

BANKING SUPERVISION

2004

BANKING SUPERVISION 2004

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METHODOLOGICAL NOTE

All data used in this publication are for banks with valid licences as of 31 December 2004, unless stated otherwise in the chapter heading or relevant passage. Data are always taken for the bank as a whole, i.e. including its foreign branches, with the exception of the data on the structure of credits and deposits by sector, economic activity and time, which cover bank transactions in the Czech Republic only.

The data for 2004 partly reflect the results of external audits, so they may differ from data previously published by the CNB. Some additional changes to the data given in this publication may arise. However, these should not significantly affect the trends described.

Extensive methodological changes to the calculation of particular indicators were introduced in 2002 following amendments to the Act on Banks and the charts of accounts for banks. Wherever possible, previous data have been recalculated using the new methodology in order to ensure maximum comparability over time. Some of the data may therefore differ from those published up to the end of 2001. The main changes are as follows:

- the deduction of securities accepted as collateral in reverse repos from total assets (in past years the value of trading CNB bills accepted by banks in reverse repos had been deducted from total assets) – this prevents reverse repos from being included twice in total assets;
- the introduction of separate monitoring of government coupon bonds, which allows them to be recorded independently of total coupon bonds and included in government bonds;
- the inclusion of creation and use of provisions and reserves for securities in profit/loss from financial activities (from securities transactions), due to the new structure of the profit and loss account;
- the inclusion of write-offs and expenses from transfer of receivables in net creation of reserves, provisions and write-offs, again due to the new structure of the profit and loss account.

FOREWORD

"Banking Supervision" is by now a traditional CNB publication. It aims to acquaint the general and professional public with the CNB's activities in banking regulation and supervision and to provide information on developments in the domestic banking sector, especially from the viewpoint of its financial situation and risk exposure.

The Czech banking sector has undergone substantial restructuring over the past few years, and its current situation can be regarded as stabilised. The sector has good financial results and sufficient capital to cover the risks it undertakes. For the first time in several years, no banking licence was revoked in 2004, no bank was under conservatorship, and no other "strong" regulatory instrument was used to regulate imprudent operation of a bank active in the domestic market.

The majority of the sector is controlled by foreign banks. The processes and standards applied in the foreign parent banks are used to enhance the management and control systems and internal rules and procedures in their domestic subsidiaries.

The Czech Republic's accession to the EU had no immediate impact on Czech banks, as their integration into the European financial system had been going on in previous years, especially after the privatisation of large banks was completed. Most of the rules regulating banking business had also been harmonised with EU rules in previous years.

EU accession resulted in a reduction of powers in the supervision of the branches of foreign banks active in the Czech Republic, which are now supervised by the CNB only to a limited extent. Primary responsibility for their supervision now rests with the home country regulator. The activity of CNB employees in European Commission and European Central Bank working groups became more intensive following EU accession. The observer status in these working groups changed into Member State status, with all the related rights and obligations. International co-operation with partner supervisory authorities was also stepped up, particularly in the context of the preparations for implementation of the new capital adequacy framework.

In the Czech Republic, co-operation between CNB Banking Supervision and other domestic financial market regulators continued. At the same time, preparations for gradual integration of these institutions were launched. As a gateway to this, banking regulation and supervision in the CNB were integrated into a single banking regulation and supervision department in mid-2004.

The Czech National Bank strives for maximum openness in providing information on its activities. I believe this publication will contribute to that end and will be a good source of information for every reader.

Michaela Erbenová
*Bank Board Member
and Chief Executive Director of the CNB*

A. BANKING SUPERVISION IN 2004

The Czech National Bank (CNB) developed its supervisory activities in 2004 in line with the Medium-term Strategy for CNB Banking Supervision for 2002-2004, which elaborates on the central bank's Medium-term Strategy. The basic goal in banking supervision is to create a comprehensive regulatory framework for banks and consolidated groups, a framework which must comply with the regulatory principles applied in the EU and in other advanced countries, ensure prudential business yet allow healthy competition. The aim as regards practical supervisory work is to improve both on-site and off-site supervision. Ever-closer co-operation with foreign regulators (especially with regard to the application of the single licence principle following the Czech Republic's accession to the EU) and with other domestic financial market regulators is becoming an important element.

Main supervisory tasks in 2004

In order to improve the conduct of banking supervision, the priorities for 2004 were defined on the basis of the Core Principles for Banking Supervision issued by the Basel Committee on Banking Supervision, the recommendations of the FSAP (Financial Sector Assessment Program)¹ mission and the changes in the banking sector resulting from the country's EU accession. The main priorities were:

- to concentrate banking supervision primarily on key risks,
- to intensify supervision on a consolidated basis,
- to intensify on-site inspections and to concentrate on the risks generated by new banking products,
- to enhance the knowledge of supervisory staff so that individual banks and consolidated groups can be supervised according to their risk profiles,
- to enhance the transparency of supervisory activities both to banks and to the public,
- to ensure a fast and efficient supervisory response to deficiencies identified,
- to enhance co-operation with domestic regulators and to eliminate some duplication of effort in banking supervision,
- to introduce regulatory provisions stipulating the requirements for the management of banking risks,
- to determine regulatory requirements for anti-money-laundering and anti-terrorism-financing procedures in banks,
- to complete the implementation of rules connected with the Czech Republic's accession to the EU and to participate in the activities of European Central Bank bodies and institutions,
- to enhance co-operation with foreign regulators.

The Core Principles for Banking Supervision were complied with in 2004. In order to improve regulation and foster efficient banking supervision, responsibilities were defined within a new organisational structure of CNB banking supervision and regulation. Laws and other regulations establishing a minimum set of prudential standards were adopted. More information on the financial strength and results of the banking sector is publicly available. The independence of CNB Banking Supervision and its funding is provided for in law. CNB Banking Supervision's authority is founded on the professionalism and credibility of its staff. Information is exchanged between the Czech financial market supervisory authorities based on a trilateral agreement. There is increasing co-operation between the regulators of the domestic banking sector and regulators in other countries. An in-depth report

¹ The Financial Sector Assessment Program was conducted jointly by the International Monetary Fund and the World Bank. It is based on the identification of the financial sector's strengths and weaknesses and system problems, and also areas which need to be improved for the financial sector to develop further and be stable. An integral part of the FSAP is an assessment of compliance with relevant international financial sector standards. The assessment for the Czech Republic was carried out in 2000 and updated in 2004.

on compliance with the Core Principles, including additional up-to-date information on the soundness and strength of the banking sector, is published on the CNB website (<http://www.cnb.cz>).

1. LEGISLATIVE CHANGES IN THE BANKING SECTOR IN 2004

Harmonisation of the banking regulations with European Community law was the main driving force behind the legislative and regulatory changes in 2004. Five revisions to the laws relating to the banking sector were made. An amendment to Act No. 126/2002 Coll., on Banks, a new Act No. 256/2004 Coll., on Capital Market Undertakings, Act No. 190/2004 Coll., on Bonds, and Act No. 189/2004 Coll., on Collective Investment, became fully effective on the Czech Republic's accession to the EU on 1 May 2004. And a comprehensive harmonisation amendment (No. 284/2004 Coll.) to Act No. 61/1996 Coll., on Some Measures Against Money Laundering, entered into force on 1 September 2004. The Czech National Bank played a significant role in preparing these laws.

On the Czech Republic's accession to the EU (on 1 May 2004), the last comprehensive harmonisation amendment to Act No. 126/2002 Coll., on Banks, became effective. The following provisions became legally binding on that date: the provisions on the single banking licence principle (see section 4 for details), the CNB's duties and rights (particularly in the areas of information and consultation) vis-à-vis regulatory authorities from other EU Member States and the European Commission in the conduct of banking supervision on a solo and consolidated basis, and also, for example, a consumer protection provision stipulating banks' duty to implement an efficient procedure for dealing with clients' complaints and to provide information on that procedure on their premises.

Act on Banks

The Act on Banks was further amended by two other laws in 2004. The first amendment, related to the adoption of the new Capital Market Undertakings Act, the Bonds Act and the Collective Investment Act, adjusted the wording of some provisions of the Act on Banks to these new laws and clarified some ambiguities regarding the interpretation of the harmonisation amendment. As a result of that amendment, the issuance of mortgage bonds is no longer an activity licensed by the CNB and the regulation of this activity was entirely dropped from the Act on Banks (and remains only in the Bonds Act and the relevant implementing regulation). The definition of financial institution was modified to include also natural persons in accordance with European Community law. The wording of the Act was also brought into line with commercial law interpretation practice, according to which a controlling or significant influence (a controlling or qualifying holding) can be exercised not only in a legal entity, but also in the business of a natural person. Any natural person who has become subject to supervision on a consolidated basis as a financial holding company due to the change in the definition of financial institution is obliged to start fulfilling the requirements arising from the consolidated supervision rules by the end of 2006 at the latest. In order to bolster market discipline, banks are required to publish an annual report including audited financial statements within four months of the end of the accounting period, and to submit it to the CNB within the same time limit.

The second amendment to the Act on Banks was made in connection with the comprehensive harmonisation amendment to the Act on the Protection of Personal Information. This amendment expressly requires banks to collect and process, for the purposes of banking transactions, the relevant personal data (with the exception of sensitive data on natural persons) necessary to perform a banking transaction without excessive legal and material risks for the bank.

<i>New laws regulating banking activities</i>	Three new laws related to banks' activities on the capital market became effective on the EU accession date, namely the Capital Market Undertakings Act, the Bonds Act and the Collective Investment Act.
<i>Capital Market Undertakings Act</i>	The Capital Market Undertakings Act replaced the public-law (regulatory) part of the Securities Act. From the point of view of banks the regulatory burden decreased somewhat, as in some of the areas where banks that are also active as securities dealers had previously been regulated/supervised twice (by rules falling within the responsibility of the CNB and rules falling within the responsibility of the Czech Securities Commission) this Act does not apply to them and they are governed only by the banking regulations (Act on Banks, CNB provisions and decrees). However, banks are still licensed to provide investment services in respect of certain investment instruments by the Commission, which supervises their performance of such activities. Banks are also subject to the duty imposed on brokerage houses to contribute to the Guarantee Fund, which by law pays compensation for insured customer assets if a dealer (bank) becomes insolvent. This Act and an accompanying amending act also ensured the inviolability of close-out netting under Czech law for the first time.
<i>Bonds Act</i>	The most important change in the new Bonds Act from banks' and the banking supervisor's point of view was a change to the regulation of mortgage bonds as bonds whose face value and proportional yield are covered by receivables from mortgage loans or parts thereof (regular coverage) and, if necessary, also in a safe alternative way pursuant to this Act (alternative coverage). Mortgage bonds may still only be issued by domestic banks (i.e. not by foreign bank branches or non-residents). Mortgage loans, however, are no longer defined in terms of their purpose (up until 30 April 2004 they had to be used for building work or for acquiring or upgrading real estate), but only in terms of the legal means whereby repayment is ensured - a lien on property, including unfinished property. Property acting as a pledge securing a mortgage loan serving as regular mortgage bond coverage can now be located in any EU or EEA Member State. The Act stipulates general rules for the valuation of pledged property. The Act charges the CNB with issuing an implementing regulation on the requisites of the records of coverage of mortgage bonds and with supervising compliance with the rules on adequate mortgage bond coverage (see below for details).
<i>Collective Investment Act</i>	The Collective Investment Act replaced the former Investment Companies and Investment Funds Act. From the regulatory point of view, the part regarding the rules governing the activity of a collective investment fund depository is probably the most important for banks. The activity of the depository is a significant control element in collective investment regulation, and depositories are also subject to a number of disclosure duties to the Commission. A bank or foreign bank branch must have authorisation to perform the activity of a depository in its banking licence, but the Act requires no further licences from the Commission. After reaching agreement with the Commission and holding consultations with some foreign supervisory authorities, the CNB arrived at the conclusion that the activity of a depository is the only one of the banking activities defined by the Act on Banks that does not fall under the European single licence (i.e. it is not a mutually recognised activity under European law).
<i>Act on Some Measures Against Money Laundering</i>	On 1 September 2004, a comprehensive harmonisation amendment to Act No. 61/1996 Coll., on Some Measures against Money Laundering and on the Amendment of Related Acts, took effect. Besides further extending and clarifying the duties of financial institutions and other relevant persons in the prevention of money laundering, this amendment entailed, for example, an addition to the definition of a suspicious transaction to include terrorist financing, and significant qualitative changes in the scope of the transaction participant's identification duty

(emphasising that banks and other relevant persons should adhere to the "know-your-customer" principle). The CNB's powers to monitor compliance with all the requirements of this Act were also extended (in addition to the general responsibility of the Ministry of Finance).

In 2004, the Czech National Bank also issued new provisions and decrees and amended existing ones regulating and changing the regulatory framework for banking business. These provisions relate to the strengthening of internal control systems in banks and respond to developments in accounting and the transfer of the regulation and supervision of mortgage bond coverage from the Czech Securities Commission to the CNB.

The main purpose of Provision No. 2 of 3 February 2004 was to combine the previous four qualitative provisions on the internal control system, market risk management, credit risk management and liquidity management standards, which were originally issued separately, into a single regulation. All these provisions placed demands on individual parts of banks' internal control systems. The aim was to consolidate the provisions so that the individual requirements providing for the effectiveness of internal control systems and risk management create a logical whole and the significance and impact of the individual requirements is clear and cohesive.

At the same time, requirements for those internal control system elements which had not previously been addressed in regulatory terms were incorporated into this consolidated provision. These requirements concerned operational risk, information systems and internal auditing.

The amendment to Provision No. 6 of 15 September 2004 comes in response to developments in accounting and to the obligatory use of international accounting standards (IFRS) by banks that are issuers of registered securities. The banks use the same method to determine provisions for compliance with the prudential rules as they do for keeping their accounts and compiling their financial statements, which prevents the occurrence of parallel records and discrepancies. The banks that follow IFRS when setting provisions estimate their expected cash flows from receivables or collateral. Other banks, provided they are sufficiently prepared, can also apply the IFRS method. If not, they determine their provisions as previously using a coefficient on the unsecured value of the receivable. Upon request the bank has to prove the reliability of its estimate of expected cash flows and justify any difference from the calculation of provisions by the coefficient method. The bank deducts from its capital any difference that it is unable to justify.

This amendment also adds another form of portfolio approach. The bank places any evaluated receivables for which it does not individually identify a diminution in balance sheet value into a portfolio of receivables with similar credit risk characteristics. It then finds out whether a diminution in the balance-sheet value of this portfolio has occurred. Standard receivables from debtors from a specific sector can serve as an example. Imagine, for example, that no receivable displays any signs of a diminution in value but the sector as a whole is in an adverse situation. If, however, the bank has information that a receivable included in portfolio displays the features of a watch or non-performing receivable, it removes it from this portfolio and classifies it as a watch or non-performing receivable. In 2005, as in the past, the bank may use the portfolio approach for individually insignificant receivables. However, the amendment newly states that as soon as a bank has sufficient information on the diminution in value of an individual receivable it must remove it from the portfolio and deal with it on an individual basis. However, this excluded receivable is taken into account when applying the statistical model and when monitoring the actual losses associated with the portfolio.

Changes to the banking business regulations

Provision on the Internal Control System

Amendment to the Czech National Bank Provision stipulating Rules for the Assessment of Financial Receivables and the Creation of Provisions and Reserves, and Rules for the Acquisition of Certain Types of Assets

The content, method of keeping and requisites of records of coverage of mortgage bonds

The Czech National Bank has been empowered by the new Act No. 190/2004 Coll., on Bonds, to monitor the compliance of banks that issue mortgage bonds with specific obligations ensuing from the Bonds Act. These duties include, in particular, the obligation to cover liabilities from mortgage bonds in circulation by selected assets, primarily receivables from mortgage loans, to keep a separate register of coverage of liabilities from issued mortgage bonds in circulation, and to fulfil an information duty. In this connection the CNB was authorised by the Bonds Act to issue a provision stipulating the content and method of keeping of the register of mortgage bonds coverage.

Based on this authorisation the CNB on 11 June 2004 issued Provision No. 5 stipulating the content, method of keeping and requisites of records of coverage of mortgage bonds. The records of coverage consist of a register of coverage and a book of coverage.

The "coverage register" is a list of assets, primarily obligations from mortgage loans, bonds or deposits, including essential information on these assets, which are used to cover obligations from issued mortgage bonds in circulation. In the "coverage book", the issuer keeps full records of obligations from all the mortgage bonds in circulation it has issued and a valuation of the assets listed in the coverage register. The issuer keeps records in such a manner as to be able without delay to submit to the CNB upon its request documents justifying the entry of each asset item in the coverage register. To prevent conflicts of interest, and in line with international practices, the register has to be administered independently of business units that are responsible for providing mortgage loans or for issuing mortgage bonds. Issuers are obliged to meet the requirements of this Provision as from 31 March 2005.

Disclosure of information by banks

A small technical amendment - in effect since 1 January 2005 - was also made to CNB Provision No. 9 of 22 December 2004, stipulating the minimum requirements for information disclosure by banks.

Official information

A total of nine official information documents concerning the laws, decrees and provisions falling within the competence of CNB Banking Supervision were issued in 2004. These documents, which are of an informative or interpretative nature, dealt with the following issues:

- the extract from a bank's issue of shares,
- money brokering,
- the single banking licence,
- treatment of claims on the European Investment Bank for prudential rules purposes,
- requirements for netting agreements (final netting) when calculating credit risk,
- equity indices for calculating equity risk,
- calculation of capital adequacy and exposure for investments in asset-backed securities,
- the term "information system of the bank" in Provision of the Czech National Bank No. 1 of 8 September 2003 on the internal control system of the bank for the area of money laundering prevention,
- the repealing of some of the CNB's official information in the area of prudential rules for banks.

A full and updated list of the CNB's prudential provisions, decrees and official information currently in force can be found on the CNB website (http://www.cnb.cz/leg_bd.php).

2. PERFORMANCE OF BANKING SUPERVISION

The Czech National Bank is the regulator and supervisor of the banking sector.² The Czech Republic's accession to European Union on 1 May 2004 brought some major changes both in the regulations and in banking supervision performance. The regulatory changes relate to the legislation. On 1 May 2004, the single licence started to apply in the Czech Republic. The powers of home and host supervisors were redefined. The CNB's banking supervisory competencies were partially limited as from this date. A change has arisen in the case of foreign bank branches from EU countries – the Czech National Bank now supervises them primarily in the liquidity area and monitors their compliance with the obligations of the Act on Banks (see section 4 - single banking licence principle; http://www.cnb.cz/leg_bd_reg_jednotna_licence.php). The emphasis is on closer co-operation and communication with partner authorities in EU countries, owing to the high share of foreign owners in domestic banks and their prevailing orientation towards EU countries. Monitoring of notifications of foreign banks offering banking products and services on the Czech market under the single licence has become part of the CNB's supervisory work.

Banking supervision in the Czech Republic continues to take the form of off-site surveillance and on-site examinations. Off-site surveillance is based on ongoing monitoring of banks' activities and on regular financial analyses. In this area of competency the CNB has to carry out licensing and authorisation activities under the Act on Banks. It newly registers entities operating under the single licence, including the scope of their activities. On-site supervision, consisting of examinations directly in banks, is the basic tool for assessing, in particular, the qualitative aspects of banks' activities, including their management and control mechanisms.

The new organisational structure of CNB Banking Supervision corresponds to its competencies. The changes in banking supervision on accession and, in particular, the ongoing changes in the regulation and supervision of the entire financial market are reflected in the new set-up. Since mid-2004, instead of two departments the CNB's regulatory and supervisory activities have been covered by just one Banking Regulation and Supervision Department performing the main tasks of the approved medium-term strategy. Since February 2005 this department has consisted of five divisions. The Regulation Division deals with legislative and methodological activities. Off-site surveillance (monitoring, analyses of banks and the banking sector, relationships with banks, notifications) is performed by only one division, whose activities are focused on the entire banking sector and the profile bank groups (large banks and specialised banks, medium-sized banks, small banks and building societies; foreign bank branches are monitored and supervised with regard to compliance with the liquidity rules). The issue of licensing and penalties is concentrated in the Licensing and Enforcement Division, which also covers activities relating to banks whose licences have been revoked. The On-Site Banking Supervision Division specialises in particular risk areas. It is responsible for credit risk and internal control systems (including money laundering prevention) and market and operational risks, including bank information system risks. The fifth division provides support to all the executive units and is also responsible for the management and development of the credit register.

² Four financial sector regulators were active in 2004. In addition to the CNB, which is the regulator of the banking sector, there was the Czech Securities Commission, which regulates and oversees investment companies, investment funds and securities traders. Insurance companies and pension funds are supervised by the Czech Ministry of Finance. The Office for Supervision of Credit Unions operates independently as the supervisory authority for credit unions. Up to the end of 2005, when the supervisory institutions are expected to merge, the Czech National Bank will remain the only regulatory and supervisory body for banks and credit unions, and after the transformation of the Securities Commission a new supervisory authority for the capital market, insurance companies and pension funds will be established. (For details, see section 8 – *Co-operation with other financial market regulators in the Czech Republic*).

2.1 OFF-SITE SURVEILLANCE

Principal off-site supervisory activities

Off-site supervision consists chiefly of regular monitoring of the activities of individual banks and the sector as whole, reviewing compliance with the prudential rules and limits, and the imposition of remedial measures when problems are identified. It is based on continuous appraisal of all available information on banks' activities, taken from various sources, in particular the statements and reports regularly submitted by banks on a solo and consolidated basis, auditors' reports, the results of on-site examinations and information-gathering visits, and other sources, including publicly available reports. To obtain additional information on banks' activities and performance, a series of meetings with bank representatives were held during 2004.

