and Regulations:

As regards the authorisation mentioned in the first sentence, the Czech National Bank uses this tool only as a sanction/remedial measure (see further, in connection with the “ring fencing”), not preventively. It is not possible to restrict territorially the activities of a bank in advance. Such regulation of a bank’s business would be contrary to the principles of the legal culture from which the Czech legal order derives. A bank must notify the Czech National Bank of the establishment of a branch or a subsidiary abroad. As to the second sentence, this right, or this duty, of the Czech National Bank ensues from the very meaning of consolidated supervision, which the Act on Banks in Section 26c paragraph 1 defines as monitoring and regulation of risks with respect to consolidated groups, a part of which is a bank, for the purpose of confining the risks the bank is exposed to due to its participation in the consolidated group. Among the manners of fulfilment of this authority is also the Decree of the Czech National Bank no. 333/2002 Coll., stipulating the Rules of Prudential Business of Controlling Persons on a Consolidated Basis.

Additional Criteria

1. For those countries that allow corporate ownership of banking companies:

- **The supervisor has the authority to review the activities of parent companies and of companies affiliated with the parent companies, and utilises the authority in practice to determine the safety and soundness of the bank.**

Compliant.

Laws and Regulations:

In addition to the regularly submitted and updated information on behalf of consolidated groups and the consolidated statements concerning observance of the prudential rules, the Czech National Bank is authorised to carry out on-site control in any entity included in the consolidated group or to ask the respective body discharging supervision over the given entity to carry out such control on an individual basis. The Ministry of Finance of the Czech Republic and the Securities Commission are obliged by operation of law to carry out such control and to submit a report on its results to the Czech National Bank. The Czech National Bank has also the right to ask for the execution of controls abroad (such controls are enabled on the basis of reciprocity, based on the Memorandum of Understanding).

- **The supervisor has the authority to take remedial actions, including ring-fencing, regarding parent companies and non-bank affiliates concerning matters that could impact the safety and soundness of the bank.**

Compliant.

Pursuant to Section 26h paragraph 2 subparagraph d) and Section 26 paragraph 1 subparagraph g) the Czech National Bank may prohibit a bank (both the controlling and the controlled bank) and a financial holding company to carry out operations with entities which form part of the same consolidated group (in the case of a bank also with entities related to it by a close connection or persons with a special relation to it) or may confine such operations. With regard to the shareholders with a qualifying holding in the bank it is possible to suspend some of shareholder's rights on the basis of the Act on Banks, Section 20a.

- **The supervisor has the authority to establish and enforce fit and proper standards for owners and senior management of parent companies.**

Materially non-compliant.

Laws and Regulations:

Within the framework of the licensing proceedings the Czech National Bank assesses the owners of a bank (see Principle 3). However, no binding standards for the fit and proper test have been set down. The Czech National Bank is not authorised to deal with the senior management of parent companies. Full compliance with this criterion would require a deep intervention in the legislation. Such change is not prepared at present.

Principle 21. Banking supervisors must be satisfied that each bank maintains adequate records drawn up in accordance with consistent accounting policies and practices that enable the supervisor to obtain a true and fair view of the financial condition of the bank and the profitability of its business, and that the bank publishes on a regular basis financial statements that fairly reflect its condition.

Comprehensive Assessment:

Largely compliant.

Essential Criteria

The senior management of a bank and the management of a foreign bank branch are responsible for correctness of their accounting statements and correctness of the disclosed information. Accounting of banks and foreign bank branches is subject to regular reviews by external auditors. The Czech National Bank has issued a comprehensive provision detailing the methodology of the banks' reporting for the purposes of banking supervision. The accounting procedures used by banks are compliant with the International Accounting Standards.

Additional Criteria

The Czech National Bank requires regular disclosure of information on a quarterly basis. In addition to information on the bank (on its capital, shareholders, consolidated group structure, activities of the bank, relations with the controlling and controlled persons and relations with members of the supervisory board, members of the board of directors and other senior managers of the bank), the bank shall disclose its balance sheet, its profit and loss statement, the amount of receivables by category and the respective provisions for these receivables, the amount of restructured receivables for the accounting period, information on derivatives and a set of indicators relating to capital adequacy). Together with the foregoing, the bank shall disclose its most recent annual financial statements. Banks also publish their annual reports. The auditors have the statutory duty to report to banking supervision, with the bank's knowledge, matters of material importance they have identified in the course of their audit.

Essential Criteria

1. The supervisor has the authority to hold management responsible for ensuring that financial record keeping systems and the data they produce are reliable, and that supervisor-required reports are submitted on a timely and accurate basis.

Compliant.

Laws and Regulations:

It follows from the generally valid legal regulations that a bank and a foreign bank branch are responsible for the reliability of their accounting data (the Act on Accounting, the Act on Banks, the Commercial Code). The Czech National Bank can always penalise a bank or a foreign bank branch (hereinafter only a "bank") as such and does have the right to penalise the individual members of its management (it may, however, require replacement of a person in the management of a bank or a foreign bank branch or replacement of persons in the supervisory board). On the basis of the Act on Banks Section 21 paragraph 1 a bank is obliged to keep accounting records in accordance with the special Act on Accounting. On the basis of the Act on Banks Section 22 a bank is obliged to have its financial statements verified by an external auditor. The requirements for information designed for discharge of banking supervision are set down in the provisions of the Czech National Bank. Failure to submit the information in time and in the appropriate format is a shortcoming in the bank's activities and it is possible to apply remedial measures pursuant to Section 26 of the Act on Banks. The Czech National Bank can for example require the bank to replace the persons in its management.

2. The supervisor has the authority to hold management responsible for ensuring that the management report and financial statements issued annually to the public receive proper external verification and bear an external auditor's opinion.

Compliant.

Laws and Regulations:

On the basis of Section 22 of the Act on Banks a bank is obliged to have its financial statements and prudential reports as at 31 December verified by an external auditor. This responsibility ensues from the Commercial Code. An external auditor's opinion on the financial statements forms part of the annual report, the requisites of which are provided for in the Act on Accounting. Banks are obliged, according to the Act on Accounting, to disclose not only the auditor's opinion, but also the auditor's report. The disclosure may be implemented through their annual report.

3. The supervisor ensures that information from bank records is verified periodically through on-site examinations and/or external audits.

Compliant.

Discharge of Supervision:

Reliability of the information from bank records is verified periodically both within the framework of off-site supervision, and during on-site inspections (see also Principle 16, Essential Criterion 1).

4. The supervisor ensures that there are open communication lines with the external auditors.

Compliant.

Discharge of Supervision:

The Czech National Bank communicates with the external auditors on general matters of common interest without any problems. It also communicates with the auditors on problems of individual banks; in this case, however, the auditor must have consent of the respective bank. The Czech National Bank considers the scope of this communication to be satisfactory.

