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in 1993*

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banknotes and coins, including  
commemorative coins, in the Czech Republic.*

*The supreme governing body  
of the CNB is the Bank  
Board, consisting of the CNB  
Governor, two Vice-Governors  
and four Bank Board members.*

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# LONG-TERM SUPERVISORY STRATEGY OF THE CZECH NATIONAL BANK

**CNB** CZECH  
NATIONAL  
BANK

*The CNB is the central  
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(April 2017 update)

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## PRINCIPLES OF SUPERVISION

### FOUNDATIONS

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*The CNB endeavours to supervise the financial market and its institutions in accordance with international standards. It actively monitors developments in this area and prudently implements new requirements or, where applicable, initiates steps to implement them.*

*The key strategic framework for the CNB's supervisory work is the Core Principles for Effective Banking Supervision<sup>1</sup> published by the Basel Committee in 2012.*

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As an institution operating in an EU Member State, the CNB observes EU legal rules relating to its supervisory competences. In this respect, it also takes into account outputs of the European System of Financial Supervision (ESFS) and the European Central Bank (ECB) when adopting new regulations and conducting supervision. The CNB actively cooperates with these institutions,<sup>2</sup> primarily in order to achieve its **objectives**. On a practical level, it seeks to ensure, among other things, that these institutions take into account the specific characteristics and needs of the supervised financial market. It applies the same approach when cooperating with supervisory authorities from other countries, for example in colleges of supervisors.

### RESPONSIBILITIES, OBJECTIVES AND POWERS

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*The CNB develops a system of financial market supervision that is based on a clear articulation of responsibilities and objectives.*

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The CNB's objective in the area of supervision, as defined by law, is to ensure financial stability and the safe and sound operation of the financial system in the Czech Republic,<sup>3</sup> thereby contributing to achieving its primary objective, namely to maintain price stability. This objective defines the CNB's area of competence as regards **supervision of compliance with prudential rules** (hereinafter also "prudential supervision") and **supervision of compliance with the rules of conduct of business** (hereinafter also "conduct of business supervision")<sup>4</sup> as well as **supervision of anti-money**

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<sup>1</sup> These standards generally correspond in terms of content to similar documents published for other sectors, such as the Insurance Core Principles, Standards, Guidance and Assessment Methodology developed by the International Association of Insurance Supervisors for the insurance sector.

<sup>2</sup> See Article 2a of Act No. 6/1993 Coll., on the Czech National Bank, as amended (hereinafter also the "Act on the CNB").

<sup>3</sup> See Article 2 of the Act on the CNB.

<sup>4</sup> Conduct of business supervision includes, among other things, supervision in the area of consumer protection under Act No. 634/2008 Coll., on Consumer Protection, as amended, which is usually performed subsidiarily to the rules set out in the relevant sectoral legal regulations.

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**laundering and combating the financing of terrorism (hereinafter also “AML/CFT supervision”)**. Legislation for the individual supervised sectors of the financial market specifies this objective in more detail.<sup>5</sup>

In the CNB’s routine **supervisory work**,<sup>6</sup> the said objective consists of several sub-objectives:

- **to contribute systematically to ensuring and maintaining the financial stability of financial market entities, with an emphasis on timely identification of potential risks** (especially in the area of prudential supervision),
- **to contribute systematically to increasing the transparency of the financial market and the quality of conduct towards clients in the overall governance and management of financial market entities, leading to increased confidence of clients in the financial market** (especially in the area of conduct of business supervision),
- **to act in systematic coordination to ensure a unified and hence also effective approach to supervision in meeting these objectives.**<sup>7</sup>

The CNB seeks to apply a single approach to individual financial market entities. To this end, it organises its supervisory activities not on a sectoral but mainly on a **functional** basis.<sup>8</sup> It separates the creation of regulations, decision-making in licensing and enforcement proceedings and activities relating to resolution and macroprudential policy (financial stability) from the direct performance of supervision.

The main components of the functional organisation of supervision are **prudential supervision, conduct of business supervision and also AML/CFT supervision**. Their activities must be coordinated to prevent conflicts arising between their different approaches and to ensure that they support each other’s activities and thereby contribute to meeting the CNB’s supervisory objectives. Nevertheless, it is not considered useful to make this distinction at division level for some supervised financial market segments (in the defined areas of competence of the Financial Market Supervision Department II), due primarily to their nature.

Supervision is further broken down according to whether it takes the form of **on-site or off-site surveillance**. These activities are also closely interrelated. With continuous supervision, the main emphasis is placed on off-site supervisory activities. Given continuous access to an extensive set of information, the job of off-site surveillance is to systematically identify potential risks (in both prudential and conduct of business supervision and AML/CFT supervision), to assess those risks and to propose appropriate measures.

<sup>5</sup> As regards capital market supervision, this objective involves, for example, “strengthening the confidence of investors and issuers of investment instruments in the capital market” (Article 2 of Act No. 15/1998 Coll., on Supervision in the Capital Market Area, as amended).

<sup>6</sup> In the rest of this text, the term “supervision” refers to the overall range of activities delegated to the Financial Market Supervision Department.

<sup>7</sup> In practice, this primarily involves the coordination of activities in prudential supervision and rules of conduct supervision. Supervisory experience shows that findings in the conduct of business area are at least valuable indicators for the prudential area. In serious cases, they can even lead to uncovering problems with an institution’s or sector’s financial stability. It is impossible, however, to ensure compliance with conduct of business rules at the required level without implementing corresponding prudential measures. As a result, the roots of most serious shortcomings in the conduct of business area are identified in the prudential area.

<sup>8</sup> Approved by the Bank Board in 2007. This organisational arrangement proved successful during the crisis.

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**Supervisory procedures** based on the regulations in force, especially Czech and EU legislation, the decisions, opinions and recommendations issued by the EC and the ESFS institutions and the standards and recommendations of the Basel Committee on Banking Supervision, the International Organization of Securities Commissions (IOSCO), the International Association of Insurance Supervisors (IAIS), the Moneyval Committee, and the Financial Action Task Force (FATF), and also on international accounting standards (IFRS), auditing standards and so on. The long-term objective of supervision is to ensure convergence of supervisory approaches to supervisory practices of the European Supervisory Authorities (EBA, EIOPA and ESMA) and the ECB.<sup>9</sup> CNB supervisors assist in the production of the “Supervisory Handbook” issued by the supervisory authorities.

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*The CNB effectively exercises the supervisory powers conferred on it by legislation, its primary objective being to ensure the stability of the Czech financial system. Supervisory actions are taken in a timely manner in a form that is appropriate to the situation to which they respond.*

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The CNB's supervisory authority is grounded not only in powers laid down in legislation, but also in its **ability to defend its conclusions in open communication with supervised entities**. The CNB strives for a broadly comprehensible dialogue in which it expresses its opinions and requirements. Only in cases where this approach is ineffective will the CNB make full use of its powers giving it special status vis-à-vis supervised entities.

The CNB measures the **effectiveness** of its work not only by evaluating its results with respect to its objectives, but also by measuring the costs that it and supervised entities incur. With regard to this fact, it routinely also uses informal means of communication; however, its actions are always traceable and justifiable in relation to the legislative requirements. If a systemically important shortcoming is identified in one entity, the supervisory authority may also examine the situation in other entities in the sector in the interests of prevention.

In cases where the tools the CNB has at its disposal are not sufficient to safeguard its supervisory objectives, it initiates **penalty administrative proceedings**.<sup>10</sup> This mainly involves cases where it cannot be sure that effective corrective action will be taken in line with its recommendations or calls for action, or where it is necessary to impose a penalty given the harmful effects of the conduct identified.

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*The CNB performs its supervisory work with due respect to the powers of other units of the state and with the aim of effectively fulfilling the CNB's mission in the supervisory area.*

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<sup>9</sup> The ECB's Supervisory Manual is not binding on the CNB – the main reason behind the convergence of CNB and ECB practices is to facilitate communication with other supervisors in the EU. The CNB is not implementing those parts of the document which would lead to a lowering of the existing supervisory standards.

<sup>10</sup> Both here and in the rest of the text, this principle is applied in cases where the CNB has the option of choosing whether or not to open such proceedings.

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The CNB cooperates with relevant units of the state and seeks to exchange information that will support it in meeting its supervisory objectives. Such cooperation with other units of the state must not influence or jeopardise the independence of the CNB's supervisory work.

## INDEPENDENCE, ACCOUNTABILITY AND ADEQUACY OF RESOURCES

---

*The CNB applies its legally defined independence in the area of supervision. This independence gives it full discretion to take action against supervised institutions.*

---

Supervisory work is an activity in which **decision-making processes** are separated from the Bank Board's decision-making. In this sense, the Bank Board does not interfere in the decision-making process at the supervisory level. Supervisory decision-making processes are transparent and decision-making powers are not concentrated but decentralised so that they cannot be abused in the conduct of supervision. The usual principles of internal governance systems are implemented. Supervisory processes are traceable. The Bank Board is regularly informed about supervisory activities, primarily with the aim of assessing the effectiveness of the work of the first-instance authority.

The CNB implements organisational measures to help ensure that supervision is independent of any other duties that might give rise to conflicts of interest with its supervisory work. These primarily include the duties of departments responsible for activities in the areas of monetary policy and payment systems.

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*In its work the CNB's supervisory unit takes into account the conclusions of financial stability analyses conducted within the framework of CNB macroprudential policy.*

---

The CNB's supervisory unit provides information for the conduct of supervision in the area of financial stability, subject to the confidentiality requirements stipulated by law. Where necessary, the information is anonymised or provided on an aggregate basis.

The CNB's supervisory unit also provides suggestions to the relevant department and holds discussions with it concerning financial market risks in order to contribute to the fulfilment of the CNB's objectives in the financial stability area.

In its supervisory work, the CNB's supervisory unit takes into account the conclusions and recommendations of the financial stability unit, which are contained primarily in the Financial Stability Report.

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*The CNB's supervisory unit provides feedback to ensure that the regulatory framework reflects practical supervisory experience.*

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The CNB's supervisory unit communicates its generalised supervisory experience to the unit responsible for preparing the regulatory framework. In particular, it makes suggestions for the preparation of the framework and comments on draft interpretation stances and legal rules. It also comments on draft official information documents relating to its area of competence.

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*In the interests of ensuring that supervision is transparent to the public, the CNB issues reports on supervisory activities<sup>11</sup> and communicates major supervisory actions and selected findings and approaches in a prompt and flexible manner.*

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The CNB's supervisory unit discloses its approaches in **official information** documents and provides information about generalised findings from its work in **supervisory benchmarks**. By doing so, it strives to ensure that the expected standard of behaviour is communicated to the market in a predictable way and this best practice is recommended by the relevant professional associations and associations of supervised entities. At the same time, if supervisors find that any findings should be communicated to clients of financial institutions or those potentially interested in their products, they choose the form of **public notices** aimed at raising public awareness of risks or other aspects relating to financial products and their functioning.

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*Supervision is organised so that information flows smoothly and appropriate decisions are taken at every level of management.*

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Supervisory activities are performed in **close cooperation** between the employees of the supervisory unit. Supervisory staff share their experience and knowledge and together seek to fulfil the CNB's supervisory objectives as effectively as possible. Employees may share supervisory findings and information in accordance with fixed rules.

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<sup>11</sup> The Financial Market Supervision Report, which the CNB is required to publish by law and which is discussed by the Czech Parliament and the Czech Government.



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*The CNB takes action to avoid conflicts of interest between the supervisory work and private interests of its staff*

---

This area is governed by the CNB's **Code of Ethics**, compliance with which is overseen by the CNB's Ethics Committee and the CNB Bank Board. Supervisory staff not only follow this internal regulation, but also observe **general ethical principles** so as to enhance the CNB's reputation.

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*The CNB creates adequate material conditions for independent, skilled and effective supervision.*

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The CNB creates an environment for supervisory work which appropriately contributes to the achievement of the CNB's supervisory objectives. It has necessary resources to ensure effective inspection and supervisory activities. In the area of personnel policy, it seeks to employ experts with high potential for further professional development. Systematic development of skills and qualifications is one of the key features of the CNB's personnel policy.