The main analytical instrument employed in off-site surveillance is regular comprehensive analyses of the financial condition of banks in relation to the risks they undertake. To identify potential negative tendencies in time, the monthly early warning system on each bank is regularly appraised for the management of CNB Banking Supervision. Proposals are made for further supervisory action in banks showing negative trends. The development of the banking sector as a whole is also subject to analysis, including regular disclosure of aggregate information on the sector for the professional public on the CNB website (http://www.cnb.cz/bd_bsindex.php).

Staff involved in off-site surveillance use an automated Banking Supervision Information Centre, which pools the data from all the supervisory reports and statements and generates standard outputs. This informational support provides a quick overview of the main indicators of each bank's financial condition and its compliance with the prudential rules.

In addition to regular assessment of the financial condition of banks, off-site surveillance also involves the assessment of the competence, trustworthiness and experience of persons nominated for executive managerial positions in banks and the approval of external auditors, lists of shareholders prior to general meetings, the inclusion of subordinated debt in a bank's capital, etc. A total of 117 decisions were issued in 2004 in this connection.

Auditors' reports as a source of information

In 2004, auditors' reports on banks' internal control systems and risk management systems were evaluated for the second year. These reports are an important source of information on control systems and risk management systems in individual banks in periods when no on-site examination covering the given area is conducted. In 2004, CNB Banking Supervision obtained auditors' reports on a total of 22 control system areas in 14 banks, evaluating these banks' condition as of 31 December 2003. The area most frequently examined by auditors was, as in the previous year, credit risk management systems. Trilateral discussions with individual banks and auditing companies were subsequently held to assess the results of these examinations. The CNB's requests for examinations for 2004 were commissioned in the same way. These examinations concern seven banks, and the results from them will be appraised in 2005.

Remedial measures

On the strength of the findings from off-site supervision and on-site inspections, remedial measures were imposed on a total of 13 banks. These measures required the institutions concerned to eliminate shortcomings in their activities within a set timeframe. Banks' progress in eliminating shortcomings is constantly monitored. In 2004, CNB Banking Supervision brought no penalty proceedings to revoke licences or impose fines for violations of the Act on Banks. To eliminate shortcomings detected in banks during on-site inspections or off-site surveillance, the supervisor used alternative and equally effective instruments available to it under the law. These led to the required corrections as regards compliance with the prudential rules.

The co-operation between the CNB, the Ministry of Finance and the Czech Securities Commission, based on a trilateral memorandum of understanding signed in February 2003, continued in 2004. Based on this memorandum, working groups composed of CNB, Securities Commission and Finance Ministry representatives were set up in 2003 for the individual consolidated groups, consisting of entities supervised by the different regulatory institutions. A second round of meetings of these working groups took place in 2004. Their members exchanged the necessary information on individual entities within each consolidated group, their activities and the activities of the regulatory bodies vis-à-vis these entities. Where necessary, the working groups' members exchange up-to-date information throughout the year.

Consolidated supervision and co-operation with regulators

2004 saw continuing exchange of information on the basis of memoranda of understanding with foreign regulators responsible for supervising parent banks that have subsidiaries in the Czech Republic. In 2004, memoranda of understanding were signed with the central banks of the Netherlands and Italy. The CNB has so far signed eight bilateral memoranda of understanding. Besides exchanging information on the financial position of banks of mutual interest, the meetings with foreign regulators focused more on practical issues related to the co-ordination of work during the introduction of the new capital framework.

2004, the year in which the Czech Republic joined the European Union, was marked by fairly intensive work in the area of licensing and authorisation proceedings.

Licensing and authorisation activities

The re-licensing of banks, launched at the end of 2002 in connection with the process of harmonising the Act on Banks with the European banking directive, was completed in the first half of 2004. Banking licences were granted to the remaining 15 banks (the last one on 25 May 2004) pursuant to the transitional provisions of the harmonisation amendment to Act No. 126/2002 Coll., on Banks.

On 1 May 2004, the EU entry date, the nine foreign bank branches operating on the Czech banking market automatically switched to the single licence system. In practice this means that as of this date branches of banks from EU countries are – in respect of most of their activities – subject to supervision by the supervisory authority of the country where the foreign bank has its registered office. One more branch of a foreign bank (from Austria) was established under this system in 2004, but it did not open for business until the start of 2005.

In 2004, CNB Banking Supervision issued a total of 35 administrative decisions. Besides the aforementioned issuing of bank licences (re-licensing in compliance with the law, at the CNB's initiative) these mostly concerned banks' applications for licence changes (extensions) – eight cases; consents to acquire qualifying holdings in banks (changes in the shareholder structure of banks) – four cases; permission to merge – two cases; plans to open a branch in an EU Member State – one case; and the sale of part of a business – one case.

In 2004, one application for a licence was submitted to the Czech banking regulator by an applicant based in a country outside the EU. The administrative procedure in this matter has been halted.

EU accession also opened up the Czech banking market to other banking entities, which can benefit from free movement of services.

A total of 63 banks from EU countries reported their intention to provide some or all of the mutually recognised banking activities in 2004 (fourteen banking activities under the Banking Directive). These institutions are supervised by the home country regulator.

2.2 ON-SITE EXAMINATIONS

In line with common EU practices and global trends, the CNB's on-site inspections in 2004 focused on assessing control processes in key areas of banks' activities. These include credit risk management, market risk management, money laundering prevention, the functionality and effectiveness of internal control systems, and information systems and technology.

Ten inspections were conducted in ten banks in 2004. Five of these were comprehensive checks, covering all main risk areas in the bank. The other five were partial, focusing on one or several selected areas of bank activities.

The key indicators of banks' soundness include information on credit portfolios, capital adequacy, liquidity and several other important areas. These data come from banks themselves and are submitted to CNB Banking Supervision in the form of regular statements. Their correctness is a crucial prerequisite for effective off-site supervision. For this reason, an examination of the methods used by banks to create these statements and reports was again a standard part of on-site inspections in 2004. The supervisors concentrated primarily on examining procedures associated with the aggregation of primary data and the maintenance of their integrity and correctness when the individual statements are compiled. The checking of the reporting system does not include any assessment of the correctness of the primary accounting data, which is carried out by external auditors as part of the auditing of banks' final accounts.

Examinations of individual risk management systems

As regards the individual banking risks, CNB Banking Supervision in 2004 focused on management of credit risk (linked not only with credit transactions, but also with trading on financial markets), market risks (i.e. interest rate risk, equity risk, foreign exchange risk and commodity risk), liquidity risk, information systems and information technology (IS/IT) risks, and risks associated with striking, processing and settling deals on the money, capital and forex markets. In these areas, emphasis was laid mainly on the method used by banks to identify, measure, evaluate, monitor and manage the risks to which they are exposed. The methods used to measure, assess and monitor risks were subject to appraisal, including verification of whether the data in banks' information systems are correct, reliable and up-to-date. The supervisors also examined whether the bank had in place adequate prerequisites for efficient and effective management of the risks it undertakes, particularly as regards the organisation, management and control of major processes, clear definition and assignment of responsibilities, segregation of conflicting duties, adequacy of internal regulations, etc. This examination of risk management systems is based on the fact that the quality of the above processes greatly affects the risk profile of each bank and the banking sector as a whole. Inspections of selected risk management systems not only assure the supervisor that risk management is adequate and capital sufficient at the time of the inspection, but also allow it to predict the likely future development of each bank's risk and capital management systems with a reasonable degree of certainty.

Credit risk remains the largest risk undertaken by banks. The examination of credit risk management systems involves checking a sample of loan receivables from nonbank clients. This is taken from various client segments so as to provide the information needed to assess the condition and quality of the bank's credit portfolio, lending-related processes and credit risk management system. Also assessed are its systems for evaluating client creditworthiness, identifying and monitoring groups of economically connected entities, managing and assessing credit transaction quality, creating provisions, and assessing and valuing collateral. Five credit risk checks were conducted in five banks in 2004, focusing on verifying credit risk management systems for transactions with non-bank clients.

Besides the standard market risk checks, market risk examinations also usually involve assessing the risks arising from acting as a depositary and providing custody services. These inspections are primarily intended to evaluate whether the bank is acting in compliance with the legislation, prudential rules and generally recommended procedures. Market risk examinations were conducted in seven banks in 2004.

The IS/IT controls performed in 2004 concentrated on how banks manage, develop and operate their information systems. The attention paid by CNB Banking Supervision to this significant component of operational risk is linked with the dynamic development, use and growing influence of IT on banks' overall risk profiles. In 2004, greatest emphasis was placed on evaluating the efficiency of processes related to risk identification, assessment and mitigation. In addition to evaluating information safety management systems primarily in terms of organisation, objectives, priorities, principles and clear division of powers and responsibilities, the examination explored how the said aspects were reflected in practice in the specific measures adopted by banks in the area of physical, logical and personal security. Security aspects were also dominant in the evaluation of IS/IT development and operation. Owing to the growing importance of communications networks, the attention paid to this area was further strengthened in 2004. Continuity management and management of the risks associated with IS outsourcing are also a standard part of the checks. Five IS/IT examinations were conducted in 2004.

In the context of Basel II implementation, the drafting of the corresponding EU directive and the generally growing awareness of the importance of operational risk, preparations for the exercise of supervision in this area in the form of on-site inspections were launched at the end of 2004. The inspection activities are expected to be put gradually into practice in 2005. These inspections will primarily evaluate the level of implementation of the requirements for operational risk management as stipulated by Provision of the Czech National Bank No. 2/2004, on the internal management and control system of a bank. An internal methodology for operational risk inspections has been developed for such purposes and will be updated based on the experience from the inspection work.

In 2003, one bank was granted consent to use its own VaR (Value at Risk) model for calculating capital requirements for market and specific risk. The process to assess whether the model had been implemented correctly was followed up in 2004 by continuous co-operation with the bank as regards adjusting and extending the model.

In 2004 Q4, two teams were set up in the on-site supervision division specialising in the implementation of advanced methods for determining capital requirements for credit risk (the IRB approach) and operational risk (the AMA approach) in compliance with the planned new capital adequacy framework (Basel II). The activities of these teams are integrated with the trilateral project of the Czech Banking Association, the Chamber of Auditors of the Czech Republic and the CNB. The main tasks of the teams include closer co-operation with banks during their preparations for the application of the advanced methods, and the specification of minimum qualitative and quantitative requirements for both approaches, including discussions thereon with the Czech Banking Association.

Owing to the application of the advanced approaches on a solo and, above all, consolidated basis, enhanced co-ordination with foreign banking supervisory authorities is an integral part of the teams' work. The aim of such co-ordination is to agree a joint procedure for verification of the advanced approaches in order to streamline the implementation of these approaches and the future approval

Ongoing co-operation with banks concerning their internal models for calculating capital requirements for market and specific risk

Preparations for Basel II implementation with regard to advanced methods for determining capital requirements

process as far as possible. Several meetings on this issue were held in 2004, with further meetings being scheduled for the first half of 2005.

Verifying the operation and effectiveness of internal control systems

Examinations in this area are conducted not only as part of the examinations of particular risk management systems (assessing in particular the operation and effectiveness of the internal management and control system for the relevant business area of the bank, including the overall control environment), but also as a separate area of comprehensive control. The basic areas subject to checking are corporate governance, the compliance function and the internal audit function. Such examinations were conducted in six banks in 2004.

In the area of corporate governance, the inspections focus on evaluating the organisational structure of the bank as a whole, the functioning of the supervisory board and its advisory bodies, the board of directors and other management and advisory bodies, and the links between those bodies. The inspections also involve checks of the efficiency and effectiveness of the control environment, including the individual control mechanisms built into the bank's routine activities.

In the area of compliance, the inspections focus on the bank's system for monitoring legislative developments and for incorporating legislative changes into its internal regulations. Also verified is whether the bank's regulations and procedures are complete, intelligible and consistent, and whether its staff abide by them. In this context, an assessment is made of whether the bank complies with the legislation and generally recommended procedures (best practice) and whether and how it applies "soft standards", in particular the principles of the general code of ethics.

In the area of internal auditing, the examinations focus on the organisation, methodology and staffing of the internal audit department. The independence of the internal audit department and its links to each of the company's bodies are evaluated. Also examined is the method whereby the bank's risks are assessed by the internal audit department, the internal audit planning process, the actual orientation of the internal audit department's work, and the quality of the outputs generated by each audit. An assessment is also made of whether the bank has a functional and effective system for eliminating problems identified by the internal audit department and whether the managers of the bank pay sufficient heed to corrective measures.

In 2004, the Czech National Bank also took part in a pilot project run by the World Bank in the area of the corporate governance of the Czech banking sector. The World Bank's recommendations will be applied in banking supervisory practice.

Prevention of money laundering

The operation and effectiveness of the bank's anti-money laundering system is examined. Supervisors concentrate on the following areas: the strategy and internal control system in this area; compliance of the bank's system with the legislative requirements; observance of the relevant provisions of the legislation; practical application of an appropriate "know-your-customer" policy; and the bank's ability to detect and evaluate suspicious transactions and to notify the Ministry of Finance's Financial Analytical Unit within the statutory time limits. Such examinations were conducted in six banks in 2004.

The Czech National Bank works closely with the Ministry of Finance's Financial Analytical Unit in this area.

3. NEW BASEL CAPITAL ACCORD

In 2004, the Czech National Bank continued its activities relating to the preparation for and implementation of the new capital framework – usually referred to as Basel II. The first draft of the new framework was prepared by the Basel Committee on Banking Supervision (BCBS) in 1999. The most recent revised version, entitled "International Convergence of Capital Measurement and Capital Standards", was published by the BCBS in June 2004.

The aim of the new capital framework is to increase the safety and soundness of financial systems and to enhance competitive equality among banks and management responsibility. In general, the framework concentrates on more accurate risk measurement and on promoting enhanced risk measurement in banks. By applying more risk-sensitive approaches, banks can make better and more efficient use of capital to cover their risks. The aim is to introduce capital regulation of operational risk and reflect credit risk more accurately in capital requirements. The new rules will facilitate convergence of the banks' internal risk management and measurement systems to the regulatory rules.

The difference between the current system (Basel I) and the new framework (Basel II) lies not only in greater complexity and flexibility for measuring risk exposure, but also in the inclusion of an additional risk, namely operational risk. At the same time, the applicability of the framework has been extended to fully cover not only the risk of the individual bank (on a solo basis), but also the risk of the whole bank group. The framework is supposed to be applied on a consolidated basis by internationally active banks. However, in order to take into consideration the different conditions in each country, Basel II allows the competent – usually national – supervisory authority to opt for one of two or more admissible alternative procedures in a number of areas (national discretion). In some provisions, discretion for banks is also allowed for similar reasons.

The newly proposed framework is based on three pillars. Pillar 1 contains methods for risk management and for setting capital requirements for credit, market and operational risk. The methods for market risk measurement remain unchanged, except for interest rate risk in the banking book. Pillar 2 focuses on the assessment of the bank's capital adequacy by the bank on the one hand and by the regulator on the other hand. The basic principle consists in the bank putting appropriate internal processes in place to assess the adequacy of its capital in relation to its risk profile. The supervisory authority examines these processes and their outputs. It is entitled to set the capital requirement higher than that calculated by the bank if it considers the capital requirement set by the bank insufficient in relation to its overall risk profile. A capital ratio of 8% of the value of risk-weighted assets will be still considered the absolute minimum. Pillar 3 deals primarily with the issues of bolstering market discipline and attaining market transparency by means of reporting and comprehensive disclosure of relevant information by banks. Full changeover to the new rules is planned for 2007.

Given the Czech Republic's accession to the EU, Basel II – in the form resulting from its transformation into Community law – is and will continue to be crucial for the Czech Republic. The core of the framework remains unchanged. However, it differs to a greater or lesser extent from the BCBS source document in some minor respects and takes into account the specifics of the European market. A comprehensive proposal was issued in July 2004 to incorporate Basel II into amendments to the relevant European directives 2000/12/EC³ and 93/6/EEC⁴ (hereinafter referred to as

Transformation of Basel II into draft EC directives

³ Directive 2000/12/EC of the European Parliament and of the Council of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions.

⁴ Directive 93/6/EEC of 15 March 1993 on the capital adequacy of investment firms and credit institutions.

the Directives) regulating the activities and capital adequacy of credit institutions and securities dealers. The issuance of the Directives was a follow-up to the publication of the most recent version of Basel II and to previous consultative versions of these Directives. The basic nature of the Directives remained unchanged compared to previous consultative documents, but a number of minor revisions were made to reflect the comments of the banking community and the evolution of the overall level of knowledge in some areas. However, one of the crucial differences between the Directives and Basel II is that the Directives will apply to all credit institutions and investment companies, i.e. to all banks, credit unions, electronic money institutions and securities dealers, while the BCBS document primarily relates to internationally active banks. It is expected that the Directives will be adopted by the European Parliament during 2005 and take effect in 2007.

Implementation of the framework in the Czech banking sector

At home, the CNB continued to implement the new capital framework in partnership with banks and within the joint trilateral project of the CNB, the Czech Banking Association and the Chamber of Auditors of the Czech Republic. Co-operation was also established with the Securities Commission and the Ministry of Finance. The joint project is aimed at ensuring effective implementation of the framework in the Czech Republic, establishing a uniform interpretation of the framework's rules and requirements, and at informing all parties involved of the implementation measures. It also serves to upgrade the skills of the project participants in respect of the new rules and to discuss the impacts of the new framework and the CNB's approach in areas of national discretion. Launched in September 2002, the joint project was stepped up a gear in 2004. Ten working groups were created, focusing on various aspects of the implementation of the new framework. Experts from the individual institutions became involved in their work.

In 2004, CNB Banking Supervision geared up for the fundamental change in banking sector regulation. Work started on elaborating relevant approaches and, above all, steps were launched to incorporate the new capital framework into laws and regulations. The new, more complex principles, combined with the individual approach to each bank, will also require an upgrading of supervisors' skills and a greater emphasis on teamwork. To ensure success, the entire implementation process will have to be transparent.

The CNB's progress with, and approach to, implementing the new capital framework is published and regularly updated on the CNB website at (http://www.cnb.cz/bd_stanoviskacnb.php)

International co-operation

The directive newly regulates relations between the home and host supervisory authorities in the performance of supervision of subsidiary banks whose parent bank or financial holding company has its registered office in another EC Member State. Much closer co-operation is required than under the existing legislation. CNB Banking Supervision therefore conducted face-to-face talks with selected foreign supervisory authorities on the implementation of the new framework and on relations between home and host supervisory authorities. Under the new conditions, the CNB will in most cases be in the position of host authority. Therefore, it supports a uniform interpretation of the rules and co-ordination of procedures.

These objectives can only be achieved through active co-operation also at international level. The CNB is involved in the preparation of Basel II through its representatives in the Core Principles Liaison Group (CPLG) and the CPLG Working Group on Capital, which guarantees a good access to the latest information and enables the CNB to voice its opinion on certain issues and, at least to some extent, to shape the new rules.

The CNB is involved in the work of relevant committees and working groups operating within European structures (see section 7 for details).

4. SINGLE BANKING LICENCE PRINCIPLE

The provisions of Act No. 21/1992 Coll., on Banks, as amended by Act No. 126/2002 Coll., regarding the single banking licence came into effect upon the accession of the Czech Republic to the European Union on 1 May 2004. The single licence principle is based on freedom to provide services and freedom of establishment as basic principles of the EU. This means that a licence allowing the holder to carry on licensed activities in the territory of the state whose authority issued such licence (the home state/authority) at the same time allows the holder to carry on such activities, or at least most of them, in the territory of another EU Member State without having to apply for a licence with the competent authority of that state (the host state/authority). The activities of the entity enjoying the benefits of the single licence are then subject to supervision by the authority of the home state, except for supervision of compliance with narrowly defined legislation of the host state. The single licence principle thus fosters greater liberalisation of banking business and increased pan-European competition.

Entities enjoying the benefits of the single licence may carry on business activity in another EU Member State either by establishing a branch (the right of establishment) or without establishing a branch (the freedom to provide services). However, services may be provided in the territory of the host state without the establishment of a branch only if such services do not have the character of permanent (continuous) economic activity.

Under the Act on Banks⁵, the single licence can be used by foreign banks and authorised financial institutions and entities authorised to issue electronic money instruments, provided they have their registered offices or places of business in an EU Member State or in an EFTA (European Free Trade Association Convention) Member State that is part of the European Economic Area – i.e. Iceland, Liechtenstein and Norway. As to domestic entities, the single licence under the Act on Banks can be used solely by banks.

However, the fact that neither banks nor any other of the aforementioned institutions have to undergo a licensing procedure in the host state does not mean that a branch can be established at will. Before such a branch is established, the intention to do so must be presented to the supervisory authority of the home state (the Czech National Bank for domestic banks). Such information must include a business plan, particularly a list of activities to be carried on by the provider of services in the host state, and a description of the organisational structure and management of the branch. The home supervisory authority examines the bank's intention and, provided it has no doubts about the bank's organisational structure and financial situation in respect of activities in the host state, refers the notification to the competent supervisory authority of the host state. Such referral must be carried out within three months of receipt of the notification by the supervisory authority. In such cases, the CNB proceeds in administrative proceedings.