5. The supervisor provides report instructions that clearly establish the accounting standards to be used in preparing supervisory reports. Such standards are based on accounting principles and rules that command wide international acceptance and are aimed specifically at banking institutions.

Compliant.

Laws and Regulations:

The Czech National Bank specifies its requirements for the structure and content of prudential reports. Reports on an individual basis are drawn up on the basis of the data from the bank's accounting, which is governed by the regulations of the Ministry of Finance of the Czech Republic. The procedures applied by banks correspond with the methods contained in the International Accounting Standards (including the application of IAS 39). The rules for evaluation of receivables and provisioning are further specified by the Czech National Bank in its prudential rules. Reports on a consolidated basis are drawn up with the application of the International Accounting Standards (this is explicitly mentioned in the Decree of the Czech National Bank and in the provision governing the elaboration of the report).

6. The supervisor requires banks to utilise valuation rules that are consistent, realistic and prudent, taking account of current values where relevant, and that profits are net of appropriate provisions.

Largely compliant.

Laws and Regulations:

Banks value their assets and liabilities in accordance with the accounting regulations, which in this

area are comparable with the International Accounting Standards (including IAS 39). The provisioning for receivables is determined by the regulation of the Czech National Bank on evaluation of receivables and provisioning for them, for the purpose of covering the expected losses from receivables.

7. Laws or regulations set, or the supervisor has the authority, in appropriate circumstances, to establish, the scope and standards to be achieved in external audits of individual banks, and to make public issuance of individual bank financial statements subject to its prior approval.

Compliant.

Laws and Regulations:

External audit is governed by the Act on Auditors and the Auditing Guidelines of the Chamber of Auditors of the Czech Republic. Audit of the financial statements is exclusively within the powers of the external auditor. The Czech National Bank does not consider it appropriate to interfere in this exclusivity and considers the criterion in the item that requires prior approval by the Czech National Bank of the financial statements to be disclosed as irrelevant.

The framework and the standards for external audit of banks are governed specially by the Act on Banks and also by the provisions and decree of the Czech National Bank.

1. The Act on Banks in Section 22 imposes on a bank the duty to ensure that an external auditor verifies:

- a) the bank's financial statements,
- b) the bank's management and control system, including its risk management system (hereinafter only "verification of the systems").

A bank is obliged to arrange for elaboration of a report on verification of its financial statements and its systems pursuant to subparagraph b) and to submit these reports to the Czech National Bank. The Czech National Bank may waive verification of the management and control system, including the risk management system, or may confine the requirement to some parts of the system only. The specific requirements on verification of the systems are set down in the Provision of the Czech National Bank no. 11/2002. Certain details relating to verification of the management and control system are contained also in the Official Notification of 16 December 2002, relating to Certain Regulations of the Provision no. 11/2002. The details in question are for example the procedure to be applied when commissioning the verification, classification of the shortcomings or an informative survey of the recognised principles, in the case of which reference is made to the website of the Czech National Bank. This list is updated on a regular basis and contains the internationally recognised and applied principles of the internal management and control system, including the risk management system.

2. The individual provisions of the Czech National Bank stipulate that an external auditor shall once a year, i.e. as at 31 December of calendar year, verify the correctness and completeness of selected reports submitted by the bank to the Czech National Bank for the purposes of discharge of banking supervision. This duty is not stipulated for all reports.

3. As regards supervision on a consolidated basis, the Provision of the Czech National Bank no. 333/2002 Coll. applies, which in Section 74 paragraph 3 stipulates that the controlling person of a consolidated group is obliged to ask an external auditor to verify and elaborate in co-operation with the auditors of the members of the regulated consolidated group a report on whether:

- a) the controlling person adheres to the procedures and requirements stipulated by this decree,
- b) the system for elaboration of the report is constructed in such a way as to reflect faithfully the real values,
- c) the reports pursuant to paragraph 1 as at 31 December are complete and correct.

The controlling person is obliged to submit the auditor's report on the above-mentioned matters to the Czech National Bank, and to do so annually, by 30 June of the current year at the latest for the preceding year.

Disclosure of the financial statements is governed by the Act on Accounting and the requisites of the financial statements are stipulated by a Decree of the Ministry of Finance of the Czech Republic, in which a number of requirements are included. Further, on the basis of the Act on Banks Section 11 and the Provision no. 1/2002 of the Czech National Bank, banks must disclose quarterly on

their websites and on their premises selected information on the bank (on its capital, shareholders, on the structure of the consolidated group, on the bank's activities on its relations with the controlling and controlled persons and relations with members of the supervisory board, members of the board of directors and other members of the bank's senior management). Further they must disclose their balance sheet, their profit and loss statement, the amount of receivables by category and the amount of provisions relating to the receivables, the amount of restructured receivables for the accounting period, information on derivatives and a set of indicators relating in particular to capital adequacy. Together with this information a bank shall disclose its latest financial statements.

8. The supervisor has the ability to treat as confidential certain types of sensitive information.
Compliant.

All information on individual banks, unless it has been disclosed by the bank itself, is subject to confidentiality on the part of the Czech National Bank. Members of the staff of banking supervision as members of the staff of the Czech National Bank are obliged to maintain confidentiality in official matters pursuant to Section 50 of the Act on the Czech National Bank. They may be exempted from the confidentiality obligation only by the Governor of the Czech National Bank on the grounds of the public interest. Exceptions from the confidentiality obligation are stipulated in the Act on Banks (see Principle 1 part 1(6)).

9. The supervisor requires banks to produce annual audited financial statements based on accounting principles and rules that command wide international acceptance and have been audited in accordance with internationally accepted auditing practices and standards.

Compliant.

See Essential Criterion 5. The accounting methods pursuant to the Czech regulations that are used by banks when drawing up their financial statements correspond to the International Accounting Standards. When drawing up its consolidated financial statements, a bank may use IAS, instead of the Czech regulations. A number of banks are, therefore, also audited according to IAS. The procedures applied by auditing firms which conduct audits of banks are in accordance with the international auditing practices and standards, provided it is permitted by the law.

10. The supervisor has the right to revoke the appointment of a bank's auditors.

Compliant.

See Principle 19.

11. Where supervisors rely primarily on the work of external auditors (rather than on their own examination staff), banks are required to appoint auditors who are recognised by the supervisor as having the necessary professional skills and independence to perform the work.

Not applicable.

The Czech National Bank does not rely primarily on the results of the activities of external auditors and arranges for the discharge of supervision by its own staff – by its banking supervision inspectors or, as the case may be, other entrusted members of its staff (see Principle 19).

Additional Criteria

1. The supervisor promotes periodic public disclosures of information that are timely, accurate and sufficiently comprehensive to provide a basis for effective market discipline.