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*When allocating its capacity, the CNB takes into account the risk profiles and systemic importance of supervised institutions.*

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In all its supervisory activities, the CNB applies a risk-based approach based on a risk assessment system (RAS). This means that **it allocates the largest proportion of its resources to areas that are systemically the most important or the most risky**. In some less systemically important areas, supervision is usually conducted reactively. In the case of credit institutions and investment firms, the risk-based approach is derived mainly from the SREP process (see below), but this approach is applied across all financial market segments.

## **APPROACH TO SUPERVISION**

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*The CNB performs supervision based on a "forward-looking" system for assessing the risk profiles and degree of systemic importance of supervised institutions. This system identifies major risks in their activities and quantifies the impacts of those risks. It also captures systemic risks relating to the conduct of financial market participants. Based on the system's outputs, the CNB sets the intensity of its supervision of individual financial market areas and individual institutions.*

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An integral part of the CNB's supervisory work is a risk assessment system (a risk-based approach to supervision). The CNB's risk assessment system has a similar internal logic to the systems used by other supervisory bodies, including the ECB. The CNB's long-term supervisory objective is to harmonise its risk assessment methodology as much as possible with the ECB methodology so as to aid communication with the ECB and other SSM bodies.

**The CNB supervisory unit decides about the allocation of its capacity, chooses relevant supervisory procedures and instruments, and communicates its requirements to supervised institutions and other supervisory authorities based on the results of risk assessments.**

Considering specifics of individual types of supervised entities, the risk assessment system is a combination of the following:

- a) **an assessment of the risk profile** of each financial institution in order to set an internal rating for it, and
- b) **an assessment of the systemic importance** of each financial institution based on selected factors making up the systemic nature of the institution (size, interconnectedness, concentration of activities, correlations with other financial institutions, amount of contracts intermediated, numbers of clients, etc.).

The risk profile of the institution is captured in a rating matrix. Its first dimension depicts the financial institution's **risk exposure** and the **quality of the control environment** in the relevant area. The second dimension of the matrix reflects the **institution's ability to cover those risks with its profitability, capital and overall strategy**.

The risk assessment system is used to set the approach to the supervision not only of individual institutions, but also of the relevant sector and, by extension, the financial market as a whole. Systemically important entities are determined on the basis of previous supervisory findings and on the actual size (scale of the activities) of the individual supervised entities in the relevant segments.

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*When conducting supervision, the CNB assesses compliance with statutory duties in the areas of prudence and conduct of business. Supervision in these two areas is coordinated to reflect their interconnectedness.*

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Compliance with statutory duties in the areas of prudence and conduct of business is assessed in a coordinated fashion. Findings in the conduct of business area are valuable inputs for the area of prudential supervision. In serious cases, they can even lead to uncovering problems with an institution's or sector's financial stability. Conversely, performing conduct of business supervision without taking into account the prudential element can, in turn, lead to decisions that jeopardise the financial stability of individual institutions or sectors. It is essential to maintain a constant balance between enforcing the interests of financial institutions' clients and taking action to safeguard the stability of financial institutions.

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## SUPERVISORY METHODS AND TOOLS

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*The CNB exercises its supervisory powers by means of off-site surveillance and on-site inspections. It selects the form of supervision with due regard to its effectiveness in each case. Supervisory work is planned and performed systematically in accordance with internal procedures ensuring internal consistency.*

*In its supervisory work, the CNB draws on a broad information base comprising both confidential and publicly available information. The information obtained is subject to regular and special (thematic) assessments based on analytical tools developed by CNB supervisors.*

---

In its supervisory work, the CNB applies methods consisting in the processing of regular and thematic analyses, ad hoc surveys, on-site inspections and validation of internal models.

In its off-site surveillance activities, it prepares regular analyses in accordance with the Supervisory Manual. It also produces thematic analyses and conducts ad hoc surveys. For its **regular analyses** it uses information from regular reporting and a related defined structure of indicators, and also findings from information-gathering visits to supervised entities.

The CNB typically conducts **thematic analyses** wherever it identifies a risk in multiple institutions (or where there are justified concerns that a risk could arise in multiple institutions) or in a large part of the market and that risk is considered relatively significant as regards the functioning of the financial market. The results of thematic analyses are used for the purposes of supervision, for preparing regulatory proposals or for setting macroprudential policy. Some of the results are made public in rare cases. The approach to their publication is similar as in the case of supervisory benchmarks.

When conducting **ad hoc surveys**, supervisors rely as much as possible on information that is already available to them. The next step is to gather information by making enquiries with the supervised institution or, where relevant, with another supervisory authority or institution so that the purpose of the inspection cannot be frustrated. Where information cannot be obtained in any other way, the CNB conducts an on-site inspection.

**On-site inspections** enable supervisors to acquire a comprehensive knowledge of how a supervised institution operates. The main instrument in all the relevant areas is to test the functionality of control mechanisms on a sample of business transactions. Information requiring verification of authenticity is also gathered during such inspections. Supervisors use interviews with the management and employees of supervised institutions and flexible access to primary documents to thoroughly acquaint themselves with the nature of the inspection.

In justified cases (especially for systemically important supervised entities), supervisory staff notify the employees of the examined entity of their findings on an ongoing basis. Before finalising their inspection report, they present their findings to the examined entity's senior managers and give them an opportunity to immediately express their opinion on them. This procedure is not followed if could frustrate the purpose of the inspection.

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The CNB conducts **comprehensive** or **thematic (targeted) inspections**. Comprehensive inspections cover all areas that are a potential source of significant risks. Thematic (targeted) inspections focus only on selected areas. In both cases, however, the supervisor aims to identify problems of a **systemic nature**. It must detect the sources of relevant risks even where the inspection is limited to a certain area.<sup>12</sup> If the inspection indicates further significant problems, the CNB extends the inspection to those areas as well.<sup>13</sup>

The CNB is aware that an inspection is the most costly method of investigation both for the CNB and for the supervised entity. When planning its inspection activities and conducting inspections, the CNB proceeds with the maximum possible regard for those facts.

The CNB participates in **inspections conducted by foreign supervisory authorities** where this helps it fulfil its supervisory duties. It carefully weighs the benefits of such participation against the costs. It also considers its participation with regard to other priorities set within the scope of its direct responsibilities.

The functioning of the **internal models** used to measure and manage risk and to set capital requirements is of vital importance for the financial stability of individual institutions and the financial system as a whole. When validating internal models, the CNB therefore seeks to ensure maximum prudence in the governance of supervised institutions. The functioning of internal models is verified by on-site inspections and subsequently by means of back-testing results. When validating internal models, the CNB focuses on the use test, i.e. on the practical use of internal models in the decision-making process, for risk management and for capital (liquidity) planning by the supervised institution. The CNB follows this approach not only when validating the models used by the institutions it supervises, but also when cooperating on the validation of the models of their parent groups.

The CNB participates in the **validation of models used at group level** where findings from such validation can be used in fulfilling its supervisory duties. In particular, the CNB carefully weighs the benefits of such participation against the costs.

The CNB meets the senior managers of systemically important institutions on a regular basis and communicates with middle managers on an ongoing basis. The main purpose of these meetings and this communication is to obtain detailed knowledge about the supervised institution's strategy and a general overview of its governance and relations with the other members of the business group to which it belongs. The senior management of systemically important institutions is also directly presented with material supervisory findings and any other topics of special importance. This approach is also applied in justified cases to supervision of other financial institutions.

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*Regular stress tests of individual banks and insurance companies<sup>14</sup> and the system for monitoring transactions in the financial market are specific analytical supervisory tools.*

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<sup>12</sup> This means, for example, that supervisors usually do not perform a forensic inspection of a selected sample of loans without trying to understand the broader consequences, such as the functioning of the lending process.

<sup>13</sup> Taking into account the available capacity and its effective use.

<sup>14</sup> Bottom-up stress tests based on detailed information about individual supervised institutions.

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The CNB makes maximum possible use of **primary data** on the individual transactions or balance sheet items of supervised institutions in its supervisory work. It uses this knowledge to assess the models it uses for stress testing (which provides the basic data for the risk map of an institution) and to understand systemic risks from the point of view of the financial market as a whole. It assesses the integration of stress-testing models into financial institutions' governance systems and their interconnectedness with internal models, risk management systems, business plans, budgets and management remuneration systems.

The CNB also uses bottom-up **stress tests** for its work and for structured communication with supervised institutions. It communicates its findings to the department responsible for financial stability; together they compare them with the top-down stress tests processed by the financial stability department.

The financial market transaction monitoring system enables supervisors to identify sources of risks in the financial system on an ongoing basis. This is a cost-effective approach in the long term.

## CONSOLIDATED SUPERVISION

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*A core part of the CNB's supervisory work is the supervision of groups of financial institutions on a consolidated basis. The aim of this activity is to understand how risks arising at group level can affect the stability of the supervised institution, usually a bank or insurance company. When conducting consolidated supervision, the CNB requires effective management of these risks.*

*Consolidated supervision involves the collection and assessment of relevant data on the group on a regular basis. The supervised institution (responsible person) is obliged to give the CNB access to all material information from individual subsidiaries and branches in the group without the need for assistance from any other (foreign) supervisory authority. In the context of consolidated supervision, the CNB works in cooperation with foreign supervisory authorities, regularly communicates with the management of important subsidiaries and branches that belong to the consolidated group and examines their risk profile and systemic importance. Where the CNB detects significant risks in the activities of these subsidiaries and branches with an impact on the consolidated group, it initiates corrective action.*

---

The CNB always **focuses on the broader context of the matter under assessment** in its supervisory work.

In the case of prudential supervision, it supervises the financial stability not only of the institution on an individual basis, but also of the group to which the institution belongs. Where the group is supervised by another supervisory authority, the CNB seeks to gain maximum access to information about the group. Where knowledge of other links, cash flows and so on going beyond the framework of the consolidated group is important from the perspective of supervisory objectives, this information is also gathered and assessed by supervisors.

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The CNB proceeds likewise in conduct of business supervision, examining the broader context of transactions and, where appropriate, investigating their potential links. Supervisors involved in prudential supervision and conduct of business supervision gather and share relevant information and carry out inspections in close cooperation to ensure that important links are not overlooked.

## REPORTING

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*For supervisory purposes, the CNB has a system of regular reporting by supervised institutions and their consolidated groups. The reports defined by the CNB contain both financial and non-financial data. Supervised institutions are obliged to have internal mechanisms in place to ensure that the reported data are correct. CNB supervisors verify the reported data and request corrections where shortcomings are identified.*

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The range of information the CNB uses for supervisory purposes extends beyond the regularly reported information. The CNB may, for example, request internal analyses, internal documents on specific transactions (including primary accounting documents) and other internal documents of the supervised institution. In some cases, it is also entitled to request information from entities not subject to its systematic supervision.

In its supervisory work, the CNB draws as much as possible on information obtained from regular reporting. It does so with regard to the costs incurred by supervised institutions in dealing with ad hoc requests and with regard to the workload involved in processing the requested information in a non-standard format. When making ad hoc requests, the CNB only demands information that is indispensable for its investigation.<sup>15</sup> These principles, however, must not harm the proper conduct of supervision. In this respect, the supervisor must consider all the options for gathering the necessary information and even choose difficult methods to obtain it in justified cases.<sup>16</sup>

## COOPERATION WITH OTHER SUPERVISORY AUTHORITIES

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*The CNB has a framework – based on legislation or specific agreements and arrangements – for cooperation with other (foreign) supervisors. Among other things, the framework provides for protection of confidential information shared by supervisory authorities.*

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The CNB seeks to establish cooperation with all supervisory authorities that may help it achieve its supervisory objectives. To strengthen confidence (and declare the degree of confidentiality of shared

<sup>15</sup> A large proportion of reporting is currently governed by European regulations.

<sup>16</sup> Such as cooperation with supervisory authorities outside the EU.