The CNB in the role of the host authority acknowledges the notification of a foreign bank's intention to provide services in the Czech Republic sent by the bank's home supervisory authority and provides it with an overview of the legal regulations that will apply to it when performing banking activities in the Czech Republic and the observance of which the CNB will supervise. The Czech National Bank does not supervise the general legislation that the branch is naturally obliged to observe when doing business in the Czech Republic. Supervision of the branch rests primarily with the supervisory authority of the home state. Nevertheless, any breach of duties when providing services abroad is dealt with by both regulators in close co-operation.

⁵ It should be noted that the single licence does not relate solely to the aforementioned entities and the CNB as the supervisory authority. A similar principle applies to numerous other branches of business.

A simpler procedure is applied if the bank wishes to carry on business in the territory of the host state without establishing a branch (i.e. in isolated cases). The bank must notify the home supervisory authority of such intention a month before the first provision of the service in the territory of another EU Member State. The home supervisory authority delivers the notification to the supervisory authority of the host state within a month. The supervisory authority hence does not have discretionary authority, i.e. the authority to block the bank's intention.

The CNB as the host supervisory authority supervises the liquidity of foreign bank branches and the performance of the duties imposed on them by the Act on Banks, for example the introduction of an effective system for dealing with clients' complaints. Foreign bank branches, entities authorised to issue electronic money instruments and authorised financial institutions enjoying the benefits of the single licence also fulfil reporting obligations, which take the form of statistical data used by both the CNB and the European Central Bank.

Banks under the single licence system are not subject to the provisions of the Act on Banks relating to the deposit insurance scheme. All deposits, including those accepted by a foreign bank branch enjoying the benefits of the single licence, are insured under the home state's scheme, which is also based on the requirements of Community law. Under the Act on Banks, however, such foreign bank branches can insure deposits under a contract with the Deposit Insurance Fund if the home insurance scheme is less favourable for the branch's depositors than the deposit insurance provided for under the Act on Banks.

The right to use the single licence as of 1 May 2004 resulted in nine foreign bank branches with registered offices in EU Member States and active in the Czech Republic on that date switching to the single licence system and the CNB significantly reducing its supervisory activities in respect of such branches. The Czech Act on Banks and related regulations apply to them to a very limited extent as of that date. Nevertheless, owing to the high degree of harmonisation of banking law within the European Union, they are subject to similar foreign regulations (those of their home state). The deposits of these branches' depositors are insured solely under the deposit insurance scheme applicable in the home state.

At the same time, the single licence principle enables Czech banks to provide services in other EU Member States based on their banking licences issued by the CNB without having to undergo licensing by the local regulatory authorities. Activities of banks having their registered office in the Czech Republic (i.e. including subsidiaries of foreign banks), including their activities abroad, whether provided through their branches or without establishing a branch, are subject to comprehensive supervision by the CNB.

The single licence principle requires closer co-operation between the CNB and other regulators from EU Member States. The legislative basis for such co-operation is the Act on Banks and the Act on the CNB. They entitle the Czech National Bank to exchange information with foreign supervisory authorities on all facts necessary for banking supervision and to conduct on-site examinations via the home supervisory authority in the host state or to request the host supervisory authority to conduct an examination in a branch or an entity having its registered office in the territory of the host state which is a member of a consolidated group that includes a bank. It can be also expected that, in addition to the memoranda of understanding already signed with some supervisory authorities, the CNB will conclude memoranda of understanding with other regulators as new foreign bank branches arrive in the Czech Republic and depending on how Czech banks make use of the single licence in other EU Member States where such memoranda have not yet been concluded.

More information on the single licence can be found at http://www.cnb.cz/pdf/bd_cnb_jednotna_licence.pdf.

5. CENTRAL REGISTER OF CREDITS

The Central Register of Credits (CRC) administered by the Czech National Bank has been in operation since 2002. It has played a major role in the banking sector since its establishment, providing banks with immediate information on a client's credit exposure for the entire banking sector. The CRC registers natural persons, entrepreneurs and legal entities, excluding banks and foreign bank branches. All banks and foreign bank branches having their registered offices in the Czech Republic are connected to the system, as is the Czech Consolidation Agency. Banks supply information in accordance with CNB Provision No. 5 of 1 August 2002, stipulating the methodology for submission of selected data by banks and foreign bank branches to the Czech National Bank. A project is being prepared within the EU to lay the groundwork for data exchange between credit registers operated by the Member States' national central banks. Following the accession of the Czech Republic to the EU, the possibility of getting involved in this project opened up for the Central Register of Credits operated by the CNB, too.

Banks request information on clients in accordance with the terms and conditions stipulated in CNB Decree No. 164/2002 on the conditions of access to information contained in the database of the Czech National Bank – the Central Register of Credits. Access is given to the individual CRC participants – banks and branches of foreign banks operating in the Czech Republic and the Czech Consolidation Agency. The CNB acts solely as the CRC operator. The basic output of the CRC is information on the credit exposure of selected clients. The number of requests for such information has been rising continuously since the register was launched. Banks are making ever greater use of other CRC instruments as well, such as predefined reports containing the credit exposures of all their own clients. The information obtained is used for credit risk management, analytical purposes, client scoring, etc. Clients registered in the CRC can access the data by applying for an extract from the register containing data on the client sent by individual banks.

The CNB regularly monitors the data administered in the database to ensure that they are correct and complete. In 2004, inspections were launched in banks aimed at ensuring compliance with the applicable methodology relating to the CRC, and methodological consultations were held as in the previous year.

Key statistics on the CRC in 2004

No. of users as of 31 December 2004	1,916
No. of registered clients as of 31 December 2004	240,758
of which: individual entrepreneurs	144,337 (60%)
legal entities	96,421 (40%)
No. of active claims as of 31 December 2004	259,867
No. of enquiries on clients registered for 2004	260,979
No. of enquiries on total credit commitments of client for 2004 (including credit commitments of own clients obtained via batch reports which bank has available after each update)	2,423,661
No. of extracts made for clients	85

Under the approved Phase II of the CRC's development, an analytical module is currently being prepared as a universal instrument for production of analytical outputs of the data administered in the CRC to be used by analysts from the CNB and the participating banks. The application is also being adjusted in order to simplify the output modules and extend the range of output reports offered to both users and application administrators in banks. Phase II also includes an extension of output forms to allow monitoring of data for economically connected groups.

6. ACTIVITY OF THE FINANCIAL ARBITER

The Financial Arbiter has been operating in the Czech Republic since 1 January 2003 under Act No. 229/2002 Coll., on the Financial Arbiter, as amended.

The Czech National Bank provides the Financial Arbiter, his deputy and five members of staff with premises, material resources and information technology. However, the Arbiter is not dependent on the CNB and is not a part of CNB Banking Supervision.

Information on the powers of the Arbiter, including conditions for opening proceedings before the financial Arbiter and the option of filing an electronic petition to open proceedings, is published on the Financial Arbiter's website (www.finarbitr.cz). The site also lists the Arbiter's awards and adjudications and gives examples of the disputes that do and do not fall within his jurisdiction. Information on similar institutions in Member States of the European Union, states constituting the European Economic Area, and European Union candidate countries is also available.

Any client of an institution may request the Arbiter's assistance, provided that the dispute falls within his jurisdiction. A transfer institution or an issuer of electronic payment instruments may not be a plaintiff for the opening of proceedings before the Financial Arbiter.

The Financial Arbiter adjudicates on disputes arising between institutions and their clients during the execution of transfers and the issuing and use of electronic payment instruments pursuant to the Payment System Act (Act No. 124/2002 Coll.). These are disputes arising during the execution of domestic and cross-border payments and the clearing of payment card transactions charged to cardholders' accounts. The amendment to the Financial Arbiter Act (Act No. 558/2004 Coll.) extended its applicability to cover corrective settlement and direct debits in the Czech Republic, with effect from 1 January 2005.

This essentially involves compliance with the statutory time limits for clearing individual payment transactions. The Financial Arbiter is legally entitled to settle disputes concerning executed cross-border credit transfers up to an amount equivalent to EUR 50,000.

The Financial Arbiter deals with corrective settlement according to the Act on Banks (Act No. 21/1992 Coll.), while direct debits in the Czech Republic are also treated in compliance with Decree No. 62/2004 Coll., stipulating the manner of execution of payments between banks, settlement on accounts at banks and the technical procedures to be used by banks for corrective settlement.

To the extent laid down in the law, such disputes can also be settled by the Deputy Financial Arbiter, who also deputises for the Arbiter in his absence to the full extent of his powers and responsibilities. In other cases a competent court must adjudicate.

Proceedings are opened upon the petition of the plaintiff. Petitions may be filed in writing by letter or on a form issued by the Arbiter. Such forms can be downloaded from the Arbiter's website. Petitions may also be filed by fax.

Petitions must contain all the information prescribed by law. The petitioner must precisely identify himself and the relevant institution with which he has unsuccessfully made a complaint falling under the Payment Systems Act. This means giving his full name, birth certificate number or date of birth, and permanent address, as well as the institution's full name, identification number and registered

address. The petitioning client must give a complete and clear description of all the significant facts of the case and provide evidence, or at least a specification or description of the evidence. Another important part of the petition is a description of what the plaintiff is seeking. An integral part of the petition is a declaration that the case has not been settled before a court of law or by an arbiter. The client must also furnish proof that he has unsuccessfully sought redress with the relevant institution (this will usually be a bank).

The Arbiter, the Deputy Arbiter or an authorised member of staff will study the petition to see whether or not it has all the information prescribed by law. If any such information is missing, the Arbiter will call upon the petitioner to provide it. If the petition contains all the required elements, proceedings will be opened before the Arbiter. The plaintiff will be notified of this fact in writing and the transfer institution will be called upon to comment on the case within the statutory time limit. As of 1 January 2005, the time limit is 15 days and may be extended by 15 days if the institution so requests.

The Arbiter need not be bound by the petition in the course of proceedings, but may himself acquire other evidence and order a hearing on the merits of the case attended by both parties to the dispute. He is authorised to solicit from the transfer institution all the evidence he requires, as well as to search the institution's systems.

The Financial Arbiter Act requires the Arbiter to co-operate with analogous authorities in the Member States of the European Union and the European Economic Area. In 2004, the Financial Arbiter and authorised persons attended two meetings of FIN-NET (Cross-border Out-of-Court Complaints Network for Financial Services), which the Financial Arbiter will become a member of after the relevant Memorandum of Understanding has been signed.

Although the public often does not have the necessary information on the existence of the Financial Arbiter, it has welcomed the establishment of an institution to settle payment disputes. The Financial Arbiter dealt with 130 cases in 2004, as compared to 66 cases in 2003. The number of legitimate cases rose to 74 in 2004, compared to just 33 in 2003.

The Financial Arbiter issued a total of 42 awards in 2004, of which 69%, i.e. 29, were in favour of the institution. The remaining 31%, i.e. 13, were in favour of the plaintiff.

In 2004, the Financial Arbiter imposed a total of 12 fines (totalling CZK 570,000), of which 8 fines (totalling CZK 270,000) related to opened disputes and 4 fines (totalling CZK 300,000) were for failure to comply with the information duty.

The Financial Arbiter Act imposes an information duty on institutions (i.e. transfer institutions and issuers of electronic payment instruments). A regularly updated list of these institutions is maintained on the Arbiter's website. The website also contains a specimen information-duty compliance form.

In compliance with the Financial Arbiter Act, the Financial Arbiter visited the French Financial Arbiter and the Financial Arbiter of Société Générale in Paris in order to gain experience of consumer protection in EU Member States.

The Financial Arbiter held a press conference in 2004 connected with the publication of his annual report. He also attended several seminars organised by renowned agencies in order to provide the public with in-depth information about his activities in the Czech Republic. The Financial Arbiter published information about his activities in specialised magazines and selected newspapers, spoke about his work on radio stations (ČR 1 - Radiožurnál, ČR - Radio Regina etc.) and also commented on several disputes at the request of TV stations (ČT 1, TV Nova).

7. INTERNATIONAL CO-OPERATION

The Czech Republic's membership of the European Union since 1 May 2004 has significantly altered the character and forms of banking supervisory co-operation within European structures. The nation's observer status in committees and working groups changed into Member State status, with all the related rights and obligations. 2004 saw an extension of Level 3 under the Lamfalussy process with the establishment of the new Committee of European Banking Supervisors (CEBS) and Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS). These committees were established next to the existing Committee of European Securities Regulators (CESR), thereby completing the European institutional framework for financial market regulation.

7.1 CO-OPERATION WITHIN THE STRUCTURES OF THE EUROPEAN COMMISSION

CNB Banking Supervision has representatives in the CEBS and in the four working and expert groups set up by the CEBS:

- a) the Groupe de Contact,
- b) the Working Group on Accounting and Auditing,
- c) the Common Reporting Group, and
- d) the Sponsor Group on Home/Host Issues.

CNB Banking Supervision helped to prepare the recommendations and standards of other expert groups which it does not have direct membership of. The CNB regards the opportunity to engage actively in strategic debates in the committees and to help to prepare recommendations, standards and principles for effective functioning of banking supervision to be the key benefits of its participation in these structures.

The main topics of the CEBS and its working groups in 2004 were as follows:

- development of recommendations for the implementation of Pillar 2 of the new capital framework, particularly risk assessment of banks by the supervisor, assessment of internal capital by the bank and assessment of the bank by the supervisor, outsourcing principles, bank governance, and procedures for approving and validating internal ratings;
- preparation of a common framework for reporting on capital adequacy, the financial situation of banks and other regulatory requirements;
- the creation of requirements for uniform content and form of information disclosure by the supervisor under Pillar 3 of the new capital framework.

CNB Banking Supervision also has a technical expert in a committee of the Lamfalussy process Level 2 – the Banking Advisory Committee (BAC). The following issues discussed were in the BAC in 2004:

- future strategy after the Financial Services Action Plan (FSAP) expires;
- the new capital framework;
- European company status in relation to credit institutions;
- comparison of the level of oversight of groups;
- electronic money institutions.

The Financial Services Action Plan, drawn up in 1999, is a set of 42 measures to enhance integration of the European financial system. Most of them are of a legislative nature (directives and regulations). Although the plan has not been fully implemented yet (in particular at national level), the preparation of a "post-FSAP" strategy has begun, with a view to completing a new plan in 2005.

CNB Banking Supervision gained highly valuable experience when participating in the discussions on draft amendments to the relevant EC directives on the new capital

adequacy framework in working groups of the European Commission and ECOFIN in the second half of 2004. Representatives of CNB Banking Supervision made comments chiefly from the position of a predominantly host supervisory authority, or the supervisory authority of a country where mainly subsidiaries of foreign banks operate. These comments related, for instance, to home-host issues, disclosure of information by banks, the procedure for approving and validating banks' models and so on. The CNB is concerned to be an equal partner with the host supervisory authorities; to be able to receive from them necessary information about parent banks; to give its opinion when approving banks' models in compliance with the new capital framework, taking into account conditions of the local market; and thereby to meet its objective to effectively supervise banks operating on the Czech market in accordance with the Czech legislation and regulations.

In 1999, ECOFIN set up a committee of so-called wise men (the Lamfalussy Committee)⁶, the objective of which was to explore conditions and needs for development in the regulation and supervision of securities.

In 2001, the Committee issued a report with proposals for further development of the relevant legislation and emphasised the importance of a proper balance in the decision-making process among EU institutions, namely the European Parliament, the Commission and the Council. Based on the Committee's recommendations the Commission issued a draft directive establishing four levels.

Level 1 deals with key principles of the primary legislation – directives and regulations, whereas Level 2 involves the adoption of more detailed technical implementing measures (comitology). At Level 3, committees deal with co-operation between supervisors and convergence of supervisory practices, drafting and issuing recommendations and standards in order to achieve greater harmonisation of procedures. Level 4 represents monitoring and enforcement of EU legislation. This is primarily a matter for the Commission, which, assisted by the committees, prepares for the financial regulation of the EU. Legislation (directives and regulations) is adopted on the basis of a joint decision-making process of the European Parliament and the EU Council.

A Level 3 committee was set up for the securities market in 2001. After the Economic and Financial Committee (EFC) issued a report in 2002 recommending an extension of the Lamfalussy process, committees for the banking and insurance sectors were set up. Subsequently, in November 2003, the Commission submitted a proposal for an extension to the entire financial sector. Two new Level 3 committees were established, namely the CEBS and the CEIOPS, which started work in January 2004.⁷

7.2 CO-OPERATION WITHIN THE STRUCTURES OF THE EUROPEAN CENTRAL BANK

The CNB has two representatives on the ECB's Banking Supervision Committee (BSC). One of them represents CNB Banking Supervision and the other represents the newly established Financial Stability Section. The CNB is represented similarly in the working groups established by and responsible to the BSC, namely the Working Group on Macro-Prudential Analyses (WGMA) and the Working Group on Developments in Banking (WGDB). At the end of 2004, Banking Supervision representatives took part in a seminar on credit registers organised by the WGCR, in which CNB Banking Supervision will also be represented.

In 2004, the BSC's activities focused on two basic areas: analysis and monitoring of the cyclical and structural development of the European banking system and the promotion of co-operation between central banks and supervisory authorities. The

⁶ See Box 1 – Annexes.

⁷ For the representation of CNB Banking Supervision staff, see Box 2 – Annexes.

CNB helped to prepare documents on these topics within the two aforementioned working groups. These included, in particular:

- Financial Stability Report,
- Banking Stability Report,
- Memorandum of Understanding (MoU) on financial crisis management,
- a study of European banks' dependence on the European retail market,
- a project on banking data collection and harmonisation, and a study of the impact on banks of factors arising from the implementation of Basel II,
- a project on the structural features of new Member States and their relationships within the European banking sector and a study of the development of competitive conditions on European banking markets.

A CNB representative was actively involved in the work of a special group established on the issue of cross-border development of banking services and barriers to wider integration of national markets within the EU. The General Council assigned this task to the group in June 2004, stating that this topic should be opened to discussion across Europe. The rapid development of cross-border banking and the formation of European-wide banking groups is causing a deepening of the system-relevant relationships between the Member States' banking systems. This, on the one hand, is leading to risk diversification, but, on the other hand, is increasing the risk of financial contagion. A comprehensive document prepared on the basis of detailed analyses and after numerous debates in the group was discussed by the General Council in December 2004. The individual topics identified in the document are being dealt with by a joint working group under the leadership of the BSC (preparation of a new MoU on cross-border crisis management) and the BAC (working groups on deposit insurance systems and mergers and acquisitions in banking). The aim is to create an appropriate framework for co-operation and to remove the legislative and practical barriers to the integration of the European banking market.

7.3 CO-OPERATION WITHIN THE BASEL COMMITTEE ON BANKING SUPERVISION

The main task of the BCBS is to serve as a platform for regular discussions of issues concerning banking supervision in the G10 countries. Recently, however, it has been dealing ever more with the development of regulation. CNB Banking Supervision has representatives in the Core Principles Liaison Group and the Working Group on Capital. Two meetings of these groups were held in 2004, focused primarily on key aspects of the new capital adequacy framework (e.g. national discretion, principles of co-operation between home and host supervisors). The idea of updating the Core Principles for Effective Banking Supervision, which should be in line with best international practices, was also approved in 2004.

7.4 CO-OPERATION WITH PARTNER SUPERVISORY AUTHORITIES

Co-operation with partner banking supervisors continued into 2004. This concentrated on the signing of new memoranda of understanding, exchange of information on banks of mutual interest, and procedures for the implementation of the new capital adequacy framework (Basel II).

In 2004, CNB Banking Supervision signed memoranda of understanding with the central banks of the Netherlands and Italy. The signing of the memorandum with Italy was combined with a working meeting focusing on exchange of information on the legal, regulatory and institutional framework in the two countries and on banks of mutual interest. The CNB has so far concluded eight memoranda of understanding: with Belgium, France, Italy, Germany, the Netherlands, Austria, Slovakia and the USA (or, more precisely, the State of New York). An MoU with the Russian Federation is under negotiation and is conditional on agreement being reached on the terms and conditions for co-operation with Russia at the EU level.

Practical co-operation between supervisors continued in 2004 both in written form and in the form of working meetings. Meetings were held primarily with partners from the countries whose banks have a major share of the Czech banking market (Belgium, France, Germany and Austria). The meetings always dealt with two main topics: exchange of information on the financial position of parent banks and subsidiaries, and exchange of information on, and experience with, the procedures used by supervisors in the preparations for Basel II implementation.

The CNB emphasised the issue of Basel II implementation to its partner supervisory authorities at various forums. For CNB Banking Supervision, which is in the position of host supervisor, it is highly desirable that the content and forms of co-operation in approving applications, model validation and continuous oversight of banks that apply for approval of advanced methods of risk management under Basel II are clarified and set as soon as possible. This will require adjustments to capacities, internal methods and staff training. In 2004, however, our foreign partners' response to this need was mostly quite limited.

7.5 CO-OPERATION WITHIN THE GROUP OF BANKING SUPERVISORS FROM CENTRAL AND EASTERN EUROPE

Although involvement in the structures of the European Commission and the ECB is now the CNB's priority, it has not been neglecting its membership in the Group of Banking Supervisors from Central and Eastern European Countries.