Compliant.

Laws and regulations

On the basis of the Act on Banks Section 11 and the Provision of the Czech National Bank no. 1/2002, banks must disclose quarterly on their websites and on their premises selected information on

the bank (on its capital, shareholders, the structure of the consolidated group, on the bank's activities, on its relations with the controlling and controlled persons and relations with members of the supervisory board, members of the board of directors and other members of the bank's senior management). Further it must disclose its balance sheet, profit and loss statement, the amount of receivables by category and the related provisions, the amount of restructured receivables for the accounting period, information on derivatives and a set of indicators relating in particular to capital adequacy. Together with this information the bank discloses its latest financial statements, into which a number of requirements of the Basle Committee relating to the New Basle Accord has been incorporated.

2. The supervisor has guidelines covering the scope and conduct of audit programmes that ensure that audits cover such areas as the loan portfolio, loan loss reserves, non-performing assets, asset valuations, trading and other securities activities, derivatives, asset securitisations, and the adequacy of internal controls over financial reporting.

Not applicable.

The Czech National Bank does not employ auditors as the primary tool of supervision (see Essential Criterion 11). Audits of banks are governed by the guidelines issued by the Chamber of Auditors. These guidelines ensue from the International Auditing Standards.

3. Auditors have the legal duty to report to the supervisor matters of material significance, for example, failure to maintain the licensing criteria, or breaches of banking or other laws. The law protects auditors from breach of confidentiality when information is communicated in good faith.

Compliant.

Laws and Regulations:

On the basis of the Act on Auditors Section 15 paragraph 3 the auditor is obliged to inform the Czech National Bank in writing of any material facts which suggest that with respect to the accounting unit a breach of the special legal regulations providing for the conditions of its activities has occurred, which have a material adverse effect on its financial management, could endanger its unlimited life span or could result in the auditor refusing to give an opinion or in his giving a negative opinion, or expressing rejection of the opinion, a negative opinion, or expressing qualifications.

4. Auditors also have the legal duty to report matters to the supervisor, in situations where they become aware of matters which, in the context of the available information, they believe is likely to be of material significance to the functions of the supervisor.

Compliant.

See Additional Criterion 3.

Laws and Regulations:

The legal regulations impose this duty directly on the auditors. They, however, impose it also on the banks themselves and within the framework of consolidated supervision they also impose on the controlling persons (banks and non-bank entities) the duty to inform the Czech National Bank of the auditor's opinion on certain matters that are of material significance for discharge of banking supervision. Information on these matters constitutes the content of the auditor's report and the auditor's report on verification of the systems. Of fundamental importance for discharge of supervision, in particular off-site supervision, is also verification of the completeness and accuracy of the financial statements of banks as at 31 December (see Essential Criterion 7).

Discharge of supervision

The Czech National Bank employs the opinion of the external auditor contained in the auditor's report, in the report on verification of the systems and in the financial statements as at 31 December verified by the auditor in its discharge of supervision over banks and also in its discharge of consolidated supervision. The Czech National Bank regularly meets auditors of the individual banks to

discuss with them matters of common interest.

Formal Powers of the Supervision

Principle 22. Banking supervisors must have at their disposal adequate supervisory measures to bring about timely corrective action when banks fail to meet prudential requirements (such as minimum capital adequacy ratios), when there are regulatory violations, or where depositors are threatened in any other way. In extreme circumstances, this should include the ability to revoke the banking licence or recommend its revocation.

Comprehensive Assessment:

Largely compliant.

Essential Criteria

The Czech National Bank has at its disposal a comparatively large set of remedial measures, from the legally non-binding recommendations, through the requirement to make good claimed outside the administrative proceedings, to the sanctions and remedial measures imposed in the administrative proceedings, the gravest of which are imposition of conservatorship or revocation of the licence. The Czech National Bank has been using these powers in practice. Imposition of remedial measures and sanctions is not always managed in time, due to late identification of the problem. Also, it cannot be guaranteed that the remedial measures will lead to the recovery and regained competitiveness of the bank that has got into serious distress.

Additional Criteria

As regards insolvency of a bank, or the threat of insolvency of a bank, due to a considerable drop in its capital adequacy which has occurred or which threatens, the Act on Banks does not simply rely on the findings made by the Czech National Bank, but requires the statutory body and the supervisory board of the bank to notify the Czech National Bank of such situation without delay. If the above bodies of the bank proceed in line with these requirements, the probability of timely adoption of remedial measures will increase.

Essential Criteria

1. The supervisor has the authority, backed by legal sanctions, to take an appropriate range of remedial actions against, and impose penalties upon, banks, depending on the severity of a situation. These remedial actions are used to address such problems as failure to meet prudential requirements and violations of regulations. They range from informal oral or written communication with bank management to actions that involve the revocation of the banking licence.

Compliant.

Laws and Regulations:

The Act on Banks authorises the Czech National Bank to utilise a number of remedial measures and sanctions, according to the materiality of the shortcomings ascertained in the activities of the bank or the foreign bank branch (hereinafter only the “bank”). The remedial measures and sanctions range from legally unbinding recommendations, through a requirement for making good claimed outside the administrative proceedings, to the sanctions and remedial measures imposed in the administrative proceedings, the gravest of which is the imposition of conservatorship or revocation of the licence.

1. A recommendation is an opinion of the Czech National Bank expressed in a letter, which is legally unbinding and in which the Czech National Bank points out the factors or facts that probably have an adverse impact on the financial condition, competitiveness or stability of the bank or the foreign bank branch or may lead to a conflict with the valid laws and other legal regulations. According to the nature of the matter, the recommendation concerns certain business transactions of the bank, risks connected with the bank’s exposures, organisational structure of the bank, systems of risks management in the bank or even the persons who manage the bank.
2. A request of the Czech National Bank to make good is the procedure pursuant to the Act on

Banks Section 26 paragraph 1 subparagraph a), which authorises the Czech National Bank, if it ascertains any shortcomings in the activities of a bank or a foreign bank branch, to require, according to the nature of the shortcoming ascertained, that the bank or the foreign bank branch should make good within the stipulated time limit, in particular that it should restrict some of its permitted activities or terminate its not permitted activities, replace persons in the management of the bank or the foreign bank branch, create a corresponding level of provisions and reserves, or that the bank should decrease its initial capital to the stipulated extent, replace the members of its supervisory board or use its after-tax profit preferentially to replenish its reserve funds or to increase its initial capital.