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information), the CNB initiates the establishment of a formal framework for such cooperation at least at **letter of cooperation** level and ideally at **memorandum of understanding** level. The absence of such a framework must not hamper supervisory activity; for example, where the CNB needs to establish cooperation with another supervisory authority in order to investigate a case, it will do its utmost to see that such cooperation is established and that the necessary conditions for sharing information are created.

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*The CNB cooperates actively with other (foreign) supervisors to ensure effective supervision within its area of competence and coordinated crisis resolution.*

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Cooperation in crisis situations is of special significance. The resolution department is responsible for such cooperation within the CNB. The supervision unit provides the necessary assistance to this department to help it achieve its objectives.

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*Where the CNB is the home supervisor, it establishes a college of supervisors and manages the work of the college, which is the main platform for cooperation. In doing so, it takes into account the risk profile and systemic importance of the supervised group and of the individual institutions that make up the group.*

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When **organising the work of colleges**, the CNB seeks to achieve a high degree of confidence between the cooperating supervisors. It uses college meetings to initiate an open discussion of supervisory findings and to coordinate the supervisors' actions. Its approach fosters openness in exchanging information and cooperation in meeting the objectives of supervision of the group.

The CNB endeavours to ensure that colleges are the main platform for information sharing between the cooperating supervisors. Colleges meet at least once a year. In the case of specialised topics, technical college meetings, which may also take the form of teleconferences, are organised.

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*In the role of host supervisor, the CNB coordinates and plans its activities in cooperation with the home supervisor to identify areas of common interest. It aims for close and open communication and close cooperation with the home supervisor in order to cover its area of competence effectively. Such communication mainly concerns material risks relating to the supervised group or to the institution subject to supervision by the CNB. The CNB participates in on-site inspections organised by the home supervisor and allows the home supervisor to participate in inspections conducted by the CNB.*

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The CNB seeks to adopt a partner approach in cooperation with the home supervisor. To this end, it approaches such cooperation with the highest possible degree of professionalism.

The CNB actively participates in the meetings of colleges. It initiates technical meetings where necessary.

## COOPERATION WITH EUROPEAN INSTITUTIONS

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*The CNB cooperates in the area of supervision with European institutions (EBA, EIOPA and ESMA) on unifying supervisory procedures and creating conditions for close cooperation between home and host supervisors.*

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The CNB pursues its supervisory objectives when cooperating with European institutions. It seeks to ensure that the outputs of European institutions take into account the specific characteristics of the supervised financial market **so that they support the financial stability of the supervised institutions and the financial market as a whole, as well as the development of the market and the protection of its participants.**

The supervisory priorities in this area are:

- to protect and develop the local financial market,
- to make sure the specifics of the local environment are taken into accounts in the outputs of European institutions,
- to protect the local financial market against potential contagion imported from abroad.

In promoting these priorities, the CNB is aware of the obligations that the Czech Republic has towards the single EU market. The supervisory unit has primary responsibility for cooperation with European institutions – the EBA, EIOPA and ESMA. It contributes to the unification of supervisory procedures and to creating conditions for close cooperation between EU supervisory authorities.

As an authority supervising credit institutions in an EU Member State which has not entered into close cooperation in the Single Supervisory Mechanism (SSM), the CNB will seek to cooperate actively with the SSM and the ECB so as to ensure that the rights ensuing from the current legislation and the CNB's status as an independent supervisor are respected. It will also endeavour to set comparable indicators and harmonise the supervisory methodology where it is useful and rational to do so and where there is no material reason for the current differences. The CNB will aim to ensure sufficient exchange of information and to share best supervisory practices. It will therefore, among other things, support the organisation of regular annual meetings of leading officials from the SSM and from supervisory authorities outside the SSM in order to hold strategic discussions about mutual cooperation. It will seek to ensure that national supervisors in states not participating in the SSM are



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informed by the SSM in good time about on-site inspections conducted in subsidiaries of supervised institutions registered in those states and, where relevant, are able to participate in those inspections.

The CNB will endeavour to ensure that the integrity of the single EU financial services market is maintained under the SSM. For this reason, it will defend the role of the EBA in achieving this goal and, within the EBA, will support the agreed voting procedures and other guarantees preventing states not participating in the banking union from being outvoted by SSM member states. The CNB's supervisory priority is to prevent a situation where Czech subsidiaries of foreign credit institutions change their legal form into subsidiaries owing, for example, to unwarranted differences in the regulatory burden, as such changes could restrict and weaken the position of the CNB as a supervisor, with all the related negative impacts that would have on the Czech economy and the stability of the financial market.

The CNB also cooperates with foreign supervisory authorities in handling requests for information under international memoranda of understanding between supervisors (for example IOSCO MoUs).

The CNB cooperates on the preparation of relevant opinions at ECB, EFC and ESRB meetings.

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## ORGANISATION OF CNB SUPERVISION

At the decision of the Bank Board, the organisation of the CNB's supervisory work was updated as of 1 March 2017. Supervision is currently performed by the Financial Market Supervision Department and the Financial Market Supervision Department II. This organisational set-up enables supervisors to focus constantly on entities engaged in the distribution of financial products and bureau-de-change activities, which would have excessively blurred the focus of the previous department's supervisory work in the future and made it impossible to allocate sufficient supervisory capacity to the supervision of such entities. The change was also due significantly to the CNB's new supervisory competences arising under new legislation on the provision and intermediation of consumer credit.

The **Financial Market Supervision Department** conducts off-site and on-site supervision of:

- credit institutions,
- insurance and reinsurance corporations,
- pension funds.

The **Financial Market Supervision Department II** conducts off-site and on-site supervision of:

- electronic money institutions, foreign electronic money institutions operating in the Czech Republic through a branch,
- payment institutions, foreign payment institutions operating in the Czech Republic through a branch,
- small-scale electronic money issuers,
- small-scale payment service providers,
- investment intermediaries and their tied agents,
- insurance intermediaries and independent loss adjusters,
- bureaux de change,
- non-bank investment firms and their tied agents,
- management companies,
- autonomous investment funds,
- depositaries and administrators of investment funds, except in the case of banks,
- entities authorised to provide or intermediate consumer credit if subject to CNB supervision,
- accredited entities in accordance with the sectoral legislation (hereinafter referred to as "supervised entities").

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## OFF-SITE SUPERVISION

### Prudential supervision

Prudential supervision observes the following principles:

- forward-looking risk-based supervision,
- the development of effective supervisory methods, including effective and meaningful integration of methods used in the supervision of the individual financial market sectors,
- close coordination with conduct of business supervision,
- the development of cooperation with foreign supervisory authorities.

The primary **objective** of prudential supervision is to contribute to ensuring and maintaining the financial stability of financial market entities in the Czech Republic, with an emphasis on timely identification of potential risks enabling supervisors to manage those risks. To this end, the CNB constantly endeavours to increase the effectiveness of supervision by working in close cooperation with supervised entities and foreign partner supervisors, taking a transparent approach, implementing new off-site surveillance methods and procedures and responding proactively to regulatory changes, financial market developments and external economic conditions.

The priorities of prudential supervision include configuring supervisory work so as to make maximum use of the benefits of the functional organisation of supervision of all financial institutions across the entire financial market. Among the other important priorities is the development and unification of risk assessment methods, and in particular the refinement of methods for quantifying the riskiness and significance of supervised financial market institutions.

Prudential supervision is largely concentrated in the area of evaluating financial risk measurement models and assessing institutions' risk profiles in relation to their internal capital, as synergies in this area have the biggest effect on the supervision of credit institutions and insurance companies. The effectiveness of supervision is enhanced especially by the possibility of direct sharing of information, knowledge and experience regarding all supervised institutions, which is enabled by consolidated supervision across entities with direct or indirect financial or economic links.

Close cooperation with conduct of business supervisors is also important, as they provide important inputs for risk assessment of supervised entities. Prudential supervisors in turn contribute with their expertise to the handling of conduct of business issues and also provide assessments of the impact of conduct of business measures on the balance sheet, the risk profile and, ultimately, the financial stability of supervised financial market institutions and sectors.

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## Conduct of business supervision

The **objective** of conduct of business supervision is to contribute, through regulatory and supervisory work, to increasing the transparency of the financial market and to resolving any systemic shortcomings that might arise in the financial market by performing off-site surveillance in the areas of conduct of business and professional care across the entire Czech financial market and in the area of capital market transparency.

Conduct of business supervision includes the handling of suggestions and submissions from the public, while emphasising the defined supervisory priorities and taking into account the available personnel resources. Stress is placed on effective supervision making full use of all the available supervisory methods and tools.

Conduct of business supervision is based on similar principles as prudential supervision. Moreover, it observes the following specific principles:

- thorough investigation of suggestions and submissions received from the public and the drawing of systemic conclusions from those submissions,
- an emphasis on educational activities,
- close coordination with prudential supervision.

Conduct of business supervision captures the systemic risks of the conduct of financial market participants. The intensity of supervision of financial market areas is set based on its findings. Conduct of business supervision primarily involves the protection of retail clients' or consumers' interests; the protection of financial professionals and qualified investors is dealt with mostly reactively on the basis of external initiatives. An identical supervisory approach is applied to all institutions to a similar extent and complexity of activities based on the principle of proportionality so as to avoid unjustified preferential treatment or discrimination of comparable financial market entities.

Suggestions arising from the continuous monitoring of compliance with the rules of conduct, professional care and market transparency are investigated. The emphasis is placed not only on eliminating the shortcoming detected in the specific individual case, but also on finding a systemic solution to the problem identified, for example in the form of setting supervisory benchmarks, interpreting ambiguous legal provisions or initiating legislative changes.

In addition to information obtained from the regular reporting duty, intensive use is made of submissions made by the public related to conduct of business and consumer protection. In specific cases, supervision is focused on areas of activity in which shortcomings have been detected based on the monitoring of compliance with legal rules and the assessment of repeated submissions from the public. Trading in investment instruments on the capital market is monitored on a continuous basis in order to detect market manipulation, insider trading and breaches of the rules of conduct towards clients.

## AML/CFT supervision

The aim of supervision in the area of anti-money laundering and combating the financing of terrorism is to contribute to enhancing internal control mechanisms in relevant entities in the AML/CFT area by assessing the system of internal principles for this area in relevant entities and, where appropriate, by

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conducting thematic sector-wide surveys. On an individual basis, it involves performing off-site supervision of relevant entities in the AML/CFT area identified in complaints from the public.

## ON-SITE INSPECTIONS

### Prudential inspections

The primary task is to conduct on-site inspections focusing on prudential rules in relevant financial market entities subject to CNB supervision.

Another key task of prudential inspections is comprehensive assessment of institutions' internal models for determining regulatory capital requirements under Pillar I of the prudential regulation of credit institutions and insurance companies, in cooperation with prudential supervisors. In addition to approval of the model itself, the model assessment includes the subsequent process of assessing changes to the model, including changes in parameters, and verification of fulfilment of the conditions for approval of the model.

The **aim** of the inspections is to verify, based on a detailed on-site inspection, the functioning of the institution's governance mechanisms and its financial position and capital adequacy relative to its risk profile and shortcomings identified.

The inspection work is performed on the principle of risk-based supervision, and the tool and methods for on-site inspections are selected so as to make the inspection work as effective as possible.

### Conduct of business inspections

The primary task is to conduct on-site inspections focusing on:

- compliance with the conduct of business rules and consumer protection rules, the rules regulating the management of client assets and the rules regulating the composition of managed asset funds,
- compliance with the rules of conduct towards clients and those interested in financial products, and
- compliance with prudential rules relating directly to conduct of business.

The primary **aim** of conduct of business inspections is to protect the clients of supervised entities. The secondary aim is to safeguard the stability of the financial sector where conduct of business overlaps with prudence.

Effective inspection work is a key criterion for meeting these aims. This is continuously ensured by means of the approach, methods and tools chosen for the inspection work and also by means of the form and intensity of cooperation with foreign institutions and supervisory authorities.