This group, established 14 years ago, has 19 members, 9 of which are not EU members. A two-day conference of the heads of banking supervisory authorities is held every year to discuss current practical issues of banking regulation and supervision. In 2004, CNB representatives attended the BSCEE conference in Dubrovnik. The discussions focused on the development of the organisational structure of banking supervision and financial surveillance in line with the needs of the countries and the market, and also on the promotion of the "forward-looking" concept of provisioning with the aim of achieving the optimal level of provisions. Both issues are highly relevant to CNB Banking Supervision, which is heading toward integration in the institutional area and studying best practices in different countries in the field of provisioning methodology. In 2004, two special seminars, attended by CNB Banking Supervision representatives, were organised as usual within the BSCEE group. These dealt with credit risk and the new capital adequacy framework. 2004 also saw the start of work on an amendment to the BSCEE Statute. The new Statute, which should take into account the practice of past years, should take effect in 2005.

7.6 CO-OPERATION WITH THE INTERNATIONAL MONETARY FUND AND THE WORLD BANK

CNB Banking Supervision was evaluated by the IMF and the WB within the FSAP (Financial Sector Assessment Program) in 2000. In 2004 this assessment was updated. The results showed that CNB Banking Supervision was essentially compliant with all the required criteria. The recommendations for improvement were not of a material nature.

In spring and autumn 2004, consultations took place between WB experts and CNB Banking Supervision staff as part of new projects to assess corporate governance and insolvency of banks. The World Bank prepared a methodology for auditing the assessment of corporate governance in banks and the efficiency of bank insolvency management systems (the CNB being involved in the relevant working group). The Czech government was one of the first in the world to offer assistance in testing this methodology.

8. CO-OPERATION WITH OTHER FINANCIAL MARKET REGULATORS IN THE CZECH REPUBLIC

In the Czech Republic, financial market participants are regulated and supervised by four different institutions. The Czech National Bank is responsible for the regulation and supervision of banks and consolidated groups containing banks; the Czech Securities Commission regulates and oversees capital market participants; and the Czech Ministry of Finance is responsible for the regulation and surveillance of insurance companies and pension funds and partly for capital market regulation. The small sector of credit unions is supervised by the Office for Supervision of Credit Unions and regulated by the Ministry of Finance. This diversified structure of regulation and supervision requires close co-operation.

The Memorandum of Understanding between the Czech National Bank, the Securities Commission and the Ministry of Finance of 28 February 2003, which replaced the former agreement from 1998, provides the formal basis for this co-operation. The primary aim of the Memorandum is to ensure the application of uniform criteria and procedures by the parties to the Memorandum in the supervision of the financial market, including supervision of entry to, and exit from, the financial sector. This includes co-operation in the areas of licensing and granting approvals, inspections, imposing remedial measures, regulation of the financial market and procedures vis-à-vis foreign supervisory authorities and international institutions. Exchange of information between these supervisory bodies is the main tool of co-operation. The Memorandum envisages the signing of individual agreements on consolidated supervision of specific consolidated groups and lays down the basic elements thereof. For the purposes of analysing the Czech financial sector as a whole and preparing the financial stability report, the parties to the Memorandum have undertaken to regularly exchange information on each sector in an agreed structure. Among other things, working groups help meet the commitments arising from the Memorandum and ensure co-operation on a consolidated basis. The creation of general policies, concepts and strategies for future supervision of the Czech financial market and the resolution of serious systemic problems is delegated to the Committee on the Co-ordination of Financial Market Supervision, consisting of two representatives of the management of each supervisory body.

Five working groups were operating in 2004, dealing with supervision, collection of data on sectors, accounting harmonisation and information disclosure, conglomerates, and licensing. The working group on supervision exchanged information on inspection procedures and the findings of on-site inspections. The data collection group focused on harmonising the content and quantity of data to be exchanged on each financial sector. The working group on accounting harmonisation and information disclosure worked on the definition of "units of public interest". These units should apply international accounting standards for financial reporting in compliance with the Government's Accounting Action Plan. The working group also discussed proposals for changes in the accounting regulations for financial institutions for 2005. In 2005, the group will seek a consensus over the implementation of Pillar 3 of Basel II as regards the requirements for the method and frequency of disclosure of information, the scope of verification by external auditors, etc. The working group on conglomerates focused on the implementation of the financial conglomerates directive into the national legislation. The licensing group dealt mainly with the method used to assess the competence of managers during the licensing of depositories.

The main topic of the Committee's meetings throughout 2004 was that of single oversight of the financial market. Firstly, the Committee discussed the Government's draft for integrated state supervision of the financial market.

The strategy was adopted on 12 May 2004. The intention to integrate all the supervisory authorities into a single institution in two steps was approved. Supervision of banks and credit unions will be integrated within the CNB during 2005. Supervision of insurance companies and pension funds and capital market surveillance should be integrated within the Securities Commission by 31 December 2005. Starting from 2006, the Czech Republic will have two supervisory authorities. These are to be united into a single institution in the future. The Government will decide on the nature of this institution by the end of 2006. In this context, the Committee on the Co-ordination of Supervision addressed the legislative issues of this integration, such as an amending law, and practical administrative issues, etc. The Committee met six times in 2004 and discussed a number of other issues, for example the implementation of the financial conglomerates directive, the work of the individual institutions' representatives in the European Commission's committees and working groups, the division of labour between the CNB and the SC in the oversight of banks-depositories, etc.

Owing to changes in managerial positions in all the relevant supervisory authorities, the Committee's structure changed partly in 2004 and particularly at the start of 2005.

Based on the Memorandum of Understanding, an agreement on the exchange of certain information between the CNB and the Czech Securities Commission was signed on 31 March 2004. The aim of this agreement was to optimise or eliminate duplicate flows of information between banks that are also securities traders and the regulators, i.e. the CNB and the Securities Commission.

9. STRATEGY OF BANKING SECTOR ACTIVITIES FOR 2005–2010

In 2005, CNB Banking Supervision will focus on the tasks ensuing from its medium-term strategy for banking supervision and regulation, which is based, in turn, on the Czech National Bank's strategy for 2005–2010. These tasks are as follows:

- the regulatory area will be greatly affected by the new capital adequacy framework, including the setting of the deciding role of the home regulator in relation to the subsidiaries of internationally active banks;
- the process of unifying the oversight of the financial market – the strategy to set up a single financial market regulator should be finalised by the end of 2006;
- high priority is assigned to the harmonisation of standards and procedures with those of foreign and domestic regulators, given the ownership structure of the Czech banking sector; the need to reach a consensus is reinforced by the role of the home regulator in internationally active banks in conditions of effective co-operation with foreign regulators, particularly in approving internal risk management models;
- to emphasise intelligibility and clarity when drafting new regulations, and to ensure ongoing publication of changes and broad communication with banks and the public;
- supervisory practice will continue to be based on a combination of off-site surveillance, on-site inspections and the use of auditors' reports to verify risk management systems and financial statements. As part of the implementation of the new capital adequacy framework, the formation of a comprehensive bank risk profile assessment system will continue, based on a combination of quantitative and qualitative information on banks allowing us to evaluate risk at a qualitatively higher level. Risk profile assessment will also serve as the basis for communication with banks during the appraisal of their internal risk assessment systems and their capital coverage of risks, for streamlining the regulation of consolidated groups and for addressing formal aspects of supervision in this area;
- to enhance the transparency of CNB Banking Supervision and the measures it adopts by publishing supervisory procedures and principles; a system for assessing the quality and effectiveness of banking supervision, including feedback from banks, is under preparation;
- the CNB will continue to prepare and publish regular reports on the banking sector and aggregate documents for the ECB and other international organisations (IMF, WB, OECD, BIS, EC, etc.); in the licensing area, a simplified procedure based on information from the relevant domestic regulator will be applied consistently; preventive measures remain a matter of priority; CNB Banking Supervision will continue to work to limit the risks associated with money laundering and terrorist financing;
- the emphasis during the process to integrate financial market supervision will be on harmonising the regulatory procedures and supervisory methods applied to analogous activities in the various types of institutions operating on the financial market; the first step in this direction will be to harmonise the rules applying to the regulation and supervision of banks and credit unions in connection with the CNB's assumption of responsibility for credit union supervision in 2005;
- the strategy can only be fulfilled if substantial changes are made to the primary and secondary legislation and if the existing methodological procedures are revised or new ones created; priority will be given to reducing the number of regulations, even at the cost of expanding their content.

B. THE BANKING SECTOR IN 2004

SUMMARY

In terms of its stability and financial position, the banking sector as a whole developed favourably in 2004. For the first time in several years, no bank collapsed and no bank was under conservatorship. This stability was underpinned by continuing growth of the Czech economy, driven primarily by investment, consumer demand and high export growth.

The Czech Republic's accession to the EU had no immediate impact on Czech banks, because their integration into the European financial system had been going on in previous years, especially after the privatisation of large banks was completed. Many foreign banks have made use of the single licence and have declared the provision of banking services in the Czech Republic, but these are cross-border services provided without establishing a branch and do not represent any major competition for the existing banks, particularly in the area of traditional banking.

The ownership structure of the banking sector has been stable for several years now, with foreign shareholders controlling – via direct or indirect shares – almost the whole banking sector, including the group of four large banks.

The year 2004 saw an increase in the volume of client loans, with loans to households showing particularly high growth. For example, mortgage loans were up by more than 50% on the previous year. Loans to households reached more than 25% of all client loans provided. On the liabilities side, modest growth was recorded for client deposits. Owing to low interest rates, most of this growth was attributable to demand deposits, which accounted for almost 50% of total client deposits.

As regards risk exposure, no major changes were registered in 2004 compared to 2003. Credit risk stemming from the banking portfolio remains the most significant risk. However, the increase in the total loan portfolio resulted in a lower proportion of classified loans, which recorded growth chiefly in the least risky watch loan category. The improvement in loan portfolio quality is also due to the increasing proportion of less risky loans to households. The sector's coverage of classified loans by provisions is sufficient.

The banking sector as a whole is not exposed to any significant foreign exchange risk or country risk. Banks mostly concentrate on trading in the Czech currency on the domestic market. The foreign currency activities of banks stem mostly from transactions with other banks. Banks have a large volume of quick assets, which, together with the present confidence in the banking sector, minimises liquidity risk.

The overall capital adequacy of the banking sector decreased as a result of pronounced growth in capital requirements and only a modest rise in regulatory capital, but it was still above 12%. All banks are compliant with the minimum capital ratio of 8%. Some banks, however, started to run into capital limits during 2004 owing to the development of their business activities. Further development of the lending and other business activities of these banks will thus depend to a large extent on the size of future capital increases.

The net profit of the banking sector as a whole was CZK 32.9 billion in 2004, thanks to growth in all components of profit from financial activities and continuing control of administrative expenses. Interest profit was again the banks' most important source of earnings. Unlike in previous years, the creation of provisions and reserves had a neutral effect, i.e. it generated no increase in expenses to the detriment of profitability, and, on the other hand, the release of provisions and reserves created in previous years made no contribution to profit in 2004.

1. THE ECONOMIC ENVIRONMENT IN 2004

The Czech economy continued to grow in 2004, albeit at a slightly slower rate than in the second half of 2003. Despite the modest slowdown, the economic growth was, as in previous years, higher than that of the Czech Republic's largest trading partner – Germany – or in the EU countries before enlargement. Domestic economic growth was driven mainly by investment. The effect of consumer demand, which had predominated in 2003, gradually weakened. In 2004 H2, growth was also supported by buoyant exports. GDP totalled CZK 2,751.1 billion at current prices in 2004. The annual growth rate was 4%, up by 0.3 percentage point on a year earlier. The economy still enjoyed a low-inflation environment.

The pick-up in GDP growth helped to strengthen the international economic position of the Czech Republic and reflected the improved macroeconomic environment in 2004. The factors underlying the overall GDP growth changed in 2004 compared to 2003. The favourable effect of household consumption on GDP growth gradually weakened owing to the evolution of disposable income. By contrast, a higher rate of growth of expenditure on gross fixed capital formation was a result of an improving income situation of non-financial corporations, allowing them to cover investment expenditure from their own funds. The positive economic developments were also reflected in a 7.8% rise in lending in 2004. Export growth was faster than import growth, and the long-running negative influence of net exports on GDP growth saw a change in trend. The higher export performance has become a significant positive factor of economic growth. For a small open economy, this is an exceptionally favourable phenomenon.

The current account deficit fell by 1.3 percentage points to 5.2% of GDP in 2004. The balance of payments accounts developed favourably in 2004. Unlike in 2003, a higher surplus of CZK 23.8 billion was achieved, despite a rising volume of repatriated earnings of foreign investors operating in the Czech Republic following a massive inflow of foreign investment. The external imbalance was reduced thanks in particular to the good foreign trade results. Exporters successfully adapted to the changing conditions connected with EU accession and made perfect use of the nascent economic recovery in their trading partners' countries. The trade balance was positively affected by the exchange rate in respect of exports. The koruna depreciated slightly against the euro (by 0.2%). A more sizeable appreciation of the koruna against the dollar also helped to improve the position as regards imports of oil and natural gas and created conditions for a 9.9% increase in the annual rate of growth of industrial production at the end of 2004. The position improved compared to 2003, with the current account deficit of CZK 143.3 billion outweighed by a surplus of CZK 180.9 billion on the financial account. This improvement was again due to a higher direct investment surplus (CZK 100.7 billion) and even faster portfolio investment growth than in 2003.

The overall consumer price level rose by 2.8% on average in 2004, an increase of 2.7 percentage points on the negligible inflation recorded in 2003. The rise in consumer price inflation was mostly due to a greater increase in services prices, as against a lower rise in goods prices. Changes in regulated prices, tax adjustments and other administrative measures contributed to a greater extent. However, concerns about a sharp price rise connected with the Czech Republic's entry into the EU did not materialise in 2004. Nonetheless, the price levels of the "traditional" and "accession" countries, or the Czech Republic, converged slightly owing to consumer price inflation of just 2.0% in the EU-15, i.e. 0.8 percentage point less than in the Czech Republic. Throughout 2004, the domestic economy thus faced consumer price inflation slightly above the level in the EU Member States before enlargement.

The contrary trend in the koruna's exchange rate against the major currencies continued, but was less pronounced than in the previous period. This was due to the dollar's depreciation against the euro. From its annual average of CZK 31.84 to the euro in 2003, the koruna weakened only slightly to CZK 31.90 to the euro in 2004. The koruna's average exchange rate against the dollar appreciated from CZK 28.23 to CZK 25.70 in year-on-year terms.

Despite the favourable cyclical situation, with the economy in an upward phase of the business cycle, and in a climate of rising inflation the labour market experienced large structural movements, including a relatively larger fall in the number of entrepreneurs (mostly those not reporting any economic activity) than in the total number of employees. Long-term unemployment is on the increase. The termination or interruption of entrepreneurial activity was probably due to the introduction of a minimum tax base and to changes to the assessment base for social security and health insurance. On the labour market the gap between demand and supply widened, which is also probably the result of legislative changes on the labour market. The entry of "baby boomers" onto the labour market increased the labour supply. One positive phenomenon was a slower relative decline in the number of employed persons. Following sizeable job cuts in 2003, employment in industry was flat. The market was very volatile in the individual months of 2004. Seasonal factors had particularly adverse effects. The registered unemployment rate for 2004 as a whole was above the 10% level, standing at 10.24% on average.

Amid tough competition, the ratio between productivity and real wages further improved in 2004. The average monthly nominal wage of employees increased by 6.6%, as in 2003. At 4.2%, aggregate labour productivity growth lagged behind the growth in nominal wages. Consequently, unit wage costs rose by 2.4%. At 3.7%, average real wage growth was 2.8 percentage points lower than a year earlier, affected by the higher inflation. The gap between wage growth in the business and non-business sectors is widening as a result of faster growth (6.9%) in the business sector (with a higher base) than in the non-business sector (5.7%).

The public budgets have regularly recorded deficits in recent years. By contrast, the declining growth of state budget expenditure since 2002 is a positive phenomenon. The year 2004 saw the lowest ever annual growth on the expenditure side of the state budget, and the deficit was lower than originally approved. This relatively favourable result was due both to higher revenues and lower expenditure. The expenditure side still reflects the transformation costs and the expenses associated with the restructuring of the economy. Mandatory social expenditures were again the largest item. To improve the public finance position it will be necessary to implement, together with the public finance reform, fundamental reforms of the pension and health care systems. The national debt amounted to CZK 592.9 billion at the end of 2004 (up by almost CZK 100 billion). As a percentage of nominal GDP the debt was 21.6%.

In line with its primary objective of maintaining price stability, the central bank raised its key interest rates twice during 2004. These monetary policy decisions were based on findings regarding the key indicator of economic growth, and net annual inflation was also taken into account. The rate changes also reflected the external economic environment and the level of interest rates in the euro area. The key domestic interest rates were raised as follows: the two-week repo rate from an initial level of 2.0% to 2.5%, the discount rate from 1.0% to 1.5%, and the Lombard rate from 3.0% to 3.5%.

2. THE STRUCTURE OF THE CZECH BANKING SECTOR

2.1 NUMBER OF BANKS

(for banks with licences as of the given date)

As of 31 December 2004, the Czech banking sector consisted of 35 banks and foreign bank branches. The number of banks and the breakdown into 26 banks and 9 foreign bank branches was the same as at the end of 2003. However, some banks changed their names at the decision of their shareholders. Credit Lyonnais Bank Praha's name was changed to CALYON BANK CZECH REPUBLIC and Interbanka's name to BAWAG Bank CZ. The majority owner Česká pojišťovna, a.s., a member of the PPF financial group, changed the name of První městská banka to PPF banka. The branch of Sparkasse Mühlviertel-West started using the name Oberbank AG, pobočka Česká republika, after being taken over by Oberbank of Austria, and following the entry of a new shareholder, Dresdner Bank CZ changed its name to BAWAG International Bank CZ.

Large banks remained the most important group in the Czech banking sector in 2004. The breakdown of entities by size into bank groups, known as "peer groups", remained unchanged. Large banks comprise bank entities with total assets exceeding CZK 100 billion. This limit is met by five banks. The large bank group consists of four universal banks providing banking products and services to corporate clients and, to an ever larger extent, to retail customers (natural persons). They have also started participating in the financing of small and medium-sized enterprises. The business activities of all the large banks are geared towards the domestic banking market. Foreign owners are dominant in all large banks. The fifth entity qualifying as a large bank in terms of total assets is a building society specialising in the building saving product.⁸

In 2004, the size of total assets of one building society fulfilled the limit for being included in the large bank group. This increase in assets is a result of the expansion recorded also in other building societies, mostly members of large financial groups operating in the Czech market. Their robust growth is due to the persisting popularity of the still state-supported building saving product. This product continues to be very popular among bank clients even following a reduction in state support introduced at the start of 2004.

In line with European and world banking trends, the process of formation of financial groups continued in the Czech banking sector. The most important financial groups in the Czech Republic are those of Československá obchodní banka, Česká spořitelna and Komerční banka, which are simultaneously members of their foreign parent banks' financial groups. The range of products and services offered by a financial group is diverse. Banking services are the mainstay of banking financial groups. In addition, these groups offer products of investment banking, investment funds, insurance companies, pension funds, factoring companies, building societies, leasing companies and consulting firms. The structure of a financial group reflects optimisation of activities within the entire multinational financial group of the parent bank, strategic investment plans, and operations on the domestic banking market.

⁸ For the purposes of analysis we use the traditional breakdown into large, medium-sized and small banks, in line with previous reports. The fifth large bank with more than CZK 100 billion in total assets has been included in the specific group of building societies. The special transactions of building societies, based exclusively on the building saving product, differ in nature from the diversified business activities of universal banks. For the purposes of this report, the large bank group consists of four banks: Česká spořitelna, a.s., Československá obchodní banka, a.s., Komerční banka, a.s. and HVB Bank Czech Republic, a.s.

In addition to the four large banks, the Czech banking sector consisted of ten medium-sized banks, six small banks, nine branches of foreign banks and six building societies as of 31 December 2004.

The banking market was liberalised upon the Czech Republic's accession to the European Union on 1 May 2004. Banks from the EU countries, as well as domestic banks, may offer banking services under the single licence in all EU countries. As at the end of 2004, a total of 63 foreign banks from EU Member States had reported their intention to provide some or all of the mutually recognised banking activities in the Czech Republic within the framework of cross-border banking. This opportunity was also taken by one Czech bank.

2.2 OWNERSHIP STRUCTURE

(for banks with licences as of the given date, excluding foreign bank branches)

The ownership structure of the banking sector underwent some changes in 2004, but the sector's structure remained stable. Banks owned by domestic banking institutions accounted for 70% of the increase in the banking sector's equity capital (of CZK 1.5 billion). This growth in capital was due to a substantial expansion of business activities.

As of 31 December 2004, the banking sector's total equity capital had increased to CZK 70.4 billion. Foreign entities accounted for 83.1% of total capital as of this date, down by 1.8 percentage points from a year earlier. This decrease was mostly attributable to foreign owners from countries outside the European Union. Conversely, the 1.8 point rise in the share of Czech private owners of banks based in the Czech Republic was due to capital growth related to expansion of business, particularly mortgage lending. The ownership share of the state and municipalities was flat at 4.4%.

With a share of 97.0%, foreign capital dominates in the group of large banks. But even in the other groups – medium-sized banks and small banks – the proportion of foreign capital exceeds 50%. The building societies group was just below the 50% level at the end of 2004. The lower share of foreign capital in building societies is due to the fact that they are part of financial groups as subsidiaries of banks based in the Czech Republic. Their owners are mostly large banks owned by a foreign strategic investor.