3. Other procedures are sanctions and remedial measures imposed in the administrative proceedings, among which are the sanctions mentioned in the Act on Banks, Section 26 subparagraphs b) to g). In the event that the requirement of the Czech National Bank (see item 2 above) is not fulfilled or if the matter brooks no delay or if the nature of the shortcoming ascertained requires so, the Act on Banks authorises the Czech National Bank to apply one or more of the following remedial measures:
 - a) a change of the licence by elimination or restriction of some activities mentioned in it,
 - b) an extraordinary audit ordered by the Czech National Bank and carried out at the expense of the bank or the foreign bank branch,
 - c) imposition of conservatorship (this measure cannot be applied against a foreign bank branch; it is provided for in detail in further provisions of the Act, see below),
 - d) imposing of a fine up to the amount of CZK 50,000,000,
 - e) reducing of the bank's initial capital by the amount corresponding to the loss after its clearing with reserve funds and other funds on condition that the loss exceeds 20% of the bank's equity,
 - f) prohibition or restriction of operations with persons who are closely related to the bank or who form part of the same consolidated group as the bank or have a special relationship to the bank (this measure cannot be applied against a foreign bank branch).

As to conservatorship, this is provided for in detail in Sections 27 to 33. The Act on Banks in Section 30 states that the Czech National Bank may impose conservatorship in the situation where shortcomings in the activities of a bank endanger the stability of the banking system and the shareholders have not taken the necessary measures to eliminate these shortcomings and also that the Czech National Bank shall request the standpoint of the Ministry of Finance of the Czech Republic concerning the imposition of conservatorship.

4. Remedial measures pursuant to the Act on Banks, Section 26a paragraph 1, which will be imposed by the Czech National Bank if capital adequacy of a bank on an individual basis is lower than two thirds of the ratio stipulated by the Czech National Bank. These remedial measures include:

- a) an increase of the initial capital so as to attain the capital adequacy ratio of a bank on an individual basis stipulated by the Czech National Bank,
- b) an order to acquire only assets with a risk weighting of less than 100%,
- c) prohibition of any acquisitions,
- d) prohibition of providing credits to persons with a special relation to the bank,
- e) regulation of the level of interest rates on deposits.

On parallel lines, it is also possible to apply remedial measures pursuant to Section 26 paragraph 1.

5. Revocation of the licence pursuant to the Act on Banks Section 34 paragraph 1, if serious shortcomings in the activities of a bank or a foreign bank branch persist. Further, revocation of the licence pursuant to Section 34 paragraph 2 subparagraph a), if a bank or a foreign bank branch has not started operations within 12 months of the day of granting the licence or if it for a period of 6 months has not accepted deposits from the general public or has not granted credits, or if the licence was acquired on the basis of false data stated in the application. And finally, revocation of the licence on the basis of the provision of Section 34, paragraph 3, i.e. if a bank's capital adequacy on an individual basis is lower than one third of the ratio set down by the Czech National Bank. When deciding on revocation of the licence, the Czech National Bank shall request the standpoint of the Ministry of Finance of the Czech Republic.

A shortcoming in the activities pursuant to the Act on Banks Section 26 paragraph 3 is taken to mean:

- a) a breach of the conditions stipulated in the (banking) licence or non-fulfilment of the conditions under which the licence was granted,
- b) a breach or circumvention of the Act on Banks, of special laws, just as legal regulations and provisions issued by the Czech National Bank,
- c) execution of business transactions by the bank or the foreign bank branch in a manner that is detrimental to the interests of its depositors or endangers the safety and stability of the bank or the foreign bank branch,
- d) management of the bank or the foreign bank branch by persons who do not possess sufficient professional competence or are not trustworthy,
- e) insufficient coverage of the risks ensuing from the volume of classified assets reported by the bank by reserves and provisions,
- f) a breach of a legal regulation of the state, on the territory of which the bank has a branch, when conducting business on the territory of that state,
- g) a decrease of capital below the minimum level of initial capital, which amounts to CZK 500 million.

Discharge of Supervision:

The Czech National Bank uses in practice all the above-mentioned procedures, starting with recommendations and ending with remedial measures and sanctions.

2. The range of possible actions available is broad, including, in addition to the others mentioned, restricting the current activities of the bank, withholding approval of new activities or acquisitions, restricting or suspending payments to shareholders or share repurchases, restricting asset transfers, barring individuals from banking, replacing or restricting the powers of managers, directors, or controlling owners, arranging a take-over by or merger with a healthier institution, and imposing conservatorship.

Largely compliant.

Laws and Regulations:

- It is possible to restrict the activities and acquisitions of a bank pursuant to Section 26 of the Act on Banks (see item 1 of this Principle).
- It follows from the legal construction of the licensing proceedings that a bank must ask the Czech National Bank for any new activities that are not explicitly defined in its banking licence. It is possible to restrict the existing activities of a bank in its licence.
- It is not possible to suspend payments to shareholders in the form of dividends directly (on the basis of Section 26 of the Act on Banks upon ascertainment of a shortcoming in the bank's activities it is possible to demand that the bank should use its after-tax profit preferentially to replenish its reserve funds or to increase its initial capital); it is, however, possible to withdraw the voting rights of the shareholders who acquired a share in the bank without prior consent of the Czech National Bank or whose activities are detrimental to the bank's proper and prudential conduct of business or, as the case may be, if such effects can be reasonably expected. This withdrawal includes the right to participate and vote in the general meeting, to initiate the convening of an extraordinary general meeting, to file with a court of law actions demanding the invalidity of the resolutions adopted by the general meeting. The Czech National Bank may prohibit or restrict the bank's transactions with persons who are closely related to the bank or who form part of the same consolidated group as the bank or have a special relation to the bank (Section 26). If the bank's capital adequacy on an individual basis drops below two thirds of the ratio set down by the Czech National Bank, the Czech National Bank may prohibit the bank to provide credits to persons with a special relation to the bank (Section 26a).
- Arranging for a take-over of the bank – this has been already described in Principle 1 Part 1 (1) item 4. The Czech National Bank takes part in solving the situations of problem banks as a consultant for potential investors in the matter of the licensing and regulatory requirements. The Czech National Bank also approves an investor who intends to acquire a stipulated qualifying

holding in a bank (see Principle 3).

- Asset transfers – this right is given to the Czech National Bank under the law; within the framework of imposition of remedial measures (Section 26 of the Act on Banks) it is possible to request that the bank should restrict some of its permitted activities or terminate its not permitted activities, i.e. also asset transfers.
- Barring of certain persons from banking – this right is not given to the Czech National bank under the law. The Czech National Bank has certain powers within the framework of the licensing proceedings, in which the competence of persons nominated to executive managerial positions in the bank is assessed. This ability is also assessed on changes in the bank's management. Within the framework of remedial measures the Czech National Bank has the right to request replacement of persons in the bank's management and in its supervisory board.
- It is not possible to order the sale of a holding.