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## AML/CFT inspections

The primary task is to conduct inspections focusing on checking compliance with the AML/CFT legislation. The main **aim** of inspections in this area is to check the functioning and effectiveness of the system of AML/CFT measures of relevant entities and to determine whether the measures are sufficiently robust and effective to prevent those entities from being used for money laundering and terrorist financing,

## COOPERATION WITH FOREIGN SUPERVISORY AUTHORITIES

### Areas of cooperation

The CNB takes an active approach to cooperation with foreign supervisors to ensure effective supervision within its area of competence and coordinated crisis resolution. For crisis situations, communication channels have been set up to enable the supervisory authorities concerned to exchange information and coordinate further actions.

In particular, the CNB works closely with competent supervisory authorities responsible for supervising groups containing institutions subject to supervision by the CNB. It processes information about the financial and prudential situation of supervised institutions, ensures timely exchange of information needed for supervision and participates in meetings of the colleges of supervisors of those groups and also in joint inspections.

It also cooperates closely within **JRAD** and **JLAD** processes in order to reach joint decisions about the risk profiles and capital and liquidity adequacy of relevant bank groups and individual supervised entities and, in the case of joint decisions, about applications for the use of internal models for the calculation of the solvency capital requirement and short-term and long-term liquidity indicators.

The CNB also establishes and manages **colleges** of supervisors in cases where it is the home supervisor. In doing so, it takes into account the risk profile and systemic importance of the supervised group and of the institutions that make up the group.

Where the CNB is in the role of host supervisor, it coordinates and plans its activities in cooperation with the home supervisor. In particular, it identifies areas of common interest. It aims for open communication and close cooperation with the home supervisor in order to cover its area of competence effectively. Such communication mainly concerns material risks relating to the supervised group or to the institution subject to supervision by the CNB.

The CNB participates in **on-site inspections** organised by the home supervisor and allows the home supervisor to participate in inspections conducted by the CNB. The CNB participates in inspections conducted by foreign supervisory authorities where this helps it fulfil its supervisory duties. It takes part in these inspections mainly in cases where they focus on issues relating directly to the supervised entity. In rare cases, it takes part in general inspections if the detailed knowledge obtained on the functioning of the parent group contributes fundamentally to the quality of supervision of the home institution. The CNB carefully weighs the benefits of such participation against the costs. The CNB generally supports joint inspections with home supervisors, among other things in order to share the maximum amount of information about the functioning of groups, to obtain information about

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procedures and supervisory benchmarks and to establish informal communication links with partner supervisors.

The CNB also cooperates with home supervisors in inspections of institutions, supervision of which falls within the competence of the CNB and which are members of groups supervised by foreign supervisors. The CNB shares information about planned inspections and their areas of focus within colleges. The home supervisor may make suggestions and requests regarding the subject and scope of the inspection. The CNB offers the home supervisor the option of participating in the inspection while maintaining the role of main coordinator of the inspection. The inspection results are shared with the home supervisor and key findings are presented within colleges.

The supervisory inspection plan is coordinated with foreign supervisors even in cases where no colleges are established. In these circumstances, it is important to:

- set up communication channels and maintain effective and fast communication with the foreign supervisor, starting with exchange of information for participation in inspection teams and continuing with exchange of information during the on-site inspection and disclosure of information about the results of the inspection,
- have a consistent ex-ante definition of the competences of the CNB and the foreign supervisor in the inspection work in order to eliminate legal and reputational risks to the CNB.

As regards **validation of internal models**, the CNB takes part in the assessment of the model at group level so as to be able to obtain the maximum amount of information about the functioning and use of the model, with the aim of influencing its methodology at the start of the validation process. This approach is much more effective in terms of results and more cost-effective than subsequently making comments during the validation of its local use by an institution supervised by the CNB.

When validating internal models, the CNB therefore seeks to ensure maximum prudence in the governance of supervised institutions. The functioning of internal models is verified by on-site inspections and subsequently by means of back-testing results. When validating internal models, the CNB focuses on the use test, i.e. the practical use of internal models in the decision-making process, for risk management and for capital (liquidity) planning by the supervised institution. The CNB follows this approach not only when validating the models used by the institutions it supervises, but also when cooperating on the validation of the models of their parent groups.

**Cooperation in the imposition of remedial measures and the provision of information about penalties imposed** are an essential part of cooperation with foreign supervisors. Due to the increase in the amount of cross-border products and services, cooperation with partner supervisors has become a regular and integral part of supervisory work.

A specific activity is international cooperation in **conduct of business**, especially in the investigation of suspected market manipulation, insider trading or churning. CNB cooperates, or requests cooperation, with foreign supervisors in order to penalise undesirable conduct effectively. Such cooperation consists mainly in the transmission of information either from the supervised entity, or from other entities. Much of the required information is available from the regular reporting duty. Interrogation of suspects or provision of documents can also be arranged through international cooperation.

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## Cooperation in colleges

Colleges of supervisors have been established to ensure effective supervision of international credit institutions. The aim of such colleges is to enhance and intensify cooperation between competent supervisory authorities at the group (home) and individual (host) levels. In November 2014, following the establishment of the Single Supervisory Mechanism (SSM), the ECB became the home supervisor of the most important European institutions.

Timely **sharing of information** should contribute significantly to the functioning of colleges. The CNB seeks to ensure that colleges perform this role. It works actively to obtain all relevant information within colleges, not only with regard to past or present events, but also when assessing future and planned or considered actions which might have a direct or indirect effect on domestic entities.

College meetings tend to take the form of face-to-face meetings, usually organised twice a year. In the meantime, teleconferences are held on specific current issues – connected either with economic and political events or with individual college activities – to ensure that the colleges run smoothly and to nip problems in the bud.

In order to ensure that the colleges work well, the CNB strives to ensure that cooperation within them is **as systematic and flexible as possible** as well as optimally intensive. It regularly participates in college meetings and works to actively uphold the CNB's interests and thereby strengthen the stability of the Czech banking sector and individual institutions. Besides the above-mentioned meetings, information is shared within colleges through regular exchanges of information (different for different colleges) and in the form of ad-hoc information, for example about inspection findings.

The duties to be performed in colleges during the year are laid down in the applicable European legislation and are based on an action plan for colleges produced annually at EBA level and approved by the members of the EBA's Board of Supervisors.

Each college also plans a work schedule for the following year and tries to coordinate the work of the participating supervisory authorities, for example in an on-site inspection plan or a plan for off-site activities.

One of the main duties of colleges is to safeguard and coordinate the JRAD process, the output of which is the adoption of:

- a joint decision on capital,
- a joint decision on liquidity (since 2014),
- a joint decision on group recovery plans (since 2015).

A joint evaluation of risks at group and individual level (SREP) serves as a basis for adopting joint decisions.

Based on the SREP analysis, the CNB submits a draft minimum capital adequacy and liquidity requirement relating to the domestic subsidiary to the college of supervisors. In subsequent college meetings, the CNB works actively to enforce **minimum capital and liquidity requirements in joint decisions**, in line with the results of assessments of the institutions' risk profiles. During negotiations,



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the CNB places emphasis on not only the absolute amount, but also the quality of the capital required of banks. In the JRAD process, the CNB oversees supervised institutions from the perspective of the going concern principle and therefore sets capital requirements in the form of Tier 1 capital.

The joint decisions adopted are subsequently communicated to individual financial institutions and become binding on them.

The assessment and evaluation of recovery plans at group level were incorporated into the responsibilities of colleges of supervisors in 2015. Next, the college takes a joint decision regarding:

- the result of the assessment of the group recovery plan,
- whether an individual recovery plan will be required of group members,
- the application of measures to eliminate deficiencies in recovery plans (or in their feasibility).

The CNB seeks to ensure that the individual **recovery plans** of systemically important institutions are part of group recovery plans. Supervisors focus on the quality of recovery plans in all institutions, assessing whether the recovery plans are based on the institution's business model and risk profile, whether they define critical functions and key business lines, whether they contain adequate indicators and scenarios and whether the measures included in the recovery plan are feasible. In the preparation of draft procedures for a college framework for emergency planning<sup>17</sup> which are drawn up by the consolidating (home) supervisory, the CNB will see to it in the comments procedure that the procedures and processes for resolving emergency situations formulated therein pose no potential threat to domestic banks (or that a sufficient framework is created to mitigate such threats) and that the information requirements specified therein provide a sufficient range of information for emergency process management by the college.

The BRRD requires all college members to be properly informed by the consolidating supervising about the main conditions for approving intra-group financial support plans,<sup>18</sup> which will be adopted in a similar process as for joint decisions. As regards its basic position on the provision of intra-group financial support, the CNB will endeavour to ensure both in the relevant EBA technical standards and guidelines and in future practice that competent authorities are given the option of checking whether the supervised entity providing support acted **in accordance with the standard prudential rules** in the transaction approval process.

## Assessment of internal models

The regulations applying to banks and insurance companies, specifically CRD IV/CRR and Solvency II, allow them to determine their capital requirements using advanced quantitative methods. The advantage of this approach is that the capital requirements are derived from the risk profile or the activities performed.

<sup>17</sup> The college framework for emergency planning and defining the scope of information requirements in preparation for emergency situations.

<sup>18</sup> The relevant EBA guidelines and regulatory technical standards have undergone a public consultation and the results will be discussed by the EBA's crisis management group. Parallel communication is ongoing between Central and Eastern European supervisors, inspired by the CNB.

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The main aim of CNB supervision is to assess in each internal model or rating system whether the model itself is sufficiently **reliably and prudentially covers the risk undertaken** (i.e. whether it distributes the relevant exposures into homogeneous groups and then models or estimates the risk parameters in those groups), whether it is properly **implemented in governance processes** in the bank or insurance company and whether all relevant units in the bank or insurance company up to board of directors level have adequate knowledge of the functioning of the model (the use test and corporate governance), whether a **sufficient control environment and model governance** is in place, and whether the model is **regularly assessed independently** (internal validation and audit).

At the request of the group supervisor, the **CNB is obliged to assess, within a set time limit, whether the methodology**, data and calibration are **suitable** for the local conditions of the Czech entity and whether the implementation of the model in the institution's local governance system is sufficient and to contribute to the joint decision of the college on the use of the internal model.

The CNB aims not to proceed formalistically in model validations and check only the methodology and mathematical and statistical assumptions of the model. It focuses on the **practical use of the model** in the bank's day-to-day management (i.e. on the use test) – i.e. the model should be used not only for the calculation of capital requirements, but also, for example, for provisioning, valuation and approvals. This means that internal model validation involves both off-site assessment of submitted documents and on-site work in the financial institution, work that has some features of an inspection.

As validations of group internal models take place in colleges, supervisors must be active in discussing them. Where the model fails to comply with all the requirements, additional conditions are set for approval of the internal model. These additional conditions must also be enforced in colleges through active cooperation and incorporated into the college's joint decision. Compliance with these conditions usually has a significant effect on the bank's total capital requirements.

In **insurance**, similarly as in the case of banks, the process of assessing group internal models is organised by group supervisory authorities. When assessing internal models, the CNB focuses on **testing the validity of the chosen method and approaches** for the calculation of the solvency capital requirement. The adequacy of the group internal model is assessed in relation to the insurance company's risk profile and with regard to sufficient coverage of local specifics.

Supervisors are involved in assessing the adequacy of the assumptions, the model parametrisation and the calculations made at local level. The **main areas assessed** include data quality, calibration, statistical quality, the assumptions and expert judgment of the validation, external models (disaster models for floods in the Czech Republic), documentation, the best estimate of technical provisions, the use test, allocation of profits and losses and the governance system in relation to the internal model. The assessment takes the form of presentations of the methodology, local implementation, assumptions and results of the calculation, with an active critical discussion and assessment of the documentation provided. Each college meeting produces an official summary of the assessment containing all the findings on the area under assessment.