The prevailing trend of a high proportion of foreign capital was also visible in the individual banks and building societies. Of the 26 banks operating in the banking sector (excluding foreign bank branches), nine were wholly owned by foreign investors as of 31 December 2004, and foreign capital predominated in further eight. Five banks had exclusively Czech capital, and in three building societies Czech capital predominated. One building society still maintains an equal share of domestic and foreign capital. The state and municipalities have stable stakes in only two banks, which specialise in delivering state programmes of support to exporters and small businesses.

The predominance of foreign capital is even greater when direct and indirect control of total assets is taken into consideration. As of 31 December 2004, foreign shareholders directly controlled⁹ 84.7% of the total assets of the banking sector,

CHART 1

BANK OWNERSHIP STRUCTURE

for banks with licences as of the given date

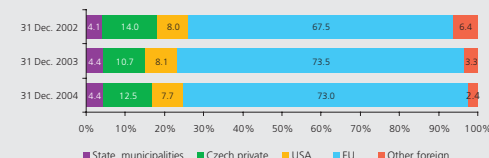


CHART 2

CAPITAL ORIGIN AS OF 31 DECEMBER 2004

for banks with licences as of 31 December 2004

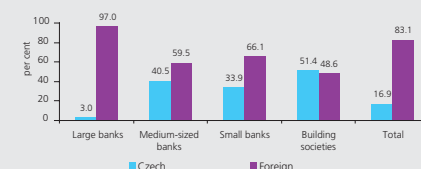
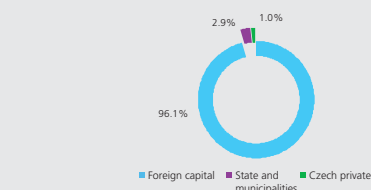


CHART 3

STRUCTURE OF TOTAL ASSETS BY OWNER AS OF 31 DECEMBER 2004

for banks with licences as of 31 December 2004



⁹ Direct control means a share in equity capital greater than 50% (including foreign bank branches).

2.2 percentage points less than at the end of 2003. By contrast, if we include indirect control, i.e. control of subsidiaries (particularly the building societies of large Czech banks owned by foreign entities), a year-on-year increase is apparent. In this case, the share was 0.2 percentage point higher than at the end of 2003, meaning that foreign capital controls 96.1% of total assets. This increase was mainly due to a fall in the proportion of the total assets of state-owned banks.

2.3 EMPLOYEES AND BANKING UNITS

(for banks with licences as of the given date)

CHART 4
STRUCTURE OF BANKING UNITS AND EMPLOYEES BY BANK GROUP
for banks with licences as of the given date

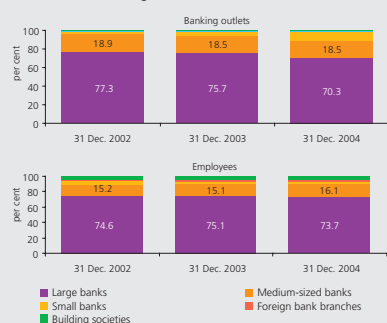


TABLE 1
NUMBER OF EMPLOYEES AND BANKING UNITS IN THE BANKING SECTOR
for banks with licences as of the given date

	31 Dec. 98	31 Dec. 99	31 Dec. 00	31 Dec. 01	31 Dec. 02	31 Dec. 03	31 Dec. 04
Number of employees (thous.)	52.8	49.4	45.5	40.9	40.6	39.0	38.2
Number of banking outlets (thous.)	2.2	2.0	1.8	1.8	1.8	1.7	1.9
Number of employees per bank (thous.)	1.2	1.2	1.1	1.1	1.1	1.1	1.1
Number of employees per banking outlet	23.8	24.6	25.2	23.3	22.8	23.4	20.4
Number of citizens per bank (thous.)	228.7	244.7	256.7	270.3	275.0	291.7	292.0
Number of citizens per banking outlet (thous.)	4.6	5.1	5.7	5.9	5.7	6.1	5.5
per employee	195.0	208.2	225.6	251.3	250.5	261.8	267.8

The downward trend in the number of employees in the banking sector continued in 2004. As of 31 December 2004, there were 38,160 people working in the Czech banking sector, 844 less than a year earlier. The 2.2% year-on-year reduction in the workforce represents a fall in the rate of decline compared to the previous year. The reduction in workforce related mainly to large banks and building societies. Conversely, medium-sized and small banks and foreign bank branches saw a rise in the overall number of employees during 2004 in both absolute and relative terms.

The number of staff and the rationalisation of banks' activities are related to the number of banking units. In 2004 banks focused on expanding the range of banking products and services they offer. To do so, they employed alternative distribution channels, direct banking and business network sharing within financial groups. They also rationalised their existing branch networks, tailoring those networks to their business needs. The number of banking units rose by 12.0% in 2004. At the end of the year, there were 1,871 units ready to serve clients. The approach to building business networks differs across the bank groups. Large banks with large branch networks are focusing on rationalising their banking units and, as in the case of building societies, the number of their units is decreasing in both absolute and relative terms. To improve their quality of services they are promoting alternative distribution channels. Building societies use the basic distribution network shared with the other members of the same financial group, and also the services of independent distributors operating without any branch network. Their own network was considerably streamlined, the number of outlets decreasing by one-third. The expansion of medium-sized banks, foreign bank branches and, in particular, small banks is subordinate to serving retail customers, whom they are targeting increasingly, and is also linked with the expansion of their retail networks and the building of direct relationships between bank and client. Small banks account for 9.5% of the banking sector's retail network.

Banks are trying to streamline their business activities and increase the efficiency of bank business. At present they are turning increasingly to retail banking. This type of banking involves the processing of large numbers of banking transactions. Providing services to individual retail clients is time-consuming and often requires the assistance of personal bankers. In the effort to streamline their activities, banks are trying to encourage their clients to employ alternative channels using the available technology. Thanks to electronic banking in the form of on-line 24-hour connection to the bank, ever wider use of the Internet and mobile phones, banks are succeeding in rationalising their banking procedures and operations.

The resultant productivity of the banking sector measured in terms of the number of citizens per bank unit and per bank employee increased during 2004. The upward trend in client service efficiency is continuing. The population of the Czech Republic increased slightly in 2004, to 10,220,600. The number of citizens per bank increased by 273 to stand at 292,000 at the end of 2004. Owing to the development of retail networks, the number of citizens per banking unit is flat at

5,500. Thanks to the rationalisation of procedures and the continuing downward trend in the number of staff in the banking sector, one bank employee is ready to serve a total of 267.8 persons; labour productivity measured in this way thus increased by 2.3% year on year. The number of clients is further increased by foreign visitors.

The gradual restructuring of branch networks, with banks striving to establish closer contacts with clients, along with the use of remote access and the employment of new technologies in the service of clients, generated a reduction in the number of employees per banking unit to 20.4. Generally, the rationalisation is not limited to retail networks, but is also being felt in client service and back office operations. The entire structure of the financial group is usually involved.

The volume of assets managed per banking unit is another indicator of the rationalisation of banking services. The increasing volume of assets managed also reflects the rising frequency of banking transactions stemming from the ever wider use of banking services and banking products in everyday life. Banking products are becoming a constant part of people's lives. At the end of 2004, assets exceeding CZK 1.4 billion were being managed per banking unit. The value of banking transactions increased in all bank groups, the trend being greatly affected by a 1.6% rise in the large bank group amid the concurrent improvement in the efficiency of use of business networks. Foreign bank branches and building societies as usual recorded above-average assets managed per unit, this being due to the nature of their banking transactions and the low number of their business units. The figure for building societies was positively affected by the advantageous yields for clients on the building saving product and also by their ability to share the retail networks of the banking financial groups to which they belong, which, in turn, means a reduced need to establish their own networks. Following the surge in building saving schemes at the end of 2003 and the sharp rise in savings agreements signed as of the same date, the building societies are returning to their usual business capacities in line with their organic growth. In an effort to get closer to clients and get involved in retail banking, small banks are expanding their retail networks faster than their transactions. By contrast, foreign bank branches, which are continuing to focus primarily on corporate clients or on providing client services in one particular region only, are maintaining a very limited number of business units.

The indicator of productivity as measured by assets managed per employee increased during the year, showing the same trend as productivity measured by total assets managed per business unit. The total assets per employee of the banking sector amounted to CZK 69.1 million at the end of 2004. Productivity measured in this way increased in year-on-year comparison, being CZK 4.3 million higher than in 2003. The trend towards more intensive staff utilisation in the banking sector was visible in all bank groups. Total assets managed per employee increased to CZK 56.1 million in large banks. Medium-sized banks are close to the average for the overall banking sector, with total assets per employee of CZK 68.4 million. The expanding small banks had yet to reach the average for the competing groups. Their figure of CZK 46.5 million in assets managed per employee was below the sector average. The figures recorded in building societies and, in particular, foreign bank branches are, respectively, 2.7 times (CZK 185.9 million) and 4.3 times (CZK 293.6 million) higher than the sector average. The markedly higher figures in foreign bank branches are due to the nature of their banking transactions. The business activities of building societies are expanding constantly, amid a modest decline in the number of employees. Productivity measured in this way increased by almost 25% in 2004.

CHART 5

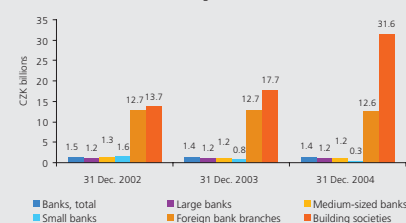
TOTAL ASSETS MANAGED PER BANKING UNIT
for banks with licences as of the given date

TABLE 2
SELECTED TYPES OF PAYMENT CARDS, ATMS AND ATM NETWORKS

for banks with licences as of the given date

	31 Dec. 98	31 Dec. 99	31 Dec. 00	31 Dec. 01	31 Dec. 02	31 Dec. 03	31 Dec. 04
Number of ATM networks	5	4	4	4	4	4	4
Number of ATMs	1,463	1,499	1,602	1,923	2,254	2,669	2,750
Annual number of ATM transactions (millions)	59.1	70.0	85.8	100.7	106.8	116.8	125.3
Annual ATM transaction turnover (CZK billions)	91.3	128.0	175.5	232.7	285.4	352.3	397.9
Cash withdrawal cards (thous.)	1,590.2	2,784.5	3,976.6	4,556.3	5,768.9	6,373.6	6,720.8
Debit cards (thous.)	1,881.8	2,790.0	3,960.4	4,516.3	5,658.3	5,803.1	6,174.0
Credit cards (thous.)	3.6	5.6	38.7	53.2	113.2	206.2	402.4
Number of terminals	6,628	8,962	13,187	17,931	25,358	31,678	44,404
Annual number of card payments (millions)	2.8	6.0	14.5	26.6	41.0	55.1	58.4
Annual card payment turnover (CZK billions)	8.4	14.0	27.0	44.7	52.5	61.3	65.9

Note: Cards issued by banks only, including for other companies

2.4 NEW TECHNOLOGY

The development of banking is closely bound up with the development of new technology. This technology is being used to enhance the range of sophisticated banking products on offer and to generate greater diversification of distribution channels. It provides direct contact between the client and the bank 24 hours a day as a means of cutting costs and optimising services. New technology provides a foundation for better service quality and a platform for e-banking, which, in turn, extends the range of services on offer and provides greater convenience and accessibility. Enhanced security of banking services, control functions and risk mitigation are also based on technological development and rapid data transmission and processing. Banks use this type of banking to cut costs, especially in the staffing area. E-banking has become part of the competitive fight between banks. In this respect, the domestic banking sector has benefited from the activities of foreign strategic partners, for whom the introduction and utilisation of new technology is part and parcel of establishing a competitive environment. A 24-hour direct link between bank and client and 24-hour provision of certain banking services are major competitive advantages.

Both banking and non-banking financial institutions offer a wide variety of payment instruments and methods. Non-cash payment for goods and services is ever more prevalent. Banks are responding to client demand based on changing lifestyles. Now that account access is a necessity and the option of withdrawing cash from ATMs is taken for granted, banks are currently focusing on increasing the supply, use and functions of payment cards, improving their quality, and, in particular, on enhancing the security of card transactions.

The four ATM networks operating in the Czech Republic fully cover clients' needs and create a sufficient competitive environment. The number of ATMs increased by a mere 3.0% during the period under review, reaching 2,750 as of 31 December 2004. The higher rise in the number of ATM transactions (of 7.2% year on year) and the almost 13% growth in the volume of ATM transactions is partly due to the fee policies of banks, which are encouraging a lower transaction frequency and higher transaction volumes. It partly reflects the growth in wages in recent years, which are, as a rule, remitted to bank accounts. Banks allow clients to optimise the fees charged for ATM use by means of special tariffs for the use of their own ATM networks or by charging a lower fee for a pre-set number of withdrawals in a particular period. In the course of 2004, the average amount withdrawn from ATMs increased by more than 5%, to CZK 3,176.

The expansion on the card market continued. Cards accompany the clients of banks and other financial and non-financial institutions in many everyday activities. Cards used for cash withdrawals from ATM networks still accounted for the largest proportion (6,720,800 cards). The number of such cards increased by 5.4% in 2004. Cards that can also be used for payments are becoming increasingly common. They rose by 6.4% year on year. Credit cards again recorded buoyant growth, almost doubling in number, although one needs to take their still relatively small base into consideration (only about 6% of the total number of cash withdrawal cards). In 2004, the number of card payments rose by 7.5%. Despite this dynamic growth, the volume of card payments was just 17% of the total volume of cash withdrawals from ATMs. This is due to the still not fully developed network of retailers accepting payment cards, and also to conservatism in client behaviour. The number of terminals allowing card payments meanwhile recorded a year-on-year rise of 40% (15 percentage points higher than at the end of 2003). Payments by card tend to be preferred by younger people. Specialised retailers issuing their own payment instruments for use in their domestic networks are competing more and more. Cards are also becoming used quite widely for

payments outside the Czech Republic (12% of the overall annual turnover of card payments).

Banks expect e-banking to develop further. Optimisation of ATM networks will be accompanied by a wider supply of products available through such networks. It will be possible to deposit money on an account and transfer funds between accounts, mobile phone credit will continue to be easy to recharge, and other new functions are expected. Credit cards will show faster progress than other payment cards. Chip cards are being offered to an ever greater extent.

2.5 CONCENTRATION

(for banks with licences as of the given date)

The Czech banking sector is stabilised with respect to structure. EU accession and the opportunity for banks from EU countries to provide banking services under the single banking licence has not changed this. In 2004, the Czech banking sector recorded no change with respect to structure or in connection with the strategic decisions of parent banks or foreign banks operating on the Czech banking market.

Compared to the end of 2003, the position of the overall banking sector strengthened slightly in terms of size of equity capital (excluding foreign bank branches). The number of banks in the group with capital of between CZK 1 billion and 2.4 billion decreased by one bank, which, by increasing its capital, replaced one bank in the group of banks with capital of between CZK 2.5 and 4.9 billion. The group of banks with the highest capitalisation (greater than CZK 5 billion) was stronger at the end of 2004. This group now consists of the entire group of four large banks, after the last of them increased its capital above this threshold in 2004. Some transfers to higher categories can also be expected next year owing to the development of banking activities, particularly lending. Only three banks were at the minimum acceptable threshold of CZK 500 million as of 31 December 2004.

The banking sector is viewed as heterogeneous in terms of capital structure. As of 31 December 2004, two pairs of large banks differed considerably in terms of equity capital distribution. Each pair has a similar equity capital level which is much higher than the other banking entities. There is a marked gap between the two pairs and between the other banks active in the Czech Republic. Many banks, however, complement their capital from other sources, e.g. reserve funds or retained earnings, which in some cases exceed the value of the equity capital itself. The four strongest banks as regards capital account for almost 63.5% of the equity capital of the banking sector. The remaining 22 banks form a relatively homogenous group with similar equity capital which is incomparably lower than that of the large bank group.

The breakdown of banks as regards total assets changed in 2004 owing to transfers of banks to higher categories in terms of the size of banking transactions. One building society, with total assets exceeding CZK 100 billion, joined the large bank group. The decline in the number of banks with assets of less than CZK 10 billion continued in 2004.

The increase in the number of banks with higher total assets is a result of the development of banking transactions in 2004. The growth in assets in individual banks and the partial shift to higher categories fed through to a rise in the total assets of the banking sector as a whole. The increase in banking transactions was chiefly attributable to a rise in lending, with building societies showing strong activity.

TABLE 3
BREAKDOWN OF BANKS BY SIZE OF EQUITY CAPITAL
for banks with licences as of the given date

CZK billions	31 Dec. 99	31 Dec. 00	31 Dec. 01	31 Dec. 02	31 Dec. 03	31 Dec. 04
over 5	6	6	5	3	3	4
2.5 to 4.9	0	0	0	2	3	3
1 to 2.4	13	12	12	10	8	7
0.5 to 0.9	6	6	6	9	9	9
0.5	7	6	5	4	3	3
under 0.5	0	0	0	0	0	0

CHART 6
EQUITY CAPITAL DISTRIBUTION OF BANKS AS OF 31 DECEMBER 2004
for banks with licences as of 31 December 2004

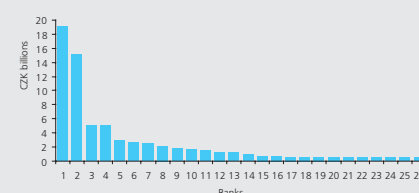


TABLE 4
BREAKDOWN OF BANKS BY SIZE OF TOTAL ASSETS
for banks with licences as of the given date

CZK billions	31 Dec. 99	31 Dec. 00	31 Dec. 01	31 Dec. 02	31 Dec. 03	31 Dec. 04
over 100	5	5	5	4	4	5
50 to 99	3	5	6	7	7	7
25 to 49	12	8	7	6	8	7
10 to 24	9	11	8	11	9	10
under 10	13	11	12	9	7	6

CHART 7
TOTAL ASSET DISTRIBUTION OF BANKS AS OF 31 DECEMBER 2004
for banks with licences as of 31 December 2004

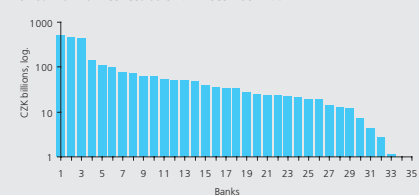


TABLE 5
PERCENTAGE SHARES OF INDIVIDUAL BANK GROUPS IN TOTAL ASSETS

for banks with licences as of the given date

	31 Dec. 99	31 Dec. 00	31 Dec. 01	31 Dec. 02	31 Dec. 03	31 Dec. 04
Banks, total	100.0	100.0	100.0	100.0	100.0	100.0
of which:						
large banks	65.1	61.5	63.8	62.2	62.1	59.8
medium-sized banks	13.2	18.2	14.8	16.6	15.8	15.9
small banks	3.3	2.6	2.3	3.4	2.0	2.3
foreign bank branches	13.6	11.8	12.8	9.6	9.6	10.0
building societies	4.8	5.2	6.3	8.2	10.5	12.0

The distribution of the total assets of banks in the Czech banking sector as of 31 December 2004 showed greater differences between the highest figures for the three leading large banks and the group of four smallest banks than in the case of their equity capital distribution. At the end of 2004 the equity capital of the largest bank exceeded the equity capital of the smallest bank approximately 38 times, while the total assets recorded by the largest bank as of the same date were approximately 550 times higher than the figure posted by the bank managing the least assets. This difference is due to the regulatory minimum equity capital requirement of CZK 500 million for the granting of a banking licence.

At the end of 2004 the group of large banks accounted for 59.8% of the total assets of the banking sector, down by 2.3 points from the preceding year. The decline was due to only a modest rise in the total assets of the sector's leading banks compared to the total assets of the overall banking sector in 2004, which rose by 4.3%. This increase was due primarily to building societies, which strengthened by 1.5 percentage points to account for 12% of the overall sector, thereby largely offsetting the reduction in the share of large banks.

2.6 COMPETITIVENESS

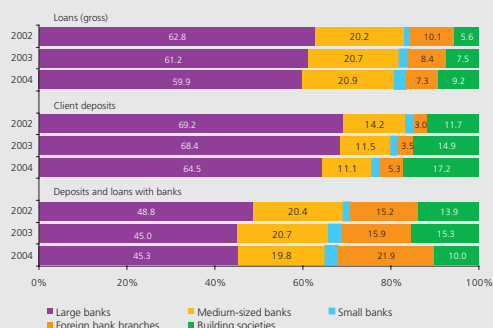
(for banks with licences as of the given date)

A functioning competitive environment, creating an ever wider supply of more sophisticated products, services and distribution channels for bank clients, is a tool shaping the innovative activities of banks and leads to the introduction of new technologies. Each bank is forced to constantly update its products and distribution channels to keep up with its competitors or achieve a competitive edge. For clients, this means ever greater user convenience.

It is clear from the development of the banking sector to date that the large banks still have a significant position. In some markets, specialised banks or specialised products are also enjoying success, creating strong competition to the universal large banks. The building societies, with their special building saving product, have a unique position in the sector. This group also benefits from state subsidies for what is already a very popular product.

CHART 8
MARKET SHARES OF BANK GROUPS IN SELECTED PRODUCTS IN PER CENT

for banks with licences as of 31 December 2004



The position of the large banks on the credit market weakened by 1.3 percentage points year on year. As of 31 December 2004 their market share was 59.9%. Banks' activities on this market are increasingly geared towards the retail customer segment. Lending to households recorded the fastest growth in 2004. In this area, large banks face competition from both medium-sized and small banks, which are strengthening their position on the client loans market in both relative and absolute terms. Their market shares increased by 0.2 and 0.6 percentage points respectively. The development of the retail credit market was utilised most markedly by the group of building societies, which recorded a year-on-year increase in market share of 1.7 percentage points. The building saving product is starting to shift from the collection of deposits to the providing of loans. The funds are being used to satisfy housing needs, for flat renovation, or in combination with mortgage loans.