Complete fulfilment of this criterion would require a deep intervention in the legislation. Such change is not under preparation at present.

3. The supervisor ensures that remedial actions are taken in a timely manner.

Largely compliant.

Discharge of Supervision:

The first step is a remedial measure outside the administrative proceedings. In this case the Czech National Bank may request arranging for a remedial measure in time, but cannot quite ensure this. The second step is a remedial measure imposed in the administrative proceedings (see the Essential Criterion above). This remedial measure can be imposed relatively quickly, especially if it is one of the more lenient remedial measures. The Bank must fulfil it within the requested time limit. Remedial measures are imposed in conformity with the law, i.e. according to the nature of the shortcoming ascertained and within as short a period as possible after ascertainment of the shortcoming by the Czech National Bank.

4. The supervisor applies penalties and sanctions not only to the bank, but, when and if necessary, also to management and/or the board of directors.

Largely compliant.

Laws and Regulations:

The Czech National Bank may apply sanctions towards the bank as such, not towards the persons in its senior management. Nevertheless, the Czech National Bank has one option, implied in the Act on Banks. Pursuant to Section 26 of this Act the Czech National Bank may request replacement of the senior management of a bank. Personal fines may be imposed only if the respective persons do not provide co-operation. Moreover, it must be proved that there is a clear causality between the shortcoming and personal liability. It is not possible to apply functional liability in these cases. The complete fulfilment of the criterion would require a deep intervention in the legislation. Such change is not under preparation at present.

Discharge of Supervision:

The Czech National Bank applies sanctions to the extent that the valid legislation enables.

Additional Criteria

1. Laws and/or regulations mitigate against the supervisor unduly delaying appropriate corrective actions.

Compliant.

In relation to the situations that endanger further operation of a bank (this does not apply to a foreign bank branch), the Act does not rely merely on what the Czech National Bank detects. Section 26b of the Act on Banks requires the statutory body and the supervisory board of the bank to notify the Czech National Bank without delay of insolvency or serious losses or probable serious losses that have

caused or may cause a decrease of the bank's capital adequacy on an individual basis below two thirds of the ratio set down by the Czech National Bank. In the event that the bank's capital adequacy drops below two thirds of the required minimum level, the Czech National Bank will impose on the bank without delay remedial measures pursuant to Section 26a of the Act on Banks. If the capital adequacy on an individual basis is less than one third of the ratio set down by the Czech National Bank, the Czech National Bank is authorised, in accordance with Section 34 paragraph 3 of the Act on Banks, to revoke the licence.

2. The supervisor addresses all significant remedial actions in a written document to the board of directors and requires that progress reports are submitted in writing as well.

Compliant.

All procedures mentioned under Essential Criterion 1 are implemented in written form in practice.

Operations of Banks in Host Countries (Cross-border Banking)

Principle 23. Banking supervisors must practise global consolidated supervision over their internationally active banking organisations, adequately monitoring and applying appropriate prudential norms to all aspects of the business conducted by these banking organisations worldwide, primarily at their foreign bank branches, joint ventures and subsidiaries.

Comprehensive Assessment:

Largely compliant.

Essential Criteria

The Czech National Bank discharges supervision over cross-border transactions and exposures of the bank that are implemented from its establishments in the Czech Republic (head office, branches). The banks having their registered office in the Czech Republic for the most part do not have branches and subsidiaries abroad (1 branch of a foreign bank and 2 subsidiaries). If they do, their branches and subsidiaries are mostly marginal. Nevertheless, the Czech National Bank will incorporate the relevant criteria into its internal procedures. The scope of information available to the management of the bank's head office from its branches is reviewed during on-site inspections. Information from subsidiaries is not reviewed. The Czech National Bank may restrict the activities of a branch abroad by restricting the bank's licence. It cannot, however, take a similar step against the bank's subsidiary.

Additional Criteria

Given the minor significance of the branches and subsidiaries abroad, we deem the Additional Criteria not relevant. The Act on Banks provides the necessary legal basis for co-operation with foreign regulators and for discharge of supervision over branches and subsidiaries.

Analysis of the Individual Criteria

Essential Criteria

1. The supervisor has the authority to supervise the overseas activities of locally incorporated banks.

Largely compliant.

Laws and Regulations:

The legal regulations that provide for regulation and supervision of banks' transactions with non-residents are harmonised with the EC law. These transactions are regulated according to the principle of equal treatment, which means that the same prudential rules apply to them as to transactions with residents and exposures towards residents. Supervision over banks' business transactions with non-residents has three basic aspects:

1. Supervision over cross-border transactions and exposures of a bank implemented from its establishment in the Czech Republic (the head office or, as the case may be, a branch).
2. Supervision on a consolidated basis. Supervision on a consolidated basis applies to both subsidiaries and affiliates. The provisions of the Act apply to subsidiaries and affiliates having their registered office in the Czech Republic and also for such companies having their registered office abroad. The Czech National Bank pursuant to Section 2 paragraph 2 subparagraph d) and Section 44 paragraph 1 subparagraph a) of the Act on the Czech National Bank and Section 25 paragraph 1 of the Act on Banks discharges banking supervision over the activities of consolidated groups, a part of which is a bank having its registered office on the territory of the Czech Republic. The Act on Banks, Section 26c, defines in a fundamental manner the rules of banking supervision on a consolidated basis. The authorisation applies to all consolidated groups, i.e. to controlling bank groups, financial holding company groups and mixed-activity holding company groups. The Act on Banks in Section 26e paragraph 1 stipulates that the Czech National Bank may waive discharge of banking supervision on a

consolidated basis over a consolidated group over which banking supervision or comparable oversight on a consolidated basis is discharged by a supervisory or overseeing agency in the home country or in another state and authorises the Czech National Bank to agree the conditions for discharge of consolidated supervision with such agency. The Act, however, at the same time stipulates that the Czech National Bank shall always discharge banking supervision on a consolidated basis over a controlling bank group having its registered office in the Czech Republic.

3. On-site inspections in a bank's branches abroad and in subsidiary banks abroad: Pursuant to the Act on Banks, Section 25 paragraph 2, the Czech National Bank may ask the supervisory agency of the respective state for on-site inspections in foreign branches of domestic banks. As regards on-site inspections in foreign branches of domestic banks, the Act starts from the principle of reciprocity, i.e. it stipulates that the Czech National Bank will enable discharge of on-site inspections by the supervisory agency of the country of incorporation of the foreign bank or financial institution on the basis of reciprocity. The Act also stipulates that the Czech National Bank may satisfy a request of the supervisory agency of the country of incorporation of the bank or financial institution for discharge of on-site inspections in the bank or foreign bank branch supervised by it.