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## Possible CNB procedures where a foreign supervisor fails to provide supervisory cooperation

Cooperation between the CNB and the supervisory authority of **another EU Member State** may include:

- an application for information for supervisory purposes or for an on-site inspection or assistance during an on-site inspection in an entity subject to (home) supervision by the CNB relating to activities in the country of the host authority,
- an application for information for supervisory purposes about another entity subject to supervision by the foreign authority,
- an application for assistance for the purposes of proceedings conducted by the CNB against a supervised entity regarding the imposition of remedial measures relating to activities in the host Member State,
- an application for verification of compliance with remedial measures imposed by the CNB relating to activities in the host country,
- some other application for information (for example in respect of licensing proceedings),
- an application for information for supervisory purposes or for an on-site inspection or assistance during an on-site inspection conducted by the home supervisor in an entity subject to supervision by the CNB as host supervisor relating to activities in the host country,
- an application by the CNB as host supervisor for remedy or the imposition of a penalty by the home supervisor,
- an application for verification of compliance with remedial measures imposed by the host supervisor relating to activities in the Czech Republic.

Cooperation between the home and host supervisor is directly regulated by the applicable EU sectoral legislation and supported by bilateral or multilateral memoranda of understanding (at ESMA and IOSCO level; group memoranda of understanding for supervision of cross-border bank groups).<sup>19</sup>

The CNB's **primary** supervisory instrument is a **request for cooperation with reference to relevant EU regulations** (transposed into sectoral regulations), which require both the home and host supervisor to provide assistance for supervisory purposes, especially as regards the provision of information and the elimination of shortcomings.

In emergencies or if the foreign supervisory authority fails to cooperate sufficiently (i.e. fails to provide information or provides incomplete information, repeatedly fails to respond in time or fails to take adequate corrective measures) or the request for cooperation seems impossible to deal with in the foreseeable future, even through less formal channels (intensive communication by phone or e-mail, a visit to the foreign supervisor – progressively through all levels of governance), the CNB is entitled

<sup>19</sup> Important bank branches and investment firms are subject to specific treatment, including intervention in the liquidity restoration plan and CNB powers in colleges of supervisors.

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to **intervene directly** in accordance with the powers laid down in EU regulations transposed into sectoral regulations (the Act on Banks, the Insurance Act, the Act on Management Companies and Investment Funds and the Capital Market Undertakings Act). As a rule, this involves **directly imposing a remedial measure or penalty, including imposing a fine on the supervised entity**.

As regards the non-cooperating supervisory authority itself, a mediation procedure before the relevant EU authority (EBA, ASMA and EIOPA)<sup>20</sup> or a procedure dealing with a **breach of EU law** may also be initiated. The supervisor takes such action only after it has exhausted all the above-mentioned options, consisting mainly in intensive communication directed at the competent supervisory authority. If no response is received, or if the response is slow, the CNB will involve the relevant EU agency in this communication. In a particularly acute situation, a representative of the CNB will raise the problem at a meeting of the relevant EU agency. **Should these actions fail, the CNB supervisory unit will ask the Bank Board to approve a plan to initiate a mediation procedure or a procedure dealing with a breach of EU law.**

After the plan is approved by the Bank Board, a petition will be filed for the opening of relevant proceedings before the selected ESA. This petition will contain the reasons for the CNB's disagreement about the procedure of the other authority, framed in terms of the relevant European legislation. The ESA then becomes the mediator in reaching an agreement between the supervisors. A crucial role is played in this process by the chairperson of the ESA, who may invite members of the mediation panel to conciliate. For the purposes of conducting the proceeding, the ESA will set a time limit taking into account the complexity of the matter. If no agreement is reached, the ESA may take a binding decision requiring the supervisory authority to take specific action or to refrain from action in order to ensure compliance with EU law.

As for a procedure dealing with a breach of EU law, the Board of Supervisors of the relevant ESA decides on the commencement thereof. The procedure may entail a discussion of the matter at the Board of Supervisors level or at the level of expert standing committees and the mediation panel, with reputational risks to the supervisory authority concerned. After the procedure ends, if a breach of EU law is identified, the relevant ESA will address a recommendation to the supervisory authority concerned. If this supervisory authority fails to respond within the set time limit, the Commission may adopt an opinion requiring the supervisory authority to take the action necessary to comply with EU law. If the supervisory authority continues not to do so, the European Commission may, where EU law is directly applicable, adopt a binding decision addressed to the institution concerned, not the supervisory authority. Institutions and supervisory authorities which have not complied with Commission opinions or decisions will be listed in the ESA Annual Report.

Cooperation between the CNB and the supervisory authority of a **non-member state of the EU** may include:

- an application for information for supervisory purposes or for an on-site inspection or assistance during an on-site inspection in an entity subject to supervision by the CNB relating to activities in the third country,
- an application for information for supervisory purposes about another entity subject to supervision by the foreign authority in the third country,

<sup>20</sup> See Article 19 of Regulations 1095/2010 (ESMA), 1093/2010 (EBA) and 1094/2010 (EIOPA).

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- an application for assistance for the purposes of proceedings conducted by the CNB against a supervised entity regarding the imposition of a penalty relating to activities in the territory of the third country,
- an application for verification of compliance with remedial measures imposed by the CNB relating to activities in the third country,
- some other application for information (for example in respect of licensing proceedings),
- an application for information for supervisory purposes or for an on-site inspection or assistance during an on-site inspection conducted by the supervisory authority of the third country in an entity subject to supervision by the third country relating to activities in the Czech Republic,
- an application by the CNB for remedy or the imposition of a penalty by the supervisory authority of the third country relating to an entity supervised by it.

Entities domiciled outside the EU are subject to the duties laid down in applicable Czech legislation and the CNB may impose penalties in accordance with the relevant sectoral legislation. **The ability of entities domiciled outside the EU to operate in the Czech market may be made conditional on the existence of a memorandum of understanding (MoU) between the CNB and the supervisory authority of the third country.** Bilateral or multilateral MoUs (IOSCO) mainly concern the exchange of information, the imposition and enforcement of remedial measures and penalties and, in some cases, cooperation in on-site inspections. However, they are usually voluntary and cannot substitute for or conflict with national legislation (MoUs are not international treaties subject to ratification by the Parliament of the Czech Republic). This determines the enforceability of the relevant MoUs.

Failure by a third-country supervisory authority to cooperate and assist may be assessed by the CNB as failure to comply with obligations arising from the MoU. However, as MoUs often state themselves, they cannot automatically give rise to a breach of the law (as is the case in the event of failure to cooperate between EU Member States). In the absence of binding and enforceable rules for resolving insufficient assistance, the CNB depends on the goodwill of the other party (the foreign supervisory authority). Failure to comply with obligations arising from MoUs with third-country supervisory authorities may at most result in withdrawal from the MoU or forced termination of the position of signatory thereto (IOSCO MMoUs), with possible impacts on the business of market participants in the relevant state where such business is conditional on the existence of an MoU. Indirect pressure to comply with obligations arising from MoUs is thus to some extent generated through reputational risks to the relevant third-country supervisory authority. Withdrawal from the MoU or forced termination of the position of signatory thereto would be decided by the Bank Board in each specific case.

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## SUPERVISORY POLICY

### FOUNDATIONS OF SUPERVISORY POLICY

The aim of this section is to set supervisory policy for each sector supervised. “Policy” means the configuration of the approach to off-site and on-site supervision, including analytical and assessment activity and the way in which the conclusions of such activity are applied to supervised entities in order to prevent the emergence of, or manage the impact of, risks to the CNB’s supervisory objectives. The core principles of supervisory policy are optimal effectiveness and efficiency of supervision. Supervisory policy is also based on a risk-based approach.

For individual sectors, supervisory policy is determined by:

- the degree of risk and systemic importance of the sector (and by the types of risks it faces),
- the corporate culture and sophistication of the sector,
- the concept and the robustness of regulation of the sector and the range of applicable supervisory instruments.

The CNB focuses its supervisory attention mainly on sectors and institutions which are systemically important or have the potential to be systemically important due to the size of the impact of their potential failure (materialisation of the relevant risks) on the CNB’s objectives. As regards riskiness, supervision is based on a risk assessment system (RAS). **This means that the CNB allocates the largest proportion of its supervisory resources to areas and institutions that are systemically the most important or the most risky.**

Although the RAS provides clear and well-structured information, it must be placed in the context of the supervisor’s knowledge of general developments in individual sectors, based on inputs of a qualitative nature which cannot be captured in an assessment, and its knowledge of developments and the situation in the regulatory environment. It must also be placed in the context of significant findings or doubts relating to specific supervised entities.

The effectiveness of supervisory actions is conditional to a large extent on the corporate culture in the sector. For supervisory measures to be appropriate to that culture, the optimal instrument must be selected from the range defined in the regulations.

For sectors where the regulations consist of a set of fixed rules with a strong emphasis on a pre-defined manner of compliance (the “rule-based approach”), failure to comply with the requirement may give rise to disqualification from the financial market or, where appropriate, penalties. As the culture of the sector rises, the regulatory concept also usually changes. It describes not only the necessary administrative measures, but also the purpose and aim of its requirements, and more often uses principles to define them (the “principle-based approach”). It assumes a continuous dialogue

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between the supervisor and supervised entities<sup>21</sup> and a choice of more sophisticated supervisory procedures, including more intense and structured mutual communication. If this contact is lost, its effectiveness drops rapidly and there is a risk of losing a level playing field. Supervisory approaches anticipate that the measures adopted by supervised institutions in accordance with the regulations in force are not just an administrative add-on to their activities, but generally influence the conduct (business) of the supervised entity in all its areas of operation. This concept is typical of the requirements of prudential rules. The requirements of conduct of business rules are often of an administrative nature.

## APPROACH TO THE SUPERVISION OF INDIVIDUAL SECTORS

### Banks

The banking sector as a whole is the **systemically most important** sector of the financial market. It contains institutions that have been assessed as exceptionally systemically important based on the results of risk analyses. This sector is typified by a high corporate culture.

However, given the importance of the banking sector for the economy and the profound impact of bank failures on the nation's finances, and hence given the total level of public interest, it is by far the most sensitive sector in terms of the impact of related adverse events on the CNB's reputation.

The **regulatory rules** applying to banks are relatively extensive and sophisticated, reflecting the sophistication of the supervised entities' activities. They apply to all activities of banks. Supervision of compliance with these rules requires great expertise and high relevant capacity on the part of the CNB.

**Off-site supervision** must be based on regular contact between the supervised entity and the supervisor. This is because risky phenomena need to be nipped in the bud and also because the supervisor's perceived closeness to the supervised institutions has a general preventive effect. Continuous communication is also necessitated by the complexity and structured nature of the subject of supervision. Supervisory communication is targeted at all major parts of the bank and is not limited to persons responsible for contact with the regulator. This applies both horizontally and vertically.

In the case of banks, it is in everyday communication where supervision has the greatest effect. If the supervisor identifies a significant problem, contact must be maintained with the top management of the institutions in each phase of remedying the problem.

Off-site supervision should not be limited to the interpretation of data contained in statements, but should aim to fully understand how each bank operates. It should be able to link specific phenomena to specific persons and their motivations. The nature of supervision should be based not only on knowledge of financial indicators, but also on overall knowledge of the bank's environment and main processes.

<sup>21</sup> The exception is cases of unfair practices and particularly serious and extensive breaches of duties imposed by law where such communication cannot reasonably be expected to contribute to the fulfilment of the CNB's objectives.

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Conduct of business supervision and consumer protection supervision are playing an increasingly important role for banks as time goes on. They may also have an impact on capital requirements. In banks, conduct of business supervision and inspections are conducted mainly in the areas of provision of investment services, provision of payment services and bureau-de-change activities, with an emphasis on compliance with the rules of conduct towards clients, and also in the area of depositaries of pension management and investment companies and autonomous investment funds. Depositaries represent a vital inspection element in the area of fund investment and pensions. The pension sector, the aim of which is to ensure that claims can be settled for a majority of the post-working age population in the long term, is particularly sensitive to possible failures and may thus be a source of reputational risks for the CNB.