Large banks also have a significant position on the client deposit market, which followed a similar trend as the client credit market in 2004. The weight of the large banks is steadily falling. Their market share was down by 3.9 percentage points from a year earlier, but their share of the total deposits accepted by the banking sector still predominated, standing at 64.5% as of 31 December 2004. By contrast, building societies have seen constant growth in client deposits, and their share in the deposits of the banking sector as a whole has strengthened significantly. At the

end of 2004, after recording annual growth of 2.3 percentage points, this group had the second highest share of the client deposit market (17.2%). The medium-sized banks, like the large banks, are still slowly losing market share and have now fallen to third position on the client deposit market (with 11.1%). However, comparing the relevant shares it is clear that the medium-sized banks specialise more in credit transactions than in deposit transactions. Foreign bank branches and small banks both showed year-on-year growth in client deposits in absolute terms and in terms of a relative strengthening of their market positions. In spite of this, the rising client deposits in foreign bank branches are lower in both relative and absolute terms, owing to the generally lower level of activity of these branches on the Czech banking market and their orientation towards specific groups of clients. For branches of foreign banks, client deposits are only a complementary source of funding in addition to funds from other banks.

Except for a modest rise in the share of receivables from banks, the large bank group lost ground on all markets in 2004. It recorded its biggest changes in share on the deposit market and (together with foreign bank branches) on the credit market. By contrast, building societies strengthened their position with respect to client credits and deposits. In 2004, building societies to an increasing extent traded the funds they obtained from client deposits in order to provide client loans; at the same time, they reduced their activities on the interbank asset market. Financing of own transactions from funds traded on the interbank market is the domain of foreign bank branches, which do not dispose of sufficient funds from deposit collection. This is reflected in their higher share of the market in receivables from banks, although their share in total banking sector deposits is constantly increasing. Along with the rise in their balance-sheet assets, small banks were more visible on all markets last year. Their activities resulted above all in a stronger position on the credit market. Medium-sized banks were flat at the 2003 level as regards banking business development. This generated a worse position on the relevant markets.

The changes in the structure of the Czech banking sector and in market shares on the domestic banking market were reflected in the values of the Herfindahl index of market competition¹⁰ for selected groups of banking transactions. In 2004, the Herfindahl index was flat or falling in all the main monitored categories of banking transactions. On the credit market it remained unchanged. Although all the bank groups except large banks and foreign bank branches recorded above-average growth in lending, the large banks' share of the credit market remained strong and was not under threat in this sense. Nor has the credit market changed with respect to the number of entities. Last year saw a continuing decrease in the index and hence also a rise in competition on the expanding deposit market, where some of the large and medium-sized domestic banks saw a weakening of their positions. The growth in competition in the relevant market is based on the expanding deposit market in the building societies segment.

The fall in the largest banks' market shares in the overall banking sector is only very slow, despite stronger competition and the changes in the structure of the banking sector stemming from the business activities of small banks and, in particular, building societies. In most cases, the three largest banks in this respect account for more than 60% of the total market in the individual items (equity, client deposits, net profit, profit from banking activities, administrative expenses). In some cases they are below this level (assets and total client credits). As a rule, the figures

CHART 9
YEAR-ON-YEAR CHANGES IN MARKET SHARES IN INDIVIDUAL MARKET SEGMENTS AS OF 31 DECEMBER 2004
(IN PERCENTAGE POINTS)
for banks with licences in the given year

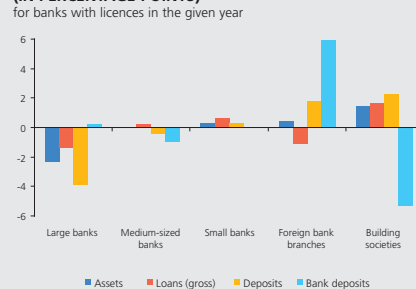


CHART 10
HERFINDAHL INDICES OF MARKET COMPETITION
for banks with licences in the given year

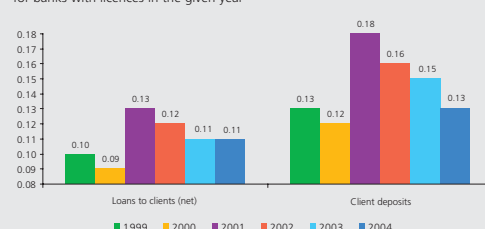
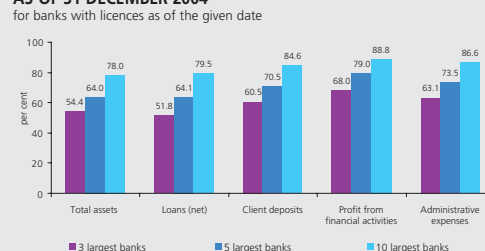


CHART 11
SHARES OF GROUPS OF LARGEST BANKS IN BANKING SECTOR
AS OF 31 DECEMBER 2004
for banks with licences as of the given date



¹⁰ The Herfindahl index of market competition can take values in the range of 0 to 1, where 1 indicates a totally uncompetitive environment. Competition on the market increases with decreasing Herfindahl index value.

exceed more than half of the total market. As of 31 December 2004 the three leading banks administered 54.4% of the total balance-sheet assets of the sector, had granted 51.8% of all client credits and had accepted 60.5% of all client deposits.

In 2004, the three largest banks accounted for 68.0% of the total profit from banking activities and 63.1% of administrative expenses. The share of profit from banking activities was 1.2 percentage points higher than in 2003. The differences in the above shares of the three, five and ten largest banks are relatively low and indicate that the largest banks still enjoy a significant lead over the other banks making up the domestic banking sector.

2.7 ASSETS AND LIABILITIES

(for banks with licences as of 31 December 2004)

As of 31 December 2004, the total assets of the banking sector amounted to CZK 2,635.6 billion, up by 4.3% on 2003. The growth rate of balance sheet assets has been accelerating in recent years; the 2004 increase represents a rise in the growth rate of 2.4 points year on year. The upward trend in the total assets of the banking sector in 2004 confirms the potential for further growth of the domestic banking sector.

Total assets did not develop evenly across all the bank groups in 2004. The overall trend continued to be affected primarily by the most strongly represented group, large banks, which showed broadly the same trend as the banking sector as a whole in 2004. All the bank groups contributed to the overall growth in total assets. While the large banks recorded only a slight rise in total net assets (0.3%), which is below the growth level of total assets in the sector, all the other bank groups in the past year increased their asset volume by more than the rise in assets for the banking sector as a whole, albeit with mixed intensity. The growth of total assets was driven above all by building societies and foreign bank branches. The assets of building societies rose by 18.9% in 2004, reaching 12% of the total assets of the sector. Although their business activities, as reflected in asset growth, tended to increase throughout the year, an acceleration is regularly recorded in the last quarter of the year. This is due to the nature of the building saving product, which allows clients to defer depositing the total or residual part of the whole-year savings figure required to qualify for the maximum amount of state support on their accounts until the end of the year. This measure leads to a significant increase in building societies' total deposits at the end of the year. Growth of client deposits in this bank group has become the main driving force behind the growth in their total assets, although building societies are also starting to lend more. With an annual increase of 9.3%, the assets of foreign bank branches also contributed to the growth in total assets. This bank group accounts for 10% of the balance sheet assets of the sector. The fastest-growing group in 2004 was the small banks, which recorded growth of 22.4%. However, the small banks had a far smaller effect on the overall trend, as their share in the total assets of the banking sector was only 2.3% as of 31 December 2004. The net assets of medium-sized banks rose by 4.6% last year, in line with the figure for the sector as a whole, and their share was 15.9%.

The structure of the assets and liabilities of the banking sector remained essentially unchanged in year-on-year comparison. The rise in the total assets of the overall sector and its individual groups was – apart from greater activity on the interbank market and continuing growth in building society deposits increasing the liabilities side of the banking sector – influenced to a great extent by changes in the credit area. Total lending consistently accounts for the bulk of total assets. The demand

CHART 12
GROWTH OF TOTAL ASSETS
for banks with licences as of 31 December 2004

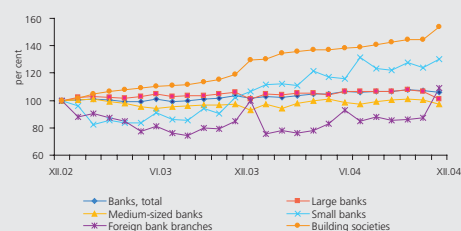
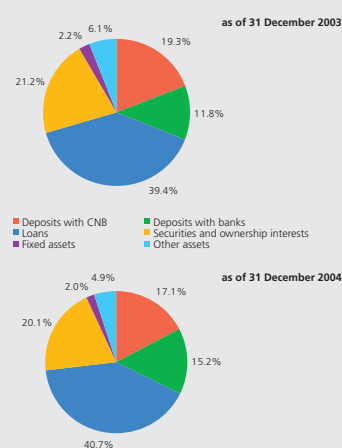


CHART 13
ASSETS STRUCTURE
for banks with licences as of 31 December 2004



for loans is increasing every year. The share of loans provided by banks to clients rose again year on year in 2004, owing to an improvement in debtors' economic situation and an increase in their ability to repay loans. Compared to the end of 2003 it was 1.3 percentage points higher. The growth in the relative figures reflected the absolute growth in total assets, and loans provided to clients also increased in absolute terms. Client loans amounted to 40.7% of total assets at the end of 2004. The intensity of lending differs across the bank groups. The group of medium-sized banks increased its share of loans in balance sheet assets to 53.3%, the highest figure in the sector. Foreign bank branches are least active in lending in terms of share in assets (30.1% of total assets). Building societies exceeded the 31% level for the first time in 2004, recording a steady increase in lending as a percentage of banking transactions.

The second largest component of the banking sector's assets is the portfolio of securities (including ownership interests). Despite a slight decline, their share of total assets was just above 20% at the end of 2004. The other components of the asset structure include deposits with the Czech National Bank and deposits with other banks, both of which remained below 20% of total banking sector assets. In 2004 they showed opposite trends. While deposits with the CNB recorded a year-on-year fall in absolute terms and their share of the banking sector's total assets also declined, the share of deposits with other banks went up quite markedly, in total by 3.4 percentage points, as a result of the increased activity on the interbank market. Banks' fixed assets, the predominant component of which is tangible assets, represented in large part by real estate (the branch network), are stable at 2% of total assets.

The liabilities side of the balance sheet has long been affected by the domestic banks' orientation towards traditional banking, in which the collection of deposits from clients and the provision of loans dominate. The structure of the banking sector's liabilities corresponds much more closely to the basic orientation of the sector than is the case on the assets side. Client deposits are far and away the main component of balance sheet liabilities, although their share fell slightly year on year, to 65.7%. The growing volume of transactions on the interbank deposit market fed through to an increase of 2.4 percentage points in deposits received from other banks as a percentage of total liabilities in 2004.

Banking business is characterised by a strong prevalence of external funds over own funds. At the end of 2004 the share of own funds in the total assets of the sector was up slightly, at 7.2%. Individual banks differ in terms of the extent of financing by their own funds. External funds predominate, although some banks, especially those that have recently opened for business, are financed exclusively by their own funds. The key large bank group uses own funds representing 8.0% of its balance sheet liabilities to finance banking transactions. The overall own funds of the banking sector rose by 6.8% during the year to stand at CZK 188.8 billion as of 31 December 2004.

Equity capital remains the largest component of own funds, although its share of own funds is continuing to edge downwards; at the end of 2004 it stood at 37.3%. The aggregate value of the other components of own funds depends on the banking sector's profits/losses in the current year and previous years. Since 2000, the banking sector as a whole has been achieving a net profit, and reserve resources in absolute terms have been increasing regularly. The growth rate of liabilities in 2004 exceeded the annual growth of banking sector reserves. Counting equity capital and reserves together, the share of this component of own funds in total liabilities rose by 0.2 percentage point year on year, although the growth rate fell. The composition of own resources, which often varies from bank to bank and also in terms of time sequence, reflects the different type of financing

CHART 14

LIABILITIES STRUCTURE

for banks with licences as of 31 December 2004

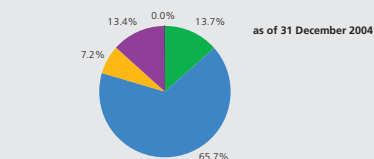
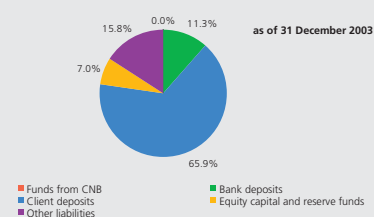
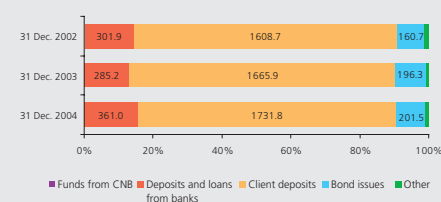


CHART 15

BANKS' EXTERNAL FUNDS

for banks with licences as of 31 December 2004



of each bank as regards the breakdown of resources into internal and external. The major factors affecting the structure of own resources include the bank's ownership structure, main transaction types, history, performance and so on. Assessing the banking sector as a whole as regards the share of reserve resources, made up of reserve funds, capital and other funds created from profit, the share of this component of own resources continues to weaken and in 2004 fell by 0.75 percentage point to 16.8%. The banking sector is profitable. Its overall profit increased by 8.5% year on year. The ratio of this profit to own resources rose from 39.1% to 39.8% year on year. Its ratio to the total assets of the banking sector also increased, to 2.8%. The growth rates of all indicators related to aggregate profits were lower than a year earlier. The banking sector recorded a stable level of subordinated financial liabilities at 0.3% of overall balance sheet liabilities for the second consecutive year.

Primary funds dominated the external funds structure in 2004, although their share did decrease slightly. The trend on the interbank market changed, with the influence of funds obtained on this market strengthening again after a long period of decline. The trend in the area of bond issuance remained unchanged, with the proportion of bonds continuing to strengthen, thanks mainly to a growing volume of mortgage bonds.

In the Czech banking sector, primary resources consist of client deposits (including deposits made by government institutions). This is entirely consistent with the basic orientation of domestic banks towards traditional banking, which is characterised by the accepting of deposits and the providing of loans. This orientation is in line with the enterprise sector's approach to financing its activities, which it does chiefly through bank loans. This trend is reinforced by the behaviour of the household sector, which traditionally has a strong propensity towards saving in the form of traditional deposits and an increasing propensity towards borrowing in the form of mortgage loans, consumer credit and loans tied to the special building saving product. Client deposits recorded growth of 4.0% in 2004, which was higher than the annual growth at the end of 2003. Despite the faster growth in client deposits, due to faster growth in both total assets and overall external funds, their share fell in year-on-year comparison (by more than 2 percentage points) to three quarters of external funds. Building societies accounted for much of the growth in client deposits in 2004, recording an almost 20% increase in deposits made up almost exclusively of household deposits. By dint of its long-term nature (a six-year saving cycle at present) the building saving product is a guarantee of stable deposit formation in the future, given all the advantages to its clients. Small banks and foreign bank branches also contributed partially to the growth in client deposits. While in the building society group the share of client deposits as of 31 December 2004 was nearing 95% of the liabilities side of the balance sheet, in medium-sized and small banks this share fluctuated around 50% of the volume of total liabilities in the course of the year, and in the group of foreign bank branches it stood at 35% of total liabilities at the end of 2004. Large banks, whose share of client deposits on the liabilities side of the balance sheet was just over 70%, are the determining factor for the figure for the entire domestic banking sector (65.7%).

Deposits received from other banks remain the second largest component of external funds. However, after a period of decline, they recorded in 2004 an increase both in absolute terms (of more than 25% year on year) and in their percentage share of overall external funds (of 2.4 percentage points, to 15.6%). Foreign bank branches and large banks are very active groups on the interbank market. The only group for which, in the long term, funds obtained on the interbank market represent more than 50% of external funds (60% at the end of 2004) are branches of foreign banks.

Issuance of debt securities is still a less significant financing source for the business activities of the domestic banking sector. At the end of 2004 debt security issuance occupied third position, despite a decline (of 0.4 percentage points) in the share of external funds (8.7%) and a year-on-year increase in the absolute value of debt securities issued. As of 31 December 2004, total bond issues amounted to CZK 201.5 billion. Debt securities constitute a kind of half-way house as regards the breakdown of banks' external funds into primary and secondary sources. The bank's creditor can be either another bank or a non-bank. Bonds with maturities of up to 1 year (short-term bonds) dominate issues of debt securities, accounting for 57% of the total. They are almost exclusively short-term deposit bills, which are very often offered by banks as a deposit product to large clients. More than 70% of long-term debt securities with maturities of over 1 year are mortgage bonds, which are still rising and are increasingly being used as a source of financing as the volume of mortgage loans grows. Debt securities covered by mortgage loan receivables rose by 16.8% during 2004. There are still large differences across banks in the use of funds from mortgage bond issues; only eight banks are active. This limited market is made up almost equally of the large and medium-sized bank groups. The entire debt securities market is also very volatile as regards the involvement of banks and bank groups. Foreign bank branches invest exclusively in short-term debt securities, whereas in the medium-sized bank group long-term debt securities prevail in a ratio of two to one.

3. RISKS IN BANKING

Banking institutions are generally exposed to many risks. However, the exposures of specific banks to individual risks can differ significantly, since each bank engages in individual kinds of activities to a different extent. The real exposure of a bank to particular risks also reflects the quality of management of those risks.

The ultimate result can be a loss, which means a reduction in the banking institution's capital or the assets of its shareholders. Where the bank's capital is insufficient to cover the losses, the bank's creditors – especially its depositors – are put at risk. Bank regulators therefore pay close attention to banks' capital and require banks to maintain at least a minimum prescribed volume of capital in relation to the risks undertaken.

Given the domestic banks' prevailing orientation towards traditional banking (i.e. the collection of deposits and the providing of loans), credit risk remains the most significant type of risk undertaken by banks during their activities. However, CNB Banking Supervision also pays due attention to the way in which banks manage other types of risks.

Banks and banking regulators are devoting more and more attention to operational risk and the methods for quantifying it. This type of risk relates to all the processes of the banking institution and can therefore affect it adversely at any point. The new capital accord (Basel II) will require banks to ensure capital coverage of this type of risk, too.

3.1 CREDIT RISK

Credit risk is the risk that is most frequently associated with the banks operating in the Czech Republic. A typical characteristic of many of these banks is the continuing predominance of traditional banking operations, i.e. a significant share of loans granted on the assets side and similarly significant weight of client deposits on the liabilities side. Even though credit risk also arises as part of many other banking activities, it is ever more frequently associated with lending. In relation to loans, credit risk represents the inability of the debtor to comply with the conditions of the loan agreement.

Given its importance, credit risk management receives extraordinary attention from banks. The basis for the management of this risk is the establishment of a system for executing loan transactions, e.g. ensuring segregation of conflicting duties, limiting subjectivity when deciding to provide a loan, providing for assessment of the client's creditworthiness, continuous monitoring thereof, etc. Furthermore, it is vital to establish a system for measuring and monitoring credit risk, to set up a system of limits, to ensure regular analyses of the loan portfolio, etc. Two independent registers of credits (debtors) are now used routinely by banks to assess client creditworthiness. These enable the participating banks to share credit information.

3.1.1 Credit structure and credit trends

(for banks with licences as of 31 December 2004)

At the end of 2004 the total volume of net loans granted to clients by banks¹¹ was CZK 1,073.9 billion, which represents a year-on-year rise of 7.8%. Gross loans

¹¹ The loan portfolio also includes loans provided to general government and bonds acquired in primary issues and not intended for sale.

amounted to CZK 1,099.9 billion as of 31 December 2004; this represents growth of 7.3% over the same period.

As in 2003, an annual increase in lending was recorded by all bank groups except foreign bank branches. In absolute terms, the volume of loans increased the most in the case of large banks, which recorded a rise of CZK 33.6 billion (or 5.5%). Building societies achieved the second largest increase, with CZK 23.8 billion (31.5%). Loans extended by medium-sized banks rose by CZK 17.3 billion (8.4%) and those by small banks by CZK 8.9 billion (41.8%).

Loans to the corporate sector continued to be the largest component of lending, with a share of 45.5%. Loans granted to non-financial businesses stood at CZK 459.5 billion at the end of 2004, an increase of 7.5% on a year earlier. The improving situation of the corporate sector, growth in industrial production and investment together with a persisting environment of low interest rates is enabling many businesses to obtain bank loans or increase their existing level of debt.

The fall in loans provided to general government continued into 2004. These loans declined by 27.6%, leading to a decrease in their share of total lending from 19.2% to 11.4%. This trend is associated primarily with the gradual winding-down of the Czech Consolidation Agency's activities and relates especially to the large bank group.

Strong growth in loans to households continued into 2004. At the end of 2004, loans granted to households amounted to CZK 283.3 billion, an increase of 34.4% in year-on-year comparison. The continuing high growth rates of loans to households are changing the structure of the loan portfolio. The base for determining the annual growth rates of loans to households is increasing every year by around one third. Loans extended to the household sector now account for 28.0% of total loans (22.2% a year ago).