Discharge of Supervision:

The provision of cross-border services from a domestic establishment (for example granting a credit abroad by the head office or a domestic branch) is the subject of on-site inspections and off-site supervision. The practical discharge of supervision over cross-border activities of banks implemented through their branches abroad and also of supervision on a consolidated basis is conditional on the conclusion of agreements on co-operation with foreign regulators. Significant progress has been made in this respect and the efforts continue to conclude agreements with the regulators of all countries, the residents (banks or other entities) of which discharge supervision over domestic banks or in which the banks, the branches of which operate on the domestic market, are incorporated, or vice versa, in which domestic banks have their branches or subsidiaries (see Principle 24, Essential Criterion 1).

As regards subsidiaries of banks abroad, then Section 16 paragraph 2 subparagraph c) of the Act on Banks stipulates the duty of a bank to notify of its intention to establish a legal entity abroad or to have a share in it and the obligation to report acquisition of a qualifying holding in a legal entity. The Czech National Bank has no authority to prohibit directly the establishment of such legal entity. The Czech National Bank, however, may prohibit a bank to acquire such holding in a situation when the capital adequacy of the bank on an individual basis drops below 2/3 of the stipulated minimum limit; the effects of the activities of subsidiaries on the bank's situation and whether the bank monitors these effects are examined within the framework of on-site inspections.

The Act on Banks in Section 24 stipulates in general that banks are obliged to provide background data and information on their subsidiaries and affiliates and that the content, form, layout, terms and manner of presentation of these background data and information shall be set forth by the Czech National Bank. Branches of foreign banks are also subject to the notification duty. The entities included in a consolidated group are obliged to communicate to the Czech National Bank all information that is necessary for discharge of supervision on a consolidated basis (Section 26f of the Act on Banks). The details are set down in the Decree no. 333/2002 Coll.

As to branches of Czech banks abroad, these are organisational components of the banks. The Czech National Bank, therefore, within the framework of on-site inspections also examines the activities of the branches and the branch management system, including the flow of information from the branches.

With regard to the fact that only one bank has a branch abroad, an on-site inspection has been carried out in this branch only. This inspection, however, was linked with an on-site inspection in the parent bank, which was then in progress, and with the shift of some of the parent bank's activities to that foreign bank branch.

2. The supervisor satisfies itself that management is maintaining proper oversight of the bank's foreign branches, joint ventures, and subsidiaries. It also satisfies itself that the local management of any overseas offices has the necessary expertise to manage those operations in a safe and sound manner.

Largely compliant.

Since 2003 the Czech National Bank has had at its disposal regular quarterly information on a bank's links within the framework of its regulated consolidated group and on its capital adequacy and exposure on a consolidated basis. Exercise of supervision over foreign subsidiaries is the subject of on-site inspections and information visits. The system of management of a bank's foreign branches is also the subject of on-site inspections and information visits.

3. The supervisor determines that bank's management oversight includes: a) information reporting on its overseas operations that is adequate in scope and frequency and is periodically verified; b) assessing in an appropriate manner compliance with internal controls; and c) ensuring effective local oversight of foreign operations.

Largely compliant.

Laws and regulations

The Czech National Bank has adequate information on cross-border operations of a bank on an individual basis. It acquires such information both within the framework of off-site supervision and during information visits and on-site inspections (see Principle 16). The same applies to capital adequacy and exposure of the bank within the framework of the consolidation whole to which it belongs. The effectiveness of the bank's internal control system is assessed within the framework of on-site inspections; the assessment also includes the quality of its internal control over the operations implemented through the bank's branches abroad. Domestic banks have only the minimum number of subsidiaries and branches abroad. The possibility of implementing on-site inspections in foreign branches of domestic banks is given in the agreements which were concluded with foreign regulators (see Principle 24, Essential Criterion 1).

Discharge of Supervision:

The Czech National Bank discharges supervision on a consolidated basis over consolidated groups of banks. Within the framework of on-site inspections the Czech National Bank examines the content of the information the bank receives from its branch abroad.

4. The home country supervisor has the authority to require closing of overseas offices, or imposing limitations on their activities, if it determines that the supervision of a local operation by the bank and/or by the host country supervisor is not adequate relative to the risks the office presents.

Largely compliant.

Laws and Regulations:

In the case that a bank has a subsidiary bank or branch abroad and a situation arises that the activities of the mentioned subsidiary bank or branch endanger the activities of the parent bank, the Czech National Bank is authorised to request that the bank should remedy the matter (the Act on Banks, Section 26, paragraph 1). The Czech National Bank, however, is not authorised to order closing down of a foreign subsidiary bank or branch. Significant opportunities in discharge of supervision over the activities of a bank abroad are given to the Czech National Bank by international co-operation in the discharge of banking supervision, which is based on the respective agreements with foreign regulators (Memoranda of Understanding). A number of these agreements has already been concluded and further agreements are under preparation.

Additional Criteria

1. The supervisor has a policy for assessing whether it needs to conduct on-site examinations or require additional reporting, and it has the legal authority and resources to take those steps as and when appropriate.

Not applicable.

Laws and Regulations:

The authorisation given by the Act on Banks is effective (see Essential Criterion 1).

Discharge of Supervision:

There is no such policy.

2. The supervisor ensures that management's local oversight of foreign operations is particularly close when the foreign activities have a higher risk profile and/or when they differ fundamentally from those conducted in the home country, or are conducted at locations that are especially remote from the principal locations at which the bank conducts comparable activities.

Not applicable.

3. The supervisor arranges to visit the offshore locations periodically, the frequency determined by the size and risk profile of the overseas operations. The supervisor meets the local supervisors during these visits.

Compliant.

Discharge of Supervision:

The domestic banks have only the minimum number of subsidiary banks and branches abroad. The Czech National Bank for the time being does not discharge on-site inspections abroad. The possibility of implementing on-site inspections is given in the agreements which were concluded with foreign regulators (see Principle 24, Essential Criterion 1). Nevertheless, meetings with foreign regulators occur, and there is an exchange of information.

4. The home country supervisor assesses the quality of supervision conducted in the countries in which its banks have material operations.

Not applicable.

Principle 24. A key component of consolidated supervision is establishing contact and information exchange with the various other supervisors involved, primarily host country supervisory authorities.

Comprehensive Assessment:
Largely compliant.

Essential Criteria

The Czech National Bank gradually concludes Memoranda of Understanding with foreign regulators in both the home and the host countries (see Principle 1, part 1(6)). The Czech National Bank does not approve opening of a branch of a domestic bank abroad; the bank is only obliged to notify the Czech National Bank of such intention (Section 16a (1) of the Act on Banks). Upon accession of the Czech Republic to the European Union the single licence principle and the procedure corresponding to it will apply to banks having their registered office on the territory of a member state of the European Union. In the case that a bank having its registered office in the Czech Republic would like to avail itself of the advantages of the single licence, the Czech National Bank as the host country banking supervision agency will decide, whether the conditions stipulated by the EC law have been fulfilled. The Czech National Bank has the right to provide information to the banking supervision agencies of the host countries where the subsidiaries or branches of the banks having their registered office in the Czech Republic operate, in accordance with Section 25a paragraph 3 and Section 38 paragraph 2 of the Act on Banks, and also to provide information detailed more specifically in the Memorandum of Understanding signed with the host country banking supervision agency (see Principle 25).