Risk-oriented supervision of banks is based on an integrated **supervisory review and evaluation process (SREP)**, which involves comprehensive assessment of the riskiness and viability of banks. The SREP is consistent across the sector, transparent, and based on clearly defined evaluation and quantification procedures. The quantitative and qualitative measures imposed on banks based on the evaluation are always justified. The outputs are used as a basis for the management of follow-up supervisory actions and the planning of supervisory resources. The SREP is an ongoing process with a summary output compiled annually. If necessary, the evaluation is performed outside the regular cycle (e.g. in connection with major findings obtained in an on-site inspection or in the event of significant changes in risk profile). The CNB maintains a continuous dialogue with banks as part of the SREP and also communicates SREP outputs to banks. In connection with measures taken against an institution, it requires that remedial action be taken. The proportionality principle is applied in the process as regards the scope, frequency and intensity of the evaluation, the choice of the methods applied, the scope of the dialogue with banks and the quality of compliance with regulatory requirements.

The SREP covers the following areas:

- monitoring of key indicators,
- an assessment of the business model,
- an assessment of the governance system and internal controls in the institution,
- an assessment of risks relative to capital,
- an assessment of liquidity risks,
- an assessment of the sufficiency of the institution's own funds,
- an assessment of the adequacy of liquidity sources.

The SREP is based on an evaluation of the information obtained in both off-site surveillance and on-site inspections. The process uses key indicators compiled in addition to regularly reported information, ICAAP and ILAAP reports, including stress tests conducted by banks, information obtained during on-site inspections, information obtained during information-gathering visits, thematic surveys and comparative analyses, supervisory stress tests and outputs of internal analytical methods, including quantitative procedures for internal assessments of capital and liquidity needs.

An understanding and assessment of the bank's business model are the key starting point for all the other elements of the process. The aim of the analysis of the business model is to assess business and strategic risks and to verify the viability of the model and the sustainability of the strategy over the



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planning cycle. The analysis of the business model is also a basis for identifying strong and weak points.

The main objective of the assessment of the governance system is to verify whether it is consistent with the bank's risk profile, business model, size and complexity. An assessment of the adequacy and quality of the bank's ICAAP and ILAAP processes is an important element. The CNB therefore assesses whether the shortcomings in the governance system and the quality of the ICAAP and ILAAP processes significantly affect the bank's viability.

The assessment of the institution's risk profile takes into account both Pillar I risks and other major risks to the bank's current or future business model. The evaluation of individual risks is based on inherent risk (risk exposure), which is adjusted for the impacts of shortcomings in the governance system. The result of the risk assessment sums up the main risk factors and is used as a basis for determining the capital requirements.

In the SREP process, the CNB assesses whether the capital available to the bank reliably covers the risks which the bank faces or may face. It determines and sets the amount and composition of the additional capital requirement which the bank must have to cover the risks of unexpected losses, the risks of expected losses not covered by provisions, the risks of shortcomings in internal models and the risks based on shortcomings of the governance system. To that end, supervisors create and apply their own supervisory benchmark calculations for individual risks.

The risks to liquidity and financing, i.e. the inherent liquidity and financing risk, and the management of those risks are assessed in the SREP process. The CNB assesses whether a bank's liquidity sources ensure sufficient coverage of liquidity and financing risks and, if necessary, determines specific quantitative or qualitative liquidity measures.

The total SREP assessment (score) is a synthesis of the outputs from the assessments of the individual components. Based on its results, supervisors assess the bank's viability with regard to risks the bank is or might be exposed to. When defining additional capital requirements and other measures, the CNB takes into account the importance of the shortcomings identified, the correlation of the risks identified, any duplication of measures for resolving shortcomings, and the optimal level and duration of each measure.

On top of the SREP requirements, which banks must comply with under all circumstances, the CNB is planning to set a "capital recommendation" in line with EBA guidelines to cover a potential lack of capital identified by stress testing where the capital conservation buffer and, as the case may be, the countercyclical capital buffer are not enough to cover the impact. Supervisors will assess whether the measures contained in the capital plan are adequate and credible and whether the bank is able to comply with the capital requirements, including the combined buffer, over a sufficient period of time.

More extensive inspections need not be performed on-site but may make use of off-site surveillance tools – whether their outputs are used for further supervisory activities or to open penalty proceedings. Generally, however, only on-site inspections can provide the deepest knowledge of how a supervised institution truly operates and an assessment of the efficiency and effectiveness of its governance system and risk management system.

The frequency and focus of such inspections should therefore be optimised. The primary aim of inspections is to understand the system, not to "check off" selected items. It is necessary to

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understand how things usually work and not pay too much attention to details. Unless such details are exceptions to standard procedures, which, on the contrary, should always be of interest to supervisors (this naturally concerns areas subject to supervision), as a high frequency of exceptions reduces the quality of the control environment and may thus generate higher risk in the bank concerned. Inspections in banks have a significant preventive effect in terms of preventing the mistakes that can be generated by a wrongly configured system.

**Inspections** are based on a sophisticated methodology defining supervisory benchmarks. Those benchmarks are communicated in interviews with specific employees. They are also applied in presentations of inspection findings and summarised in an inspection report.

In the CNB's opinion, the optimum average frequency of on-site inspections in the banking sector is **four years** (and no more than five years). Taking into account all the time and procedural parameters of inspection work and the decision-making process in administrative proceedings in the Czech Republic, four years is a broadly optimal period for closing an inspection cycle in a single institution – starting with carrying out the inspection and dealing with any objections, through imposing remedial measures (either by the supervisor or in the form of an administrative proceeding as a last resort), to monitoring compliance with the schedule of remedial measures and carrying out a follow-up on-site inspection to verify compliance with all the measures and describe the current state of functioning of each bank.

Generally, the CNB regards **three years** as the shortest possible bank inspection cycle (given the time it takes to carry out the inspection and the reasonable time needed for the bank to implement all remedial measures). This frequency is therefore applied to the **large banks** segment, reflecting their fundamental systemic importance in the Czech financial market. The CNB strives to maintain an average inspection frequency of four to five years in the other banking segments.

Inspections are supplemented by audits of internal control systems. The CNB waives an audit if an on-site inspection is planned for that year or if the supervisor has information giving it a comparable degree of assurance. The CNB uses the option of informing the auditor of its plans regarding the focus of the audit.

The CNB's supervisory tools are usually sufficient to **ensure rectification** of shortcomings identified in banks. The advantage of this approach is that contact is maintained with the bank throughout the rectification process and this rectification can be monitored in the overall context of the functioning of the institution. Where particularly significant findings are identified, the top management of the bank must be involved in the process. However, this approach should not be overused in order to avoid reducing its effectiveness. Major shortcomings should also be reflected in the Pillar II capital requirements and in the risk assessment of the institution concerned.

The supervisor proposes a penalty procedure where it has little confidence that shortcomings will be eliminated or where special emphasis needs to be put on the seriousness of the misconduct. Such proposals are rare in practice. They are mostly limited to confirmation of the remedial measure by an administrative decision, sometimes accompanied by a capital requirement. In exceptional cases, the administrative proceeding may focus on penalising specific individuals. Proposals for the imposition of fines are particularly common in the area of conduct of business and consumer protection.

As regards the **focus of banking supervision**, attention will be paid in the **near future** to the implementation of the new European CRD IV/CRR capital regulations both in on-site inspections, the

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assessment of internal models and, where relevant, the incorporation of new risk factors, and in the area of methodology and cooperation with other key foreign supervisors and the ECB in colleges and on EBA platforms.

The main attention will be paid to current or major risky issues, in particular:

- credit risk, in particular:
  - specialised financing (project financing, property financing, etc.),
  - credit standards and their decline and the related expected rise in output in retail financing secured by real estate collateral,
- information systems and technology risk,
- liquidity and its management in financial groups,
- prudential valuation of assets at fair value,
- outsourcing activities (IS/IT and other operational activities of banks).

In the area of banking supervision, increased attention is being paid to banks' credit portfolios (especially categorisation of receivables, sufficiency of provisioning and collateral value) and to capitalisation and the situation of their parent groups, including monitoring of intra-group transactions. The CNB will also continue to pay attention to the performance of new banks and banks with new owners.

## Credit unions

The credit unions sector is **not systemically important** in terms of financial market stability. However, the CNB has paid increased attention to it in the past, intervening proactively given the sector's potential to jeopardise the CNB's objectives. Just a handful of credit unions account for the bulk of the sector.

Generally, it is a sector with **higher riskiness** due mainly to the chosen business models and generally to the lower corporate culture in the sector.

The sector's **financial condition** is volatile over time. It therefore requires increased attention owing to the higher degree of uncertainty about its future development.

The **regulatory rules** for credit unions are relatively extensive and complex. In this case, therefore, the CNB places special emphasis on the proportionality principle in the application of those rules. Given the legislative changes currently being adopted, however, supervision of credit unions will require increased supervisory attention and capacity.

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Supervision in this sector is based on a **review and evaluation process**. In this process, the CNB endeavours to communicate frequently with credit unions.<sup>22</sup> For such communication to be effective, the most important owners of credit unions must be involved in addition to employees and senior officers.

**Off-site surveillance** cannot rely solely on information from regular reporting, but must be complemented with extraordinary monitoring adapted to the current situation.

Inspection work, which in the past was very intensive in relation to the sector's lower systemic importance, plays an important role in the supervision of credit unions. Given the nature of the findings, inspections often require a more forensic approach. The communication of benchmarks is structured in a similar way as for banks, but in this case greater emphasis is placed on the educative role of such communication.

As in banks, **inspections** are complemented with governance system audits. In the case of credit unions, the use of this instrument is limited by law to a maximum of one inspection every three years.

Where **shortcomings identified** need to be **remedied**, the CNB usually initiates the opening of administrative proceedings in the matter in question, as it has less confidence in the motivation of credit unions to adopt remedial measures voluntarily in an informal procedure. In addition to organisational measures, a proposal to impose remedial measures may include measures to impose a capital buffer or measures to relieve certain persons of their duties. Given the culture of the credit union sector, this type of measure is by no means rare. As in the case of banks, imposing fines is not very effective. In the event of serious shortcomings giving rise to doubts about whether the credit union is able to continue its business pursuant to the regulations, licence revocation is proposed.

Given the numerous shortcomings identified, increased attention will be paid in the period ahead to credit portfolio categorisation, sufficiency of provisioning, financing of groups of connected persons, compliance with regulatory limits and the origin of credit unions' capital, and the use of outsourcing.

## Insurance companies

The insurance sector is **systemically important** from the perspective of the financial market as a whole. It is specific in that it is dominated by two insurance groups. These two groups can be regarded as systemically important, as their failure would have a significant impact on the entire insurance sector.

The sector has a strong focus on sales, and its typical products – which are important with regard to their stabilising role in the economy in the event of large insurance losses – typically have low profit margins. In this environment, even small players are able to push market conditions beyond the boundaries of prudential business. The financial stability of individual insurance companies can in turn depend on these competitive pressures, amplified by the importance of independent insurance intermediaries.

<sup>22</sup> This is a general principle; the specific form and frequency of communication is always tailored to the specific characteristics of the institution. Cases of unfair practices and particularly serious and extensive breaches of duties imposed by law warrant a different approach.

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The new prudential **regulatory framework** may help cultivate the sector. Its level of sophistication gives insurance companies many opportunities to enhance their procedures and internal processes. The CNB is seizing this opportunity and constantly discussing the manner of implementation of the new regulation with individual insurance companies. This activity will gradually move from education to benchmark creation.

In the area of conduct of business, practical application – reflected in published benchmarks – plays a stronger role given the simplicity of the regulatory framework. This also opens up room for self-regulation. Both will apply until the current regulatory framework is replaced by European law.

As in the case of banks, **off-site surveillance** must be based on continuous contact with insurance companies. The CNB derives most of its current authority in this area from ongoing communication with insurance company employees. Its counterparties are most often insurance company employees who have a good knowledge of the technical substance of the insurance business. Under the new prudential regulations, more frequent contact with top management about specialised topics will be necessary. The CNB is already applying this approach in the internal model validation process currently under way. This is to make sure that insurance companies understand the more elaborate risk management procedures, as well as to stress their responsibility for correct implementation of the regulatory framework.