In 2004, the share of mortgage loans in total loans provided to households rose from 37.3% to 42.4%, and the share of building society loans was virtually unchanged at 29.4%. The rate of growth of consumer credit continued to decline in 2004, falling to 13.7% (a fall of 3.3 percentage points), while its share of the total volume of loans provided to households fell to 24.4%.

Mortgage loans provided in the Czech Republic are a key determining factor of the trend in lending. Their enormous growth in 2004 fostered a gradual convergence to the level in EU countries, where mortgage lending not only has a long tradition, but is an important segment of the bank loan market. In EU countries a full two thirds of loans granted to the household sector in the form of mortgages, and around 35% of all bank loans (excluding loans to financial and government institutions), are also of this type. Mortgage loans rank among most important banking transactions, are very stable and provide a substantial part of banks' income from financial activities.

Although it is not yet possible to compete with the advanced and traditional EU market in absolute comparison, mortgages are converging towards the EU.

The year-on-year growth in mortgage loans was the highest of all the types of loans provided, reaching 52.8% (with and without state support). Mortgage loans without state support were the fastest growing market segment in absolute terms, with growth of 65.5%. Mortgages account for 20.2% of total bank loans (excluding loans to financial and government institutions). A year earlier the figure was 15.4%.

CHART 16
STRUCTURE OF LOANS BY ECONOMIC SECTOR
for banks with licences as of 31 December 2004

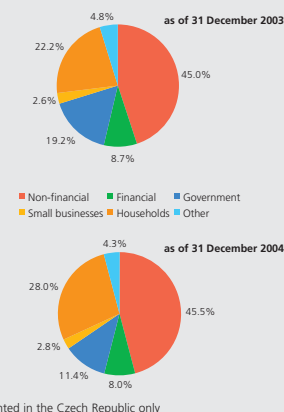
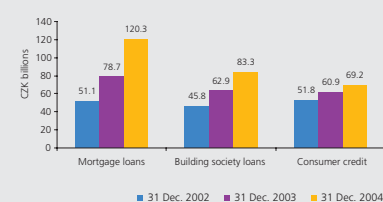


CHART 17
LOANS TO HOUSEHOLDS
for banks with licences as of 31 December 2004



The factors underlying the expansion in mortgages are equally spread between the loan supply side and loan demand side, including favourable external economic conditions. On this growing market banks are competing for potential retail clients and taking the opportunity to use their still sufficient resources. The low interest rate environment has enabled the market leaders to offer very low mortgage rates. Most of the competition lies in the conditions for providing mortgage loans, in administrative simplicity and in maximum speed. Up to 100% LtV (100% Loan to Value - the provision of a loan equal to the full value of the pledged real estate) is on offer, as are "American mortgages" (loans secured by real estate and with no stated purpose). The demand side is being affected by the need for housing among the strongly represented category of households (particularly 1970s baby-boomers), whose incomes, along with the low rates, allow them to apply for mortgage credit. Mortgages are also being used to fund investment activities. A higher yield on real estate (sale and rental) can be expected by comparison with the current real interest rate on deposits. The decision by many people to purchase real estate was also influenced by the widespread opinion that property prices would rise following the Czech Republic's accession to the EU. Another stimulus was the announcement that construction work for housing purposes was to be moved to the higher VAT rate in 2007. The stable economic situation and the improving income situation of households are allowing them to take on long-term commitments.

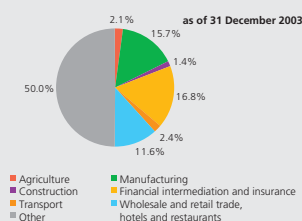
In the Czech Republic, banks with universal licences provide mortgages as part of their normal business activity. Of the total of 35 banks and foreign bank branches, 18 provide mortgages. A total of 10 banks use the option of issuing mortgage bonds to finance their mortgage transactions. From the point of view of business activity, mortgages are a very efficient banking product for banks. Mortgage deals are retail transactions with a high average nominal value, they establish a long-term relationship between the client and the bank (95% of all housing loans are long-term), they simultaneously allow relations between the bank and the client to be diversified on the basis of cross-selling, they positively affect cash-flow, and they are a source of long-term and regular income to banks. Banks also offer complementary services that often use other financial products provided within their financial groups.

The mortgage market will be affected going forward by state housing support policy, the rent deregulation process, the entry of baby-boomers onto the labour market and their decisions as regards working in the EU labour market, state tax policy in support of house-buying, immigration policy, investment opportunities and so on.

The structure of loans by economic activity recorded no major changes in year-on-year comparison. The exception was a decline of almost 30% in loans to the financial intermediation and insurance sector, to CZK 112.0 billion, which caused their share of the total to fall from 16.8% to 11.1%. This decline was due in part to the repayment of loans by the Czech Consolidation Agency, which forms part of this segment. The item "other loans" also includes loans to households, which were the main reason for the year-on-year growth in its share from 50.0% to 55.9%.

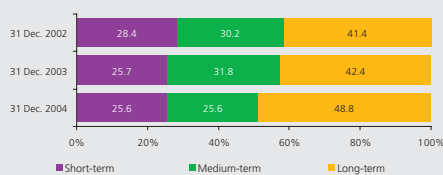
As regards the maturity of the loans provided, 2004 saw a further significant increase in the share of long-term loans (over 5 years) in total loans. These loans rose by 19.3% in 2004, reflecting the rise in loans to households for housing purposes, which are mostly of a long-term nature (mortgage loans and building society loans).

CHART 18
STRUCTURE OF LOANS BY ECONOMIC ACTIVITY
for banks with licences as of 31 December 2004



Note: Loans granted in the Czech Republic only

CHART 19
TIME STRUCTURE OF LOAN PORTFOLIO
for banks with licences as of 31 December 2004



Note: Loans granted in the Czech Republic only

3.1.2 Classified and non-performing loans and their coverage

(for banks with licences as of 31 December 2004)

As of 31 December 2004, classified loans amounted to CZK 118.8 billion, which represents a slight increase of almost 4.2% compared to the end of the preceding year. Owing to the significant growth in total client loans, however, the share of classified loans in their total volume fell from 11.2% to 10.8% year on year.

The increase in classified loans resulted from a 15.4% year-on-year rise in watch loans, i.e. the lowest-risk category of loans. A greater rise in watch loans occurred at the very end of the year, when some banks transferred part of their standard loans into this category owing to a potential worsening of the economic situation of some of their clients.

Non-performing loans (i.e. loans classified by banks as substandard, doubtful or loss), which have a higher level of risk, continued to develop favourably in 2004, falling by 10.3% year on year. At the end of 2004 they amounted to CZK 44.5 billion, i.e. 4.1% of total client loans.

The rising share of loans to households in total loans is fostering an upturn in the quality of the banking sector's loan portfolio. Loans to households (excluding small businesses) recorded a rise of CZK 72.5 billion (34.4%) in 2004. Loans to non-financial corporations rose by CZK 31.9 billion (7.5%). The share of classified loans provided to households in the total volume of loans to this segment is 5.4%, significantly lower than in other sectors. The rising share of loans to households in total loans is thus positively affecting loan portfolio quality.

Loans associated with satisfying housing needs, i.e. mortgage loans and building society loans, which account for 71.8% of total loans to households, dominate the structure of loans to households. In their case, classified loans make up less than 4% of the total. In the case of consumer credit, which accounts for 25% of loans to households, the figure is 10.8%. The generally lower quality of consumer credit is due to the nature of such loans, which are often for lower amounts, and to their simpler application and approval processes.

In all, 70% of the fall in classified loans involved standard repayment and 24% involved banks deciding to transfer them to the standard loan category following an improvement in the client's economic situation. Unlike in previous years, when some banks had sold off larger volumes of claims (either individually or in whole packages) as part of the "clean-up" of their loan portfolios, only around 1% of the total decrease in classified loans in 2004 involved sales of claims to other entities (compared to 6.3% a year earlier). Only 1 per mille of cases were repaid by sale of collateral.

CNB Banking Supervision monitors and regularly evaluates the weighted classification indicator, which enables loans with varying probabilities of default to be recalculated on a single base. The weighted classification thus allows us to evaluate and summarise truly non-performing classified loans with much greater precision than in the case of mere summation of the volumes in each classified loan category. At the end of 2004 the weighted classification totalled CZK 27.9 billion, or 2.6% of total loans granted. The weighted classification has long been falling, but owing to the completed clean-up of the banking sector this process has slowed significantly. Classified loans fell by 13.6% year on year in 2004, as against 37.3% in 2003 and 43.8% in 2002.

The quality of the banking sector's loan portfolio is very good. The potential losses from credit transactions are covered sufficiently. The reserves and provisions

TABLE 6

STRUCTURE OF CLASSIFIED AND NON-PERFORMING LOANS
for banks with licences as of 31 December 2004

	31 Dec. 02	31 Dec. 03	31 Mar. 04	30 Jun. 04	30 Sep. 04	31 Dec. 04
Classified loans in CZK millions	147,102	114,009	116,212	114,190	111,358	118,826
as percentage of total loans	15.8	11.2	11.2	10.8	10.2	10.8
Non-performing loans in CZK millions	75,770	49,608	49,955	47,127	47,147	44,506
as percentage of total loans	8.1	4.9	4.8	4.5	4.3	4.1
of which:						
in CZK millions						
watch loans	71,332	64,400	66,257	67,063	64,211	74,320
substandard loans	27,515	19,298	19,416	18,371	19,376	19,344
doubtful loans	11,689	6,913	7,375	6,886	5,772	5,306
loss loans	36,566	23,398	23,165	21,869	21,998	19,857
of which:						
in per cent						
watch loans	48.5	56.5	57.0	58.7	57.7	62.5
substandard loans	18.7	16.9	16.7	16.1	17.4	16.3
doubtful loans	7.9	6.1	6.3	6.0	5.2	4.5
loss loans	24.9	20.5	19.9	19.2	19.8	16.7

CHART 20

DECREASES IN WATCH AND NON-PERFORMING LOANS
for banks with licences as of 31 December 2004

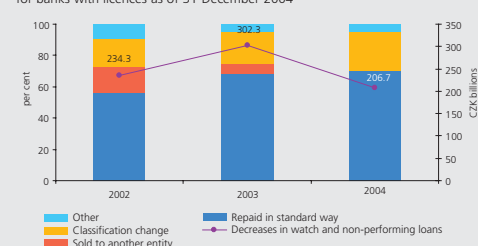
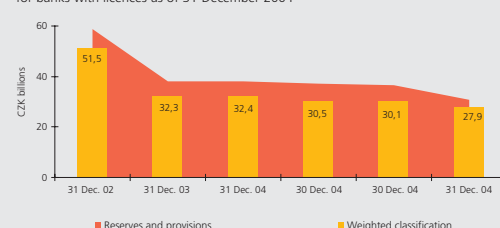


CHART 21

COVERAGE OF POTENTIAL LOSSES FROM LOAN PORTFOLIO
for banks with licences as of 31 December 2004

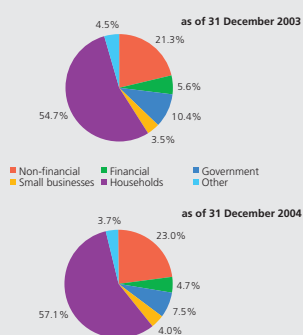


created during 2004 repeatedly exceeded the values of the weighted classification. Reserves and provisions stood at CZK 31.2 billion, exceeding the value of the weighted classification by CZK 3.3 billion as of 31 December 2004. They recorded a downward trend throughout the year, as well as by comparison with 2003. The reduced need for provisions and reserves is a direct consequence of the constantly improving loan portfolio. Although banks also use quality collateral, very often real estate, as loan security, this currently represents only enhanced additional coverage of the potential risks. All the potential risks connected with lending by banks as expressed by the weighted classification have been fully covered by reserves and provisions since 2002.

CHART 22

DEPOSIT STRUCTURE BY SECTOR

for banks with licences as of 31 December 2004

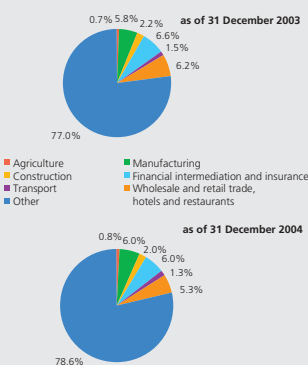


Note: Deposits accepted in the Czech Republic only

CHART 23

DEPOSIT STRUCTURE BY ECONOMIC ACTIVITY

for banks with licences as of 31 December 2004

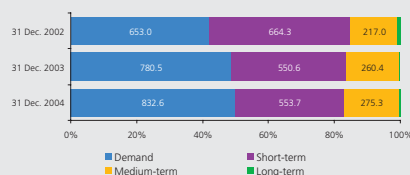


Note: Deposits accepted in the Czech Republic only

CHART 24

TIME STRUCTURE OF DEPOSITS

for banks with licences as of 31 December 2004



Note: Deposits accepted in the Czech Republic only; the data in the chart are in CZK billions

3.2 LIQUIDITY RISK

Liquidity risk is the risk that a bank will lose its ability to meet its financial liabilities on their due date or to finance its assets. A lack of disposable liquid funds may thus result in losses connected with the extraordinary costs of securing such funds. For the purposes of liquidity risk management banks must have suitable procedures for measuring and monitoring net financial flows and liquidity positions in each of the main currencies with which they work. When determining the maturities of many asset and liability items, banks must use assumptions based on historical experience. Matching the maturities of assets and liabilities is a basic prerequisite for managing this type of risk.

In addition to standard liquidity scenarios, banks must have contingency procedures in place for emergencies that affect the bank alone or the financial market as a whole. Therefore, banks must continuously monitor their options for accessing the market in order to acquire additional funds or to sell their assets.

3.2.1 Primary funds

(for banks with licences as of 31 December 2004)

Client deposits increased by CZK 66.0 billion (4.0%) year on year, amounting to CZK 1,731.9 billion at the end of 2004.

Household deposits grew by 6.2% in 2004 to stand at CZK 952.6 billion at the year-end. Deposits of the non-financial sector, which is the second largest banking sector depositor, increased by the same percentage. At the close of 2004, non-financial sector deposits totalled CZK 384.5 billion.

Given the continuing low interest rate environment, which is providing no incentive for depositing funds on term accounts, most of the rise in client deposits is due to demand deposits. They rose by 6.7% (CZK 52.1 billion) year on year and now account for one half of all client deposits. However, unlike in 2003, time deposits also recorded a slight increase in absolute terms. They rose by CZK 20.4 billion (2.5%) in 2004, compared to a decline of CZK 80.8 billion (9%) in 2003. At the year-end, client deposits formed 65.7% of the total liabilities of the banking sector, practically the same figure as a year earlier.

The increase in time deposits was due in particular to a rise in building society deposits of CZK 48.8 billion (19.6%). Conversely, in the case of the other bank groups time deposits were flat or continued declining. Building society deposits exceeded 17% of the deposits of the banking sector as a whole. The state-subsidised building saving product allows for irregular depositing – almost half the deposits are usually made during the final month of the year.

Turning to the time structure of time deposits, medium-term deposits (maturing within 1 to 5 years) saw a particularly strong increase. This is consistent with the rise in building society deposits. Long-term deposits (i.e. those with maturities of over 5 years) continue to be of marginal significance in the deposit time structure. Owing to a change to the building saving terms and conditions as from 1 January 2004 which prolonged the minimum saving time for qualifying for state support to 6 years, long-term deposits increased from CZK 4.9 billion to CZK 8.6 billion in 2004.

3.2.2 Secondary funds

(for banks with licences as of 31 December 2004)

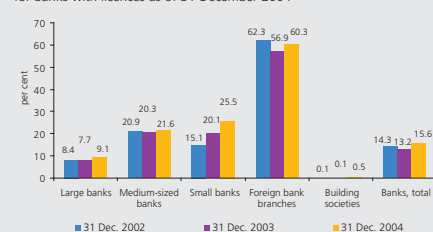
The volume of liabilities to other banks within the entire banking sector varies significantly from month to month, reflecting the activities of individual banks on the interbank market, which depends in particular on their current need to supplement their funds. Liabilities to banks stood at CZK 361.1 billion as of 31 December 2004, up by CZK 75.8 billion (26.6%) year on year. Of the total liabilities to banks, 75% fall to large banks and foreign bank branches. At 13.7% of the total, liabilities to banks are the second largest item of the banking sector's liabilities.

The banking sector in the Czech Republic as a whole remains a net creditor to foreign banks on the interbank market. Large banks and building societies have the largest positive position on the interbank market, while foreign bank branches are the biggest net debtor. The positions of small and medium-sized banks fluctuate between positive and negative in individual months.

Large banks are not among the key players financing themselves on the interbank market. They have no need to top up their own funds on the relevant market, as they have sufficient primary funds obtained directly from their own clients in the form of primary client deposits. The extensive branch networks of each large bank, together with client confidence in the banking sector and the functioning deposit-guarantee scheme, play an important role in acquiring such funds. Another group even less dependent on secondary funds is the building societies, thanks to the high popularity of the building saving product (based, in turn, on the opportunity to gain higher returns on deposits). In the case of building societies, client deposits cover the need for funds to a sufficient extent. For these reasons, the share of deposits from other banks in total external funding sources as of 31 December 2004 was just over 9% in the large bank group and only 0.5% in the building societies group. In both groups the level has long been stable.

On the other hand, foreign bank branches are very active in utilising funds gained from other banks. Their share of liabilities to banks in external funds has long fluctuated between 60% and 70%. At the end of 2004, it stabilised at 60%. This relatively high dependence on external funds from other banks derives historically from their limited branch networks and the minimal share of client deposits in their balance sheets. Foreign bank branches tend to have a low share of client deposits (5.3% at the end of the year) in total deposits accepted by the Czech banking sector. Given their 10% share in total assets their weight in the sector is almost twice as high. As these are branches of renowned banks operating on international markets, they are not limited in their business activities and they generally have smooth access to the interbank market under very advantageous conditions. The medium-sized banks' level of financing by secondary funds is edging up and now exceeds 20%. Small banks are more dependent in this regard, with a figure of over 25%.

CHART 25
SECONDARY FUNDS AS A PERCENTAGE OF EXTERNAL FUNDS
for banks with licences as of 31 December 2004



Debt securities continue to be a less significant source of financing for domestic banks. The share of debt security liabilities in the total liabilities of the banking sector is 8.1%. Their rate of year-on-year growth is also lower, being only 6.4% in 2004. Short-term securities prevail, at CZK 115.5 billion (53.8%). These are solely short-term bills, which banks use as a deposit product for major clients. Long-term debt securities amount to CZK 85.9 billion, representing 40.0% of total debt security liabilities. Most of these are mortgage bonds, which totalled CZK 61.7 billion at the end of 2004, up by CZK 9 billion on a year earlier. The volume of long-term coupon and zero-coupon bonds fell by CZK 12.1 billion year on year, to CZK 23.4 billion. More than 60% of total debt security liabilities pertain to the large bank group. The medium-sized banks, with 35.3%, are the second most significant group.

3.2.3 Quick assets

(for banks with licences as of 31 December 2004)

The banking sector continues to dispose of sufficient quick assets, despite a year-on-year decline of 4.8% to CZK 864.1 billion. The total quick assets of the banking sector are significantly affected during the year by repos with government institutions, which deposit their short-term free funds with banks. Banks then deposit these funds in repos with the CNB. In December, however, the volume of these operations always falls significantly, and this is reflected in a decline in quick assets. The situation was the same in 2004, when throughout the year quick assets markedly exceeded their end-2003 level and did not fall significantly until December (by CZK 69 billion).

Quick assets account for 32.8% of the banking sector's total assets, down slightly by comparison with the end of 2003 (35.9%). The structure of quick assets was virtually unchanged in year-on-year comparison. With a 52.1% share, deposits with central banks still dominate, despite recording a slight year-on-year decline (from CZK 484.8 billion to CZK 450.0 billion), just as in 2003.

At CZK 332.4 billion, or 38.5% of total quick assets, Treasury and other bills remain the second largest component of quick assets. Current accounts with banks and cash are not very significant in terms of volume; their shares in quick assets remain below 10%.

3.2.4 Matching of asset and liability maturities

(for banks with licences as of 31 December 2004)

When managing liquidity risk, banks endeavour to match the maturities of their assets and liabilities.

For time bands covering maturities of up to two years, there is typically a slight excess of liabilities over assets. The single exception is the band for one week to one month, where assets exceed liabilities once demand deposit liquidity has been taken into account. The assets side of the balance sheet exceeded the liabilities side in all residual maturity bands of over 2 years. The resulting net balance sheet positions (whether positive or negative), once demand deposit liquidity has been taken into consideration, do not exceed 9% of total assets in any of the bands monitored. In none of the bands up to three months – considered of prime importance in terms of liquidity management – did the percentage exceed 2.5% in absolute terms. The liquidity position of the banking sector as a whole can therefore be considered balanced at the end of 2004.

CHART 26
QUICK ASSETS
for banks with licences as of 31 December 2004

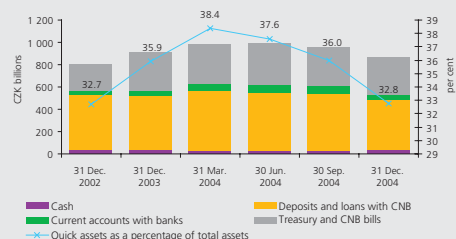
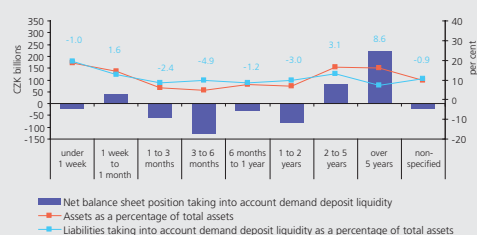


CHART 27
ASSETS AND LIABILITIES BY RESIDUAL MATURITY AS OF 31 DECEMBER 2004
for banks with licences as of 31 December 2004



Note: The data in the chart represent the difference between the share of assets and liabilities in each time band

TABLE 7
MATCHING OF ASSET AND LIABILITY MATURITIES
for banks with licences as of 31 December 2004; percentages

	31 Dec. 03	31 Mar. 04	30 Jun. 04	30 Sep. 04	31 Dec. 04
Cumulative net position:					
to 3 months as a percentage of assets ¹⁾	-1.95	-0.94	-0.80	-2.73	-1.80
to 1 month as a percentage of assets ^{1),2)}	-0.95	1.38	0.39	-2.59	-0.01
Assets/liabilities maturing:					
within 1 month	51.72	54.06	53.01	48.45	51.78
in more than 1 year	251.36	254.91	258.89	264.30	263.81
in more than 5 years	498.46	526.36	610.93	689.21	720.07

1) Minus 80% of demand deposits
2) Including off-balance sheet

The liquidity risk of the banking sector as a whole – expressed by the cumulative net position to one month (including the off-balance sheet and net of 80% of demand deposits) in relation to total assets – at -0.01% indicated a practically balanced situation between the most liquid assets and liabilities as of 31 December 2004. The liabilities component, which slightly predominates, is in this regard negligible. The resulting, almost balanced indicator is much better than in preceding periods. At the end of 2004, the cumulative net position to three months as a percentage of total assets (net of 80% of demand deposits) was 1.8% in absolute terms, again better than at the end of 2003.

In the longer time bands, i.e. for residual maturities of one year or more, assets exceed liabilities in the cumulative net position. This trend is intensifying. The situation is similar with assets and liabilities with maturities exceeding five years, although with a greater trend towards a strengthening of asset items. In both maturity bands, banks are thus using funds with shorter maturities to finance their medium-term and, in particular, long-term activities, which may pose a potential risk if certain conditions are fulfilled.

3.3 MARKET RISK

Market risk consists in the potential for a bank to incur a loss due to changes in interest rates, exchange rates, share prices on the capital market or prices of other assets. It is an umbrella term for interest rate risk, foreign exchange risk, equity risk and other risks associated with movements in market prices. Market risk also affects the liabilities side of the balance sheet, since it can influence the level of a bank's liabilities.

3.3.1 Foreign exchange risk

(for banks with licences as of 31 December 2004)

Foreign exchange risk is the risk of losses arising from movements in exchange rates. A bank is exposed to this risk in the event that it has foreign currency assets or liabilities in its balance sheet or off-balance sheet. As the values of these assets and liabilities are expressed in Czech korunas, any changes in exchange rates automatically bring about changes in their values. The degree of foreign exchange risk depends on the proportion of foreign currency assets and liabilities in its balance sheet, which is given by the extent of its involvement in foreign-currency activities.

The Czech banking sector as a whole is not exposed to any significant foreign exchange risk. This ensues primarily from the local nature of domestic banks, whose business activities are largely geared towards the domestic market. Their presence on foreign markets, be it direct (e.g. purchases of foreign securities, lending to foreign entities) or via their branch or subsidiary networks, remains very limited. The Czech Republic's accession into the EU has not changed this situation.

The share of net assets of the banking sector in foreign currencies in total net assets was 19.0% as of 31 December 2004, compared to 16.9% a year earlier. In absolute terms, the volume of net foreign exchange assets rose by CZK 74.2 billion to CZK 500.2 billion. Most of this increase was due to receivables from banks, 22.9% of which are denominated in foreign currencies. The share of foreign exchange receivables from other banks in total receivables from other banks (i.e. adjusted for liabilities to central banks) was 41.7% (compared to 35.0% a year earlier). Foreign exchange client receivables were virtually unchanged year on year.

CHART 28

FOREIGN EXCHANGE ASSETS AND LIABILITIES AS A PERCENTAGE OF TOTAL ASSETS AND LIABILITIES
for banks with licences as of 31 December 2004

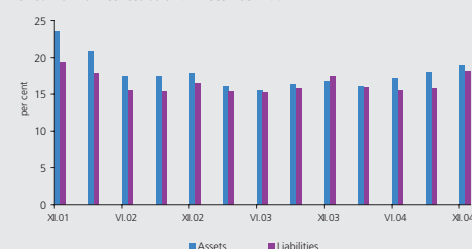


CHART 29

STRUCTURE OF FOREIGN EXCHANGE ASSETS AND LIABILITIES AS OF 31 DECEMBER 2004
for banks with licences as of 31 December 2004

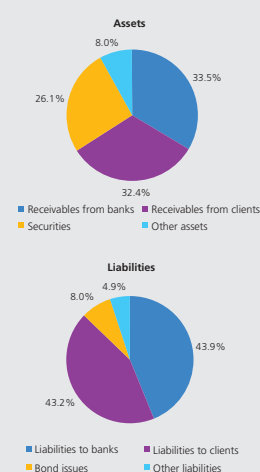
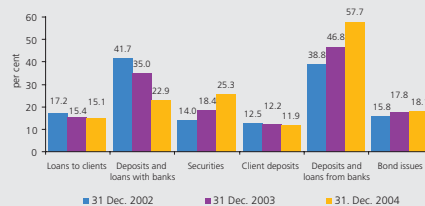


CHART 30
SHARE OF FOREIGN EXCHANGE IN SELECTED PRODUCTS

for banks with licences as of 31 December 2004



Note: For asset items, the percentages are calculated from net asset values

TABLE 8
PERCENTAGE SHARES OF FOREIGN EXCHANGE IN ASSETS,
LIABILITIES AND SELECTED TYPES OF BANKING TRANSACTIONS

for banks with licences as of 31 December 2004; in the case of asset items, the percentages are calculated from their net values

	Large banks	Medium-sized banks	Small banks	Foreign bank branches	Banks, total
Assets	20.8	22.1	17.9	26.2	19.0
Liabilities	15.1	24.3	17.0	47.1	18.0
Receivables from banks	17.7	39.4	15.2	32.6	22.9
Receivables from clients	16.2	15.1	23.7	21.9	15.1
Securities	39.9	18.4	1.8	0.4	25.3
Liabilities to banks	50.1	55.4	45.3	67.1	57.7
Liabilities to clients	12.8	18.7	10.6	24.9	11.9
Bond issues	14.1	23.9	5.0	52.5	18.1
Receivables from derivatives transactions	22.3	28.3	50.8	39.4	27.4

CHART 31
FOREIGN EXCHANGE POSITION OF THE BANKING SECTOR

for banks with licences as of 31 December 2004

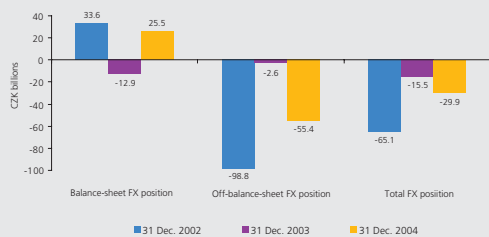
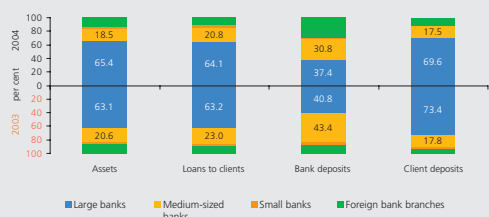


CHART 32
MARKET SHARES OF BANK GROUPS IN ASSETS AND SELECTED
FOREIGN CURRENCY PRODUCTS IN PER CENT

for banks with licences as of 31 December 2004



Their share in total receivables was 15.1% in net terms. The rise in foreign currency securities, which rose by more than CZK 30 billion, or 31.7%, year on year, continued into 2004. Foreign currency bonds of general government recorded the biggest increase, whereas the volume of corporate bonds went down slightly in year-on-year terms. Foreign currency securities make up 25.3% of all the securities in the banks' assets.

Foreign currency liabilities developed analogously to foreign currency assets in 2004. Their share in total liabilities rose from 17.4% to 18.0% in 2004. In absolute terms that means an increase of CZK 35.8 billion to CZK 474.7 billion. The increase came at the cost of liabilities to banks (primarily time deposits accepted from banks). Foreign currency client deposits and securities issued in foreign currencies rose only negligibly.

Off-balance sheet foreign currency assets and liabilities made up, respectively, 26.8% and 29.4% of total off-balance sheet assets and liabilities as of 31 December 2004. Derivatives – specifically fixed-term transactions – were the most significant component.

The structure and volume of foreign exchange transactions differ from bank to bank. The share of foreign exchange assets in total assets continues to be the highest in foreign bank branches, at 26.2%. In the large banks the figure is 20.8%, in medium-sized banks it is 22.1% and in small banks it is 17.9%. Given the legally restricted range of transactions that building societies are allowed to carry on, this group registers only 1 per mile of assets in foreign currencies.

Foreign exchange positions, i.e. differences between balance-sheet/off-balance-sheet assets and liabilities, have recorded quite dramatic developments over the past three years. The balance-sheet position started as long and, after a decline at the end of 2003, changed to short (CZK -12.9 billion), only to end 2004 as long again, to the tune of CZK 25.5 billion. The increase consisted primarily in faster growth in balance-sheet foreign currency assets than liabilities; specifically, there was a rise in the values of foreign currency transactions on the interbank market (both deposits with banks and liabilities to other banks in foreign currencies). Foreign exchange risk has increased slightly since the end of 2003 in this respect.

The banking sector recorded its largest open foreign exchange position vis-à-vis the euro. As of 31 December 2004 this was a long position (i.e. the volume of assets exceeded the volume of liabilities) of CZK 3 billion, which represents 2.04% of the banking sector's regulatory capital. The second largest was an open position vis-à-vis the Slovak koruna (short, CZK 1.5 billion, 1.03% of capital) and the third largest was the position vis-à-vis the dollar (short, CZK 0.7 billion, 0.51% of capital).

The off-balance-sheet position always ended short during 2004. As of 31 December 2004 it had increased again to CZK -55.4 billion from the final value of CZK -2.6 billion recorded at the end of 2003. This was again due mainly to a more than twofold increase in off-balance-sheet foreign currency liabilities relative to the same off-balance-sheet asset item. The increase (of CZK 87 billion) in liabilities from fixed-term transactions in foreign currency interest rate and currency instruments seemed to be a significant factor. The off-balance-sheet foreign exchange risk increased somewhat in 2004, following a decline in 2003.

The market shares of the bank groups in the individual foreign exchange items of the banking sector's balance sheet differ considerably. These shares also differ from their shares in total balance sheet items. More changes occurred during the period under review. The share of large banks in foreign exchange assets stood at 65.4%

at the close of 2004, an increase of 2.3 percentage points on a year earlier. Other significant market shares in foreign exchange assets as at 31 December 2004 were recorded by both medium-sized banks and foreign bank branches, with 18.5% and 13.8% respectively, representing declines of 2.1 percentage points and 0.3 percentage point respectively relative to the end of the previous year. The market shares of the small banks in foreign exchange assets are in keeping with their overall share in the sector. The building societies' shares are negligible in this regard.

The large banks are maintaining their position on the foreign exchange client deposit market, thanks in large part to their extensive branch networks. Nevertheless, these deposits recorded a decline in share during 2004, falling below the 70% level for the first time. The shares of small and medium-sized banks were flat. Foreign bank branches gradually caught them up: their share of foreign exchange client deposits rose by 3.9 percentage points to stand at 11.1% at the end of 2004. The large bank group still has a strong position on the foreign currency client loan market, with a share steadily approaching 65%. By contrast, the foreign exchange bank deposit market recorded significant shifts for the second consecutive year. The share of foreign bank branches rose to almost 30%, at the expense of the large and medium-sized banks (whose shares decreased to 37.4% and 30.8% respectively). The relevant market segment is now divided almost equally among the major players.

3.3.2 Equity risk

(for banks with licences as of 31 December 2004)

The total volume of securities held by the domestic banking sector recorded no major changes during 2004. Their structure did not change significantly either. As of 31 December 2004, the banking sector held securities (including ownership interests) totalling CZK 529.2 billion, 66.5% of which were government bonds (including other government institutions) and central bank bills, which is essentially the same percentage figure as at the end of 2003. In all, 60.5% of the total volume of securities is held by large banks. Taking into consideration only non-government securities, the share of this bank group is even higher, at 74.4%.

The securities portfolios of the banks operating in the Czech Republic contain mainly bonds. Shares and units amounted to CZK 10.4 billion as of 31 December 2004 (excluding ownership interests). Of this figure, shares alone totalled CZK 1.3 billion, but only CZK 73 million was held in the trading portfolio. Shares and units account for around 0.4% of total banking sector assets. Most are held by large banks (CZK 9.9 billion). Some banks execute most of their securities transactions through their subsidiaries. Nevertheless, the banking sector is exposed to equity risk only to a very limited extent, since most such transactions are executed on clients' accounts.

The book value of the ownership interests of the banking sector increased by CZK 6.5 billion year on year, to CZK 18.6 billion. CZK 18.2 billion of this total falls to the large bank group.

Securities held to maturity continue to have the largest share as regards the three types of portfolio into which the securities held by banks are broken down, i.e. trading securities, securities available for sale and securities held to maturity and ownership interests. At the end of 2004 this item accounted for 58.4% of the total securities portfolio. The trading portfolio showed a modest year-on-year decline, while the portfolio of securities available for sale recorded a slight increase.

TABLE 9

STRUCTURE OF SECURITIES BY TYPE

for banks with licences as of 31 December 2004; CZK billions

	31 Dec. 02	31 Dec. 03	31 Dec. 04
Securities accepted by central banks for refinancing	214.0	304.5	291.6
Government bonds	210.8	291.3	272.6
Central bank bonds	3.2	13.2	19.0
Bonds	165.7	200.4	200.7
issued by government institutions	45.5	53.2	60.4
issued by central banks	0.0	0.0	0.0
issued by other entities	120.1	147.2	140.3
Bills of exchange	5.9	1.9	2.1
Securities secured by assets	10.5	8.4	5.9
Shares	1.3	1.3	1.3
Units and other interests	45.8	6.4	9.1
Ownership interests	15.6	12.1	18.6
substantial	4.3	1.3	2.3
controlling	11.3	10.8	16.3
SECURITIES, TOTAL	458.8	535.0	529.2

CHART 33

STRUCTURE OF SECURITIES PORTFOLIO BY PORTFOLIO TYPE

for banks with licences as of 31 December 2004

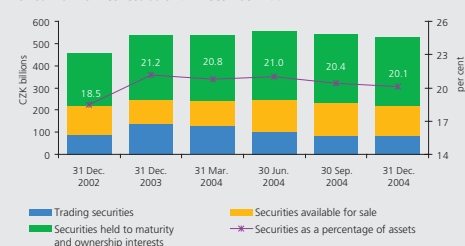


TABLE 10

STRUCTURE OF SECURITIES AS OF 31 DECEMBER 2004

for banks with licences as of 31 December 2004; excluding securities of government institutions and CNB bills

	Large banks	Medium-sized banks	Small banks	Building societies	Foreign bank branches
Securities, total, in CZK billions	148.3	11.4	1.2	15.9	0.4
of which:					
trading securities	17.0	4.9	0.2	0.0	0.3
securities available for sale	65.9	5.7	0.7	0.0	0.0
securities held to maturity and ownership interests	65.3	0.8	0.3	15.9	0.1
of which:					
trading securities	11.5	43.1	16.3	0.0	78.1
securities available for sale	44.4	49.7	60.5	0.0	0.8
securities held to maturity and ownership interests	44.1	7.2	23.2	100.0	21.1

CHART 34
RECEIVABLES FROM DERIVATIVES TRANSACTIONS AS
A PERCENTAGE OF TOTAL ASSETS
for banks with licences as of 31 December 2004

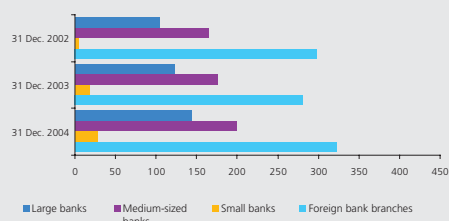


CHART 35
DERIVATIVES STRUCTURE BY UNDERLYING ASSET
for banks with licences as of 31 December 2004

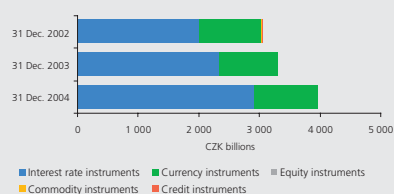
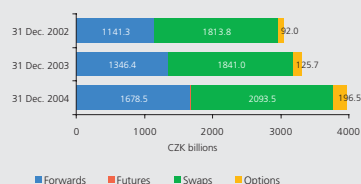


CHART 36
DERIVATIVES STRUCTURE BY CONTRACT TYPE
for banks with licences as of 31 December 2004



3.3.3 Derivatives risks

(for banks with licences as of 31 December 2004)

The upward trend in derivatives transactions continued into 2004. Receivables and liabilities from derivatives transactions rose by 19.8% and 19.3% year on year to CZK 3,969.7 billion and CZK 3,940.1 billion respectively. The rise in derivatives transactions meant that their value exceeded the total assets of the banking sector by 50%, an increase of 19 percentage points compared to the previous period.

Despite the increase in the nominal value of derivatives transactions, the underlying net position within the banking sector remains very low. An increase was recorded for the net position from interest rate forwards only, which rose by CZK 16 billion year on year to CZK 22 billion. This is, at the same time, the highest net position of all the types of derivatives transactions. Foreign bank branches accounted for most of the aforementioned increase.

The banks that are active on the derivatives market have not changed substantially over time. In 2004, 22 banks and foreign bank branches – from all groups of banks (excluding building societies) – of the total of 35 banks were involved in this field. There are still large differences between individual groups and between individual banks as regards their involvement in derivatives transactions. The most active in this respect are foreign bank branches.

The structure of derivatives transactions remains practically unchanged. Turning to the underlying instruments used, interest rate instruments still dominate. At the end of 2004, they accounted for 73.5% of the total, up by 2.5 percentage points year on year. The share of underlying currency instruments continued falling during 2004, stopping at 26.3%.

As regards the individual types of derivatives operations, receivables from forwards are growing at the fastest rate (by 24.7% year on year), accounting for 42.3%. The highest share of all derivatives transactions is still recorded by swaps, with 52.7%. The 5.0% share recorded by options is insignificant, albeit slightly increasing, in this respect. The volume of futures (i.e. stock-exchange derivatives transactions) is negligible.

3.4 COUNTRY RISK

Country risk is the risk of potential losses arising from the unwillingness or inability of entities from a particular country (or the country itself) to meet their external liabilities for reasons that are not related to any current credit risk. Unwillingness to fulfil obligations may arise, for instance, during a change in political regime in the country, while inability to fulfil obligations may be a consequence of an economic crisis or natural disaster. The level of country risk can be sometimes similar for several countries in a particular region where they display similar basic characteristics. Quantifying country risk is not easy, as it is related to economic and political developments in the country, which are often very difficult to predict. Banks manage this risk primarily by setting limits for their exposures to individual countries or regions and by differentiating the conditions under which commercial contracts are concluded.

3.4.1 Activities vis-à-vis non-residents

(for banks with licences as of 31 December 2004)

Activities vis-à-vis non-residents as a whole allow us to obtain a rough estimate of the overall level of risk towards clients and other banks having their registered

offices or places of residence abroad. The most important factor in this respect is the absolute level of the bank's asset and liability exposure (balance sheet and off-balance sheet). Another significant factor is the structure of non-resident assets and liabilities.

The exposure of the domestic banking sector vis-à-vis non-residents rose slightly in 2004. From the longer-term perspective, however, this is not a significant change. The share of non-resident assets in total assets was 19.9% on 31 December 2004, compared to 17.5% a year earlier. In the case of liabilities the share remained unchanged, being 13.2% at the end of both 2003 and 2004. In absolute terms, non-resident assets in gross terms amounted to CZK 541.9 billion and increased by CZK 84.3 billion (18.4%) year on year. Non-resident liabilities amounted to CZK 348.4 billion, up by CZK 15.2 billion (4.6%) on a year earlier.

The share of non-resident off-balance-sheet transactions in total off-balance-sheet transactions did not change significantly in 2004. Off-balance-sheet assets vis-à-vis non-residents represented 60.9% of total off-balance-sheet assets at the end of 2004, while liabilities accounted for 48.4%. The lower share in the case of liabilities is due to the volume of contingent liabilities received and assets accepted into custody or for management, which are part of off-balance-sheet liabilities and 95% of which are of resident origin. Excluding them from off-balance-sheet liabilities, non-resident transactions account for 65.1%. As regards derivatives, the share of transactions with non-residents in their total volume is slightly below 70%.

Receivables from foreign banks (excluding central banks) account for 44.1% of the total volume of non-resident assets. They were another cause of the rise in total non-resident assets, as their volume increased by CZK 67.3 billion year on year. At 23.9%, debt securities are the second-largest component of non-resident assets. Debt and equity securities together represent 29.4% of total non-resident assets. Receivables