Additional Criteria

Fulfilment of the requirement that the Czech National Bank should consult measures it intends to adopt on the basis of information acquired from another banking supervision agency prior to their adoption is not contrary to either the Act on Banks or the text of the signed memoranda, even though the consultation duty was not expressly stated in them. The requirement for an exchange of information with other banking supervision agencies also in the case of minor cross-border operations is fulfilled above all in those instances where Memoranda of Understanding are in existence.

Analysis of the Individual Criteria

Essential Criteria

1. For significant overseas operations of its banks, the home country supervisor establishes informal or formal arrangements (such as memoranda of understanding) with host country supervisors for appropriate information-sharing on the financial condition and performance of such operations in the host country. Information sharing arrangements with host country supervisors include being advised of adverse assessments of such qualitative aspects of a bank's operations as the quality of risk management and controls at the offices in the host country.

Largely compliant.

Laws and Regulations:

The exchange of information between the Czech National Bank and banking supervision agencies and analogous institutions of other states is provided for in general outline only in the Act on Banks, Section 38, paragraph 2 and Section 25a, paragraph 3.

Discharge of Supervision:

The Czech National Bank has concluded agreements on co-operation (Memoranda of Understanding) with regulators from Slovakia, Austria, France, the Federal Republic of Germany, the USA (New York State) and Belgium. Agreements with regulators from the Netherlands and Italy are under negotiation. Informal relations have been established with the British regulator.

2. The supervisor can prohibit banks or their affiliates from establishing operations in countries with secrecy laws or other regulations prohibiting flows of information deemed necessary for adequate supervision.

Largely compliant.

Laws and Regulations:

The notification duty in the case of establishing a branch or a representative office of a bank abroad ensues explicitly from the Act on Banks, Section 16a; the same duty in the case of establishing a legal entity abroad or acquisition of a holding abroad ensues from Section 16 paragraph 2 of the Act on Banks. A branch of a bank is its organisational component and, therefore, it cannot carry out activities for which the bank as a whole does not have the licence from the Czech National Bank. It is not so in the case of a subsidiary.

3. The home supervisor provides information to host country supervisors concerning the specific offices in the host country, concerning the overall framework of supervision in which the banking group operates, and, to the extent appropriate, concerning significant problems arising in the head office or in the group as a whole.

Largely compliant.

Laws and Regulations:

The Czech National Bank as the home agency discharging banking supervision may provide information to foreign host country banking supervision agencies pursuant to the Act on Banks Section 38, or Section 25a.

Discharge of Supervision:

The provision of information is arranged for in the case of countries with which agreements on co-operation (formal or informal) were concluded.

Additional Criteria

1. A supervisor who takes consequential action on the basis of information received from another supervisor, consults with that supervisor, to the extent possible, beforehand.

Compliant.

Laws and Regulations:

This procedure is not prohibited by the law.

Discharge of Supervision:

This requirement is not covered by the Memoranda of Understanding. In practice, no remedial measure has been imposed as yet by the Czech National Bank on the basis of information acquired by a foreign banking supervision agency. However, in the case of imposition of a remedial measure on a subsidiary or branch of a foreign bank, the Czech National Bank would consult such remedial measure with the banking supervision agency, within the authority of which the parent company or institution falls.

2. Even for less than significant overseas operations of its banks, the home country supervisor exchanges appropriate information with host country supervisors.

Largely compliant.

Discharge of Supervision:

The Memoranda of Understanding (both formal and informal) state explicitly that there will be an exchange of information relating to facts with significant impacts on the bank and also of information that the contracting parties may consider as significant or appropriate for the other contracting party.

Principle 25. Banking supervisors must require the local operations of foreign banks to be conducted to the same high standards as are required of domestic institutions and must have powers to share information needed by the home country supervisors of those banks for the purpose of carrying out consolidated supervision.

Comprehensive Assessment:

Compliant.

Essential Criteria

Subsidiaries of foreign banks are subject to the same prudential rules as domestic institutions. The same applies also to foreign bank branches, unless the Act on Banks or a provision or a decree of the Czech National Bank stipulates that the relevant regulation does not apply to them. In 2002 intensive negotiations commenced with foreign regulators, above all with those from the countries of registered office of the parent companies of the subsidiary banks and branches of foreign banks operating in the Czech Republic. The Czech National Bank has familiarised itself with the method and scope of supervision in the country where the parent bank or company has its registered office. All approached banking supervision agencies have confirmed that they perform supervision on a consolidated basis. Six Memoranda of Understanding on co-operation in the area of banking supervision were signed with foreign banking supervision agencies. The memoranda set down, *inter alia*, in accordance with Section 25 paragraph 2 of the Act on Banks, the possibility of on-site inspections in the host country by the banking supervision agency of the country of incorporation of the parent bank or company, and in accordance with Section 25a paragraph 3 of the Act on Banks they also provide for an exchange of information on all facts that are essential for proper discharge of banking supervision over cross-border institutions.

Additional Criteria

Memoranda of Understanding on co-operation in the area of banking supervision were signed with the foreign banking supervision agencies of Austria, the Federal Republic of Germany, France, Slovakia, the USA (New York State), and Belgium and memoranda with the banking supervision agencies of Italy and the Netherlands are under negotiation. Discussions of the memoranda have considerably enhanced the mutual agency-to-agency contacts between staff members and expanded the possibilities of an exchange of information. This information is much more exploited than in the past. The amended Act on Banks has harmonised this Czech act with the respective EU Directive and has enabled conclusion of the above memoranda in the scope that is usual between regulators of member countries of the European Union. Thereby, it has enhanced the regulators' trust in the Czech National Bank and has shifted the co-operation with the Czech National Bank onto the level of co-operation between the banking supervision agencies of the EU countries.

Analysis of the Individual Criteria

Essential Criteria

1. Local branches and subsidiaries of foreign banks are subject to similar prudential, inspection, and regulatory reporting requirements as domestic banks.

Compliant.

Laws and Regulations:

The licensing proceedings make the same demands on domestic and foreign applicants. Banks – subsidiaries of foreign banks and branches of foreign banks – are obliged to adhere to the prudential measures, just as to the notification duty towards the Czech National Bank without any differences (except for capital adequacy and exposure of branches).