As regards prudence, supervision must be based on a good knowledge of the actual functioning of individual insurance companies. The findings of conduct of business supervision are equally important. The combination of these inputs and high-quality analysis of a broad data base creates conditions for forward-looking supervision.

Conduct of business supervision should not rely solely on suggestions from the public,<sup>23</sup> although these will remain an important input. Its approach should be more proactive and systematic. Regular thematic surveys should rank among its standard tools. Its analyses should be able to exploit risk management expertise. Judging from experience, this approach should result in fewer suggestions from the public and higher consumer confidence in the insurance sector.

A proactive approach is applied to **inspections** of important and risky insurance companies. The importance of this sector (represented mainly by its long-term liabilities to retail clients) and its potential riskiness (a high systemic cyclical tendency towards insufficient premiums connected with pressures on profitability and therefore insufficient provisioning) necessitate a **sufficient supervisory presence in selected entities**. A proactive approach focusing on ever-improving internal processes (amplified by the Solvency II requirements) and on sufficient implementation of all remedial measures after each inspection (thanks to follow-up inspections conducted after an appropriate period of time) again implies a sufficiently short inspection cycle. The **inspection frequency** in important and risky entities is therefore set at **five years**. In other entities (typically very **small, mostly single-branch insurers**), inspections are only carried out on the basis of a **reactive approach** in the event of strong negative signals.

**In the near future**, supervision will continue to be focused in the prudence area on assessing the adequacy and effectiveness of the implementation of the new Solvency II framework. Attention will be focused on the assessment of internal models. As in the banking sector, the new regulatory framework entails increased demands as regards its implementation into supervisory procedures. As

<sup>23</sup> See the separate sub-section below.

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in the banking sector, an integrated supervisory review process (SRP) is being implemented and conducted in the supervision of insurance companies. The components of this process are similar to those in the SREP. The RAS is also an integral platform.

Other challenges facing both insurance companies and supervisors will include:

- the risk of a persisting low interest rate environment,
- the ability to generate revenues to cover guarantees in insurance policies,
- changes in investment strategies,
- product changes,
- changes in the methodology for the adequacy of technical provisions,
- quality of risk management systems and asset and liability management systems,
- assessment of insurers' ability to absorb changes in risk parameters (stress tests),
- adequacy of technical provisions and premiums in vehicle liability insurance,
- monitoring of portfolio structure with regard to financial market developments,
- impacts of the new Civil Code, especially in the area of liability insurance and bodily injury losses, which can be expected to result in higher claim settlement costs,
- adequacy of the calculation of the best estimate of life insurance technical provisions and application of policy limits,
- aggressive dividend policies.

In the area of conduct of business, emphasis will be placed on further developing supervisory benchmarks and official information documents, which, where deemed useful, the CNB publishes to create a predictable standard for the concept of conduct of business. The absence of a more detailed legislative framework and best practices, coupled with often unlawful and unethical conduct by insurance intermediaries, poses a persisting risk to this sector. In the short term, the necessary changes in supervision and inspection should be delivered by the PRIIPs regulation.

In the area of conduct of business, supervision will be focused mainly on:

- the configuration of the governance system as regards control mechanisms for the management of distribution network quality,
- compliance with the rules for offering insurance products,
- the implementation of the requirements of the PRIIPs regulation and its subsequent application.

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## Pension management companies and their funds

Given the steady growth in total assets in managed funds and the need to ensure that claims can be settled for a majority of the post-working age population in the long term, the sector of pension management companies and their funds is a **systemically important sector**. Two PMCs control almost half the market. The market shares have long been stable and the market has no large growth potential in terms of recruiting new planholders. In view of legislative measures, the systemic impact of the failure of any single PMC is quite limited.

The **regulatory framework** for the sector is relatively detailed and accurate in those parts which mirror the regulation of management companies and investment funds, i.e. in the parts concerning the savings phase. The framework for the payment phase is relatively simple and relaxed. This may cause reputational risk to emerge in the sector owing to the system's potential to fail in the area of conduct of business.

PMCs are systematically supervised by **off-site surveillance**. This supervision lacks the extent and depth of that applying to credit institutions and insurance companies: less personnel capacity is assigned to individual PMCs, and a set of pre-defined indicators is monitored. Increased attention is paid to a PMC on an ad hoc basis if those indicators record a substantial fluctuation.

From the long-term perspective, supervision in the PMC sector is focused primarily on capital adequacy compliance, i.e. on whether PMCs keep their capital above the capital requirement, and in the case of transformed funds on compliance with the duty to always cover liabilities with assets. The CNB is paying increased attention to checking the investment limits of managed pension funds and participation funds, as the two-year temporary exemption from compliance with those limits expired at the end 2014 for most of these funds. Supervisors will focus on the effectiveness of the governance system, and in particular the quality of the risk management system and the asset and liability management system.

In the **inspection** area, the CNB endeavours to inspect all entities on an ongoing basis. This approach reflects the sector's sensitivity to failure and the number of participants in the system. The average inspection frequency is set at **five years**.

Given the previous intensive communication between the CNB and pension funds regarding measures to strengthen capital, PMCs perceive a relatively strong supervisory presence and are aware of the existence of reputational risks stemming from any shortcomings. The corporate culture in the pension fund sector is relatively high. This shapes the CNB's approach to dealing with **shortcomings identified**. In most cases, therefore, such shortcomings can be dealt with using supervisory tools.

In the case of PMCs, assessment of their compliance with the new legal framework will remain a supervisory priority. Inspections are focused mainly on the configuration of the governance system and on assessment of the risk management system and, in terms of conduct of business, on conformity of the requirements and needs of potential clients with the supplementary pension savings product negotiated and on migration of planholders from transformed funds to participation funds.

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## Management companies and autonomous investment funds

The sector of management companies and autonomous investment funds has been recording stable growth over recent years. The market is relatively concentrated, with the three largest management companies managing around 65% of the assets in fund portfolios. Funds for qualified investors have been showing a steady increase in assets.

The sector has been undergoing a constant process of legislative change since 2011 as a result of the UCITS 4 and AIFMD directives, implemented along with other new rules in the new Act on Management Companies and Investment Funds.

**Off-site surveillance** work is based mainly on data collected from information and reporting duties. This information is used primarily for supervising management companies and autonomous investment funds. Other inputs include suggestions from the public and thematic surveys.

Supervision of fund investment entities is focused mainly on funds for the public and entities with a significant systemic impact.

In the case of funds for qualified investors and individual asset management, where direct intervention of investors in the investments is assumed, supervision is focused mainly on whether the manager's governance system is correctly configured.

**Inspection work** is focused mainly on the configuration of governance systems in retail management companies and selected management companies managing funds for qualified investors whose failure could have a systemic impact on the sector. It also focuses on compliance with the rules of conduct of business in portfolio management, especially in the case of retail investment funds and the fee structure in collective investment.

In the sector of **management companies and autonomous investment funds**, the supervisory strategy is based on a **proactive approach** to inspections of the **most important and riskiest entities**. This approach is applied according to current outputs from the risk assessment system and supervisory findings on the entity concerned. The importance of entities (as expressed by their market share in retail fund investment) and their potential riskiness require a sufficient supervisory presence in selected entities. The inspection frequency is set at **five years** for the most important and riskiest entities. **A reactive approach is assumed for the other entities**, with inspections responding to any strong negative signals.

The approach to individual fund investment entities is graded, focusing on business models where retail funds predominate or which are associated with greater systemic risk.

## Investment firms

The investment firms sector comprises non-banks and banks (see above). The two most important investment firms account for about 60% of total trading in domestic securities on the Prague Stock Exchange. They are non-bank investment firms. Also subject to supervision by the CNB is a non-bank investment firm that has a significant share in total trading on some globally important organised commodity derivatives markets.



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The market environment in the investment firm sector is very competitive, with great pressure on the revenue side. In this respect, some investment firms may be motivated to compensate for missing revenues by engaging in conduct which does not accord with the best interests of their clients (typically front running or churning). The development of electronic platforms is being accompanied by a rise in trading in risky investment instruments such as contracts for difference and binary options, which are sensitive as regards the provision of services with professional care.

The (non-bank) investment firms sector has been affected only marginally by **regulatory changes** since the adoption of MiFID (primarily the implementation of the CRD IV/CRR package). Major changes in legislative framework are thus not expected before the implementation of MiFID 2.

Risk-oriented supervision of investment firms is based on an integrated supervisory review and evaluation process (SREP), which involves comprehensive assessment of the riskiness and viability of banks. The SREP is consistent across the sector, transparent, and based on clearly defined evaluation and quantification procedures. The outputs are used as a basis for the management of follow-up supervisory actions and the planning of supervisory resources. The SREP is an ongoing process with a summary output compiled annually. If necessary, the evaluation is performed outside the regular cycle (e.g. in connection with major findings obtained by an on-site inspection or in the event of significant changes in risk profile).

**Off-site surveillance** is focused on the area of conduct of business. As regards domestic investment firms specialising in intermediation, the crucial factor in the prudential area is the functioning of the specific governance system and strict separation of client assets and own assets.

The key supervisory activity in the conduct of business area is monitoring of transactions, complemented by investigations based on suggestions made by the public and other external suggestions, and thematic examinations. Transaction monitoring is based on data collected from both internal and external sources. Continuous analysis of transactions takes place on the basis of these data, focusing on market manipulation practices such as insider trading and front running and violations of the duty to provide professional care to clients (best execution, churning, etc.).

**Inspections** of investment firms complement off-site surveillance and are focused mainly on risky investment firms. Planned inspections serve mainly to check the functioning of the governance system and compliance with the rules of conduct towards clients. Unplanned inspections typically focus on investigating suspicious transactions.

A **proactive approach** is applied to inspection of **important or risky entities** in the investment firm sector. In this case, the supervisory cycle is set at six years. **In the case of investment firms which are not systemically important or risky, a reactive approach** based on ad hoc supervisory findings is applied.

## Consumer credit providers

The sector of non-bank providers of consumer credit has been supervised by the CNB since 1 December 2016. The sector contains companies which provided consumer credit based on a relevant trade licence. In some cases, these are companies which are assessed as systemically important. They have been operating in the non-bank providers market for a long time, have

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standardised procedures for the supply and provision of consumer credit and usually have a licence for the pursuit of business of a payment institution.

Before the Consumer Credit Act took effect, the sector of non-bank providers of consumer credit amounted to almost 60,000 trades. It consisted of a large group of entities operating across the entire range of services, from companies engaged in the provision of consumer credit secured by property, through leasing and traditional consumer credit, to companies providing micro-loans which were not subject to consumer credit regulation. Besides consumer credit providers, this segment includes companies authorised to test the professional expertise of all persons negotiating and assessing consumer credit ("accredited persons") and companies which provide consumer credit without proper authorisation or registration.

**Off-site surveillance** is based mainly on data from information and reporting duties. Off-site surveillance also involves investigating complaints from the public sent in to the CNB. These complaints are an important source of information for supervisory work, as they draw attention to potential shortcomings in the activities of supervised entities. Supervisors also focus on notifications about persons carrying on business without relevant authorisation. Off-site surveillance also consists in continuously monitoring the activities of supervised entities so as to identify and detect possible risky phenomena and link them with service conduct.

**Inspection work** focuses mainly on the configuration of the governance system and compliance with the rules of conduct towards clients. The supervisory cycle for consumer credit providers is set at **5–9 years** depending on their importance and riskiness. A **reactive approach** based on ad hoc supervisory findings is applied in other cases.

Since the Consumer Credit Act took effect on 1 December 2016, the CNB has also been responsible for supervising autonomous intermediaries of consumer credit and their tied agents and foreign intermediaries of consumer credit for house purchase.

## **Insurance, investment and consumer credit intermediaries (financial product distribution)**

The financial product distribution segment is characterised by a high number of entities subject to CNB supervision. The insurance intermediaries sector is the largest segment of the Czech financial market in terms of the number of entities supervised. There were more than 150,000 registered investment intermediaries in 2016. More than 7,000 entities were registered in the investment intermediation sector. Some of them were also intermediaries of supplementary pension savings contracts.