Discharge of Supervision:

On-site inspections in subsidiaries and branches are carried out according to the level of risk they represent for the sector.

2. For purposes of the licensing process as well as ongoing supervision, the host country supervisor assesses whether the home country supervisor practices consolidated global supervision.

Largely compliant.

Laws and Regulations:

With respect to the area of licensing of banks, Section 4 paragraph 3 subparagraph i) of the Act on Banks stipulates that one of the conditions to be fulfilled for granting a licence is that in the state, on the territory of which the group has close links, there are no legal or factual restraints to discharge of supervision. Further, the Decree of the Czech National Bank no. 166/2002 Coll., which in Section 2 paragraph 3 subparagraph h), or in Section 9 paragraph 3 subparagraph b) requires to submit together with an application for a licence, and also in the case of an application for consent to the acquisition or increase of a qualifying holding in a bank, a written standpoint of the agency carrying out supervision over the bank, or the financial institution, if the applicant is a financial institution, in the country of its registered office on the intention to establish a bank in the Czech Republic, or on the intention to acquire or increase a qualifying holding in a bank. In the case of an application for a licence to establish a foreign bank branch Section 5 paragraph 2 of the Act on Banks stipulates the duty of the foreign bank applying for a licence to submit a statement of the banking supervision agency of the country of the registered office of the foreign bank on the intention to establish a branch in the Czech Republic and also its statement that banking supervision will be carried out over the branch. The memoranda concluded and those which are currently negotiated with foreign regulators provide in detail for the exchange and extent of information that the home country banking supervision agency will provide to the host country banking supervision agency on the parent bank that asks for a licence for the establishment of a cross-border institution or for consent to the acquisition of a qualifying holding in a bank in the Czech Republic.

Discharge of Supervision:

The Czech National Bank is partly examining this aspect in practice and intends to concern itself with it to a greater extent in the future. The criterion ought to be reflected also in the assessment of the bank's risk profile and the related matters. This aspect is important above all in the case when the subsidiary has a significant position on the Czech banking market. The concluded and the still negotiated memoranda with foreign regulators set down the exchange of information in discharge of supervision, when both agencies will mutually inform themselves on all facts in the parent bank or in the cross-border institution which might have an adverse impact on the financial condition and stability of the parent bank or the entire group, and further on all breaches of the regulatory rules in the parent bank or in the cross-border institution and on the remedial measures imposed which may have an influence on the entire group. The memoranda also provide for the regulators' obligation to inform each other about any changes in the laws and regulatory rules in their respective countries that might have an influence on the discharge of consolidated banking supervision.

3. The host supervisor, before issuing a licence, determines that approval (or no objection) from the home supervisor has been received.)

Compliant.

Laws and Regulations:

The requirement to have, prior to the issuance of a licence, statement of the banking supervision agency in the country of incorporation of the foreign bank is mentioned in Section 5 paragraph 2 of the Act on Banks for a foreign bank branch and further in Section 2 paragraph 3 subparagraph h) of the Decree of the Czech National Bank no. 166/2002 Coll.

Discharge of Supervision:

If the banking supervision agency of the country of incorporation of the foreign bank gives a negative statement, the Czech National Bank will consider this as information on the untrustworthiness of the applicant and will not issue a banking licence to it.

4. The host country supervisor can share with home country supervisors information about the local operations of foreign banks provided its confidentiality is protected.

Compliant.

See also Principle 1, part 1 (6), item 3. The conditions, on the fulfilment of which it is possible to provide information acquired in connection with discharge of banking supervision to banking supervision agencies abroad and to agencies of supervision over financial institutions and financial markets in the home country and abroad, are stipulated in Section 25a of the Act on Banks. The information acquired from agencies of foreign states may not be used for a purpose other than that for which they were provided and may not be provided to any other person without consent of their provider. Home regulators are bound by the confidentiality obligation stipulated by special acts (for example the Insurance Act). The Agreement on Co-Operation between the Czech National Bank, the Securities Commission and the Ministry of Finance of the Czech Republic for the Performance of Banking Supervision and State Control also requires to maintain confidentiality with respect to the provided information pursuant to Section 25a of the Act on Banks. The provision on the obligation to maintain confidentiality with respect to the information acquired within the framework of co-operation with a foreign banking supervision agency has been incorporated in each of the memoranda which the Czech National Bank concluded with foreign banking supervision agencies and also in the drafts of such memoranda which are for the time being still under negotiation.

5. Home country supervisors are given on-site access to local offices and subsidiaries for safety and soundness purposes.

Compliant.

Laws and Regulations:

Section 25 paragraph 2 of the Act on Banks enables to carry out on-site inspections by the banking supervision agency of the country of incorporation of the foreign bank or institution in a bank or a foreign bank branch operating on the territory of the Czech Republic which it supervises. The concluded or the still negotiated memoranda with foreign regulators provide for the conditions of on-site supervision by the domestic banking supervision agency in the country of the host banking supervision agency. From the day when the Agreement on Accession of the Czech Republic to the European Union becomes effective the issues of supervision over branches of foreign banks that operate in the Czech Republic on the basis of the single licence will be governed by Section 5j of the Act on Banks.

6. The host country supervisor advises home country supervisors on a timely basis of any material remedial action it takes regarding the operations of a bank from that country.

Largely compliant.

Laws and Regulations:

The Act on Banks does not prohibit consultations with the banking supervision agency of the country of incorporation of a foreign bank or financial institution; on the contrary, Section 25a paragraph 3 of the Act on Banks enables an exchange of information with agencies carrying out supervision over banks, financial institutions or financial markets in another state. The memoranda concluded with foreign regulators stipulate that both parties will mutually inform themselves of all remedial measures and other actions against parent banks and cross-border institutions which are of major importance and may have an influence on the entire group. Further consultations and a mutual exchange of information will take place between the Czech National Bank and the banking

supervision agencies of other states, or the Commission of the European Communities, pursuant to Section 38c to 38h beginning from the day when the Agreement on Accession of the Czech Republic to the European Union becomes effective.

Discharge of Supervision:

In the case of application of major measures against a bank from another country the Czech National Bank would consult such measures in advance with the supervisory agency of the country of incorporation of the foreign bank which has its branch or subsidiary on the territory of the Czech Republic. In the case of minor measures, however, we do not consider such consultations as necessary and desirable, above all from the point of view of the time delay.

Additional Criteria

1. The host country supervisor obtains from home country supervisors sufficient information on the banking group to allow it to put into proper perspective the activities conducted within its borders.

Largely compliant.

Discharge of supervision

The memoranda concluded with foreign regulators also provide for an exchange of information on parent banks and the entire groups from the home country, both on submitting an application for a licence for a cross-border institution and during the ongoing discharge of banking supervision.