The **systemic importance** of the insurance intermediation sector consists in its impact on the stability of the insurance market, which derives from the current degree of dependence of insurance companies on insurance intermediaries. The systemic importance of investment intermediaries is lower – capital market institutions are less dependent on this method of selling. The scale of activity of insurance and investment intermediaries in terms of the number of clients and the value of contracts intermediated is very different and volatile over time. The turnover of entities in the sector is high. A similar trend is expected for consumer credit intermediaries.

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**Off-site surveillance** work is usually reactive, based mainly on data from information and reporting duties. Other inputs include suggestions from the public and thematic surveys.

**Inspection work** focuses mainly on compliance with the rules of conduct towards clients in the provision of services and on the configuration and functioning of the governance system.

A proactive approach to inspections is applied to important or risky entities, with an average inspection cycle of **four years**. A **reactive approach** is applied to **less important or less risky intermediaries**. Inspection work in the financial intermediation sectors is **accompanied by regular broad-based surveys focusing on the most problematic issues in financial intermediation and by investigations of suggestions from the public**. Supervisory and inspection activities will stay focused on observance of the rules of conduct of business vis-à-vis clients and potential insurance clients and on prevention of unlawful conduct by insurance and investment intermediaries.

In the area of insurance intermediaries, supervision will focus specifically on:

- conduct of business vis-à-vis clients of insurance intermediaries (including the issues of misselling and switching) and proper compliance with pre-contract information duties (including recording of the requirements and needs of potential insurance clients and the reasons for recommendations).
- the AML/CFT area, in the case of activities relating to life insurance,
- governance of financial intermediaries' own distribution networks (including identification of potential prohibited pyramid schemes in the case of insurance intermediaries).

The investment intermediaries sector has recently seen a slight decrease in the number of entities supervised, but the scope of activities of individual intermediaries remains broadly unchanged. In addition, many investment intermediaries have been authorised to intermediate contracts on supplementary pension savings, which has extended the regulated and supervised activities of individual intermediaries. Given the fact that – as in the case of insurance intermediaries – there are large differences between investment intermediaries in terms of the volume of services provided, supervision must be focused primarily on entities of high and medium importance. The most serious forms of unlawful conduct by investment intermediaries are misselling and churning, which in practice means that inspections focus mainly on the process of negotiation between investment intermediary and client, including the process of gathering and providing information.

In the area of investment intermediaries, supervision will focus mainly on:

- conduct of business vis-à-vis clients of investment intermediaries (including the issues of misselling and churning) and proper compliance with pre-contract information duties (including recording of the requirements and needs of clients and assessment of the suitability of products offered relative to clients' expertise and experience) and
- the AML/CFT area, as investment intermediaries are also obliged persons under the amended AML Act (in line with the implementation of the fourth AML Directive).

In the area of consumer credit intermediaries, supervision will focus mainly on:

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- conduct of business vis-à-vis clients of these intermediaries, proper compliance with pre-contract information duties (including advertisements and the provision of advice or recommendations to clients and the assessment of their creditworthiness) and verification of the essential elements of consumer credit contracts and consumer credit intermediation contracts,
- quality management and control systems in distribution networks, and
- the AML/CFT area.

### **Payment institutions, electronic money institutions, small-scale payment service providers and small-scale electronic money issuers**

The payment institutions sector currently contains 190 entities (excluding banks and credit unions providing payment services). With the exception of credit institutions, the sector is of **medium systemic importance**.

The payment institutions segment is currently being affected by changes in EU legislation (PDS 2 and the MIFS regulation). AML/CFT is a major area of risks in this sector. New harmonised rules for this area significantly affecting inspections of branches of foreign payment institutions are under preparation in an ESA committee.

With regard to the adoption of the Consumer Credit Act, the CNB is also focusing on compliance with the duties of non-bank payment services providers arising under this act. Some non-bank payment services providers under the Consumer Credit Act have authorisation to provide consumer credit under the Payment Systems Act; this involves the provision of loans relating to payment services provided.

The payment services providers segment is characterised by a constant upward trend in the number of supervised entities. The current number is almost double that in 2013.

**Off-site surveillance** is based mainly on a regular reporting duty. Payment institutions are supervised aggregately and compliance with defined indicators is assessed. Greater attention is paid to an institution if deviations from the expected values emerge. The CNB also acts on suggestions from the public or other external suggestions (above all from the Financial Arbitrator and the Financial Analytical Unit of the Ministry of Finance).

On-site **inspections** in non-bank payment services providers are currently focused primarily on systemically important entities, with an emphasis on the constantly growing category of small-scale payment services providers, given that some of these entities, with regard to their scope of activities, subsequently apply for a licence for the pursuit of business of a payment institution. The inspections aim to verify whether the systemic prerequisites for carrying on business are met. Emphasis is placed on compliance with conduct of business rules.

Supervisory practice in the non-bank **payment services** providers sector is based on a **proactive approach** to inspections of **important** payment institutions and electronic money institutions in terms of number of clients or potential money laundering risks. The CNB considers 4 or 7 years (depending

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on their importance) to be the optimal cycle. A reactive approach to inspections is applied to **small-scale payment services providers and small-scale electronic money issuers**.

## Bureaux de change

Around a thousand bureaux de change are currently registered with the CNB. Given the risks associated with providing bureau-de-change services and frequently repeated shortcomings on the part of bureaux de change, the sector receives comparatively greater attention even though **it is not systemically important**.

In 2014 the bureaux de change sector underwent changes related to a revision of the **legal framework** following the entry into force of the new Act on Bureau-de-Change Activities on 1 November 2013. A register of bureaux de change, managed and operated by the CNB, was created under this Act.

The approach to **off-site surveillance** is reactive, focusing on investigations acting on suggestions from the public. Data from regular reporting are used mainly to provide the focus for inspection activities.

As regards their scope, **inspections** are usually targeted with an emphasis on effectiveness – as in the case of financial product distributors. The CNB has identified systemically important bureaux de change, which are paid regular attention every 4 years. A reactive approach is also applied to inspections in other bureaux de change.

## Investigation of submissions from the public

Data from regular information duties can generally be used only to a limited extent in supervising compliance with the duties of supervised entities. Therefore, complaints from the public are an important source of information about the approach of supervised entities to clients, especially in the case of credit and payment institutions, bureaux de change and insurance companies. Findings obtained in off-site surveillance investigations when dealing with complaints, suggestions and enquiries from the public are used not only to eliminate shortcomings in the supervised entity's activities, but also to identify possible systemic shortcomings in the provision of financial market services.

In some cases, findings obtained when investigating submissions made by the public are used as a basis for **thematic surveys** focusing on the breadth of occurrence of unlawful conduct in the sector concerned. These findings are also used to identify supervised entities to be included in the on-site inspection plan as well as the specific areas of activity to which attention should be paid during on-site inspections. If systemic shortcomings are indicated on the basis of submissions from the public in the area of conduct of business in a large proportion of supervised entities, the supervisor requests the preparation and publication of a CNB interpretation regarding the specific duty imposed by law on supervised entities, and, where relevant, clarification or tightening of specific legal provisions governing the conditions of financial market service provision.

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The standard **approach to dealing with suggestions from the public** in the area of supervision consists in a comprehensive investigation of the suggestion. This investigation is not restricted to the conduct deemed unlawful by the submitter, but also looks into potential systemic shortcomings in the activities of the supervised entity identified on the basis of the suggestion. The primary reason why the CNB investigates clients' complaints against supervised entities is not to find out whether the client suffered a loss and whether such loss was caused by the supervised entity's conduct, but to fulfil the objectives of financial market supervision conducted by the CNB.

In order to fulfil its public law mandate and correctly identify whether the conduct complained against was random and does not necessitate special measures or, conversely, was systemic and does necessitate remedial measures or penalties, the CNB must assess each complaint in the overall context of the supervised entity's conduct towards the client in question. Following an initial assessment, if the complaint is deemed to be specific enough and indicate a potential breach of the supervised entity's legal duties, the standard course of action is to request relevant documents from the supervised entity to an extent that is usually broader than necessary to investigate the subject of the complaint.

In addition to inspections directly linked with the subject of the submission and with the suspicion of potential violations of valid legal rules indicated in the submission, information obtained in the course of the investigation must be analysed with regard to any other potential breaches of legal rules the observance of which is subject to supervision by the CNB and which might be identified using that information, so that the later use of that information in potential administrative proceedings is not rendered impossible by lapse of the preclusion period. As a result of the comprehensive assessment of all information gathered in the course of investigating suggestions from the public, shortcomings may be identified in the activities of a supervised entity even in cases where the suggestion itself is assessed as unjustified. The most typical shortcomings are non-compliance with the supervised entity's statutory information duty to the client resulting in the client misunderstanding the nature of the service provided, and the provision of an inappropriate service (misselling). Thus, even systemic shortcomings in a supervised entity's conduct in applying a generally binding legal rule may be identified on the basis of suggestions from the public. In addition, systemic shortcomings can often be identified on the basis of a greater number of complaints concerning the same conduct by a supervised entity even though the claims of the individual complainants cannot be proven.

Findings from investigating submissions made by the public are often a useful source of topics or ideas that need to be explained to supervised entities in more detail in the form of supervisory benchmarks.

In the case of systemic shortcomings of a broad-based nature (i.e. shortcomings pertaining to almost all entities in the relevant financial market segment) with a potential negative impact on clients (for example a change or manner of change in the terms and conditions for various financial market products), a CNB information document or public notice is prepared, explaining to clients the nature of the problem and the pitfalls they may face if they fail to study the terms and conditions carefully.

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## ABBREVIATIONS

1. AIFMD – Alternative Investment Fund Managers Directive
2. AML/CFT – anti-money laundering and combating the financing of terrorism
3. BRRD – Bank Recovery and Resolution Directive
4. CRD IV/CRR – Capital Requirements Regulation and Directive – a new regulatory framework for credit institutions and investment firms
5. CNB – Czech National Bank
6. EBA – European Banking Authority
7. ECB – European Central Bank
8. EFC – Economic and Financial Committee
9. EIOPA – European Insurance and Occupational Pensions Committee
10. EC – European Commission
11. ESA – European Supervisory Authorities
12. ESFS – European System of Financial Supervision
13. ESMA – European Securities and Markets Authority
14. ESRB – European Systemic Risk Board
15. EU – European Union
16. FATF – the Financial Action Task Force – an organisation participating in the creation of standards in the area of combating money laundering and terrorist financing
17. IAIS – International Association of Insurance Supervisors
18. ICAAP – Internal Capital Adequacy Assessment Process
19. IFRS – International Financial Reporting Standards
20. ILAAP – Internal Liquidity Adequacy Assessment Process
21. IOSCO – International Organization of Securities Commissions
22. IS/IT – information systems and information technology

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23. JLAD – Joint Liquidity Assessment Decision – a joint decision by supervisory authorities on the liquidity of a financial group and its individual supervised institutions, which also includes setting requirements for the liquidity management indicators of the individual entities
24. JRAD – Joint Risk Assessment Decision – a joint decision by supervisory authorities on the risk profile of a financial group and its individual supervised institutions, which also includes setting capital requirements for the individual entities
25. MiFID 2/MiFIR – Markets in Financial Instruments Directive and Regulation
26. MIFS – a regulation on multilateral interchange fees
27. MMoU – Multilateral Memorandum of Understanding – a multilateral international memorandum on cooperation between supervisory authorities
28. MoU – Memorandum of Understanding – an international memorandum on cooperation between supervisory authorities
29. PRIIPs – regulation on key information documents for Packaged Retail and Insurance-based Investment Products
30. PSD – Payment Services Directive
31. RAS – Risk Assessment System
32. Solvency II – a directive on the solvency of insurance companies
33. SREP – Supervisory Review and Evaluation Process – evaluation of an institution's risk profile by the supervisory authority
34. SSM – Single Supervisory Mechanism
35. TREM – Transaction Reporting Exchange Mechanism – international exchange of information on transactions concluded
36. UCITS – Undertakings for Collective Investment in Transferable Securities Directive – a directive on the coordination of legal and administrative rules concerning collective investment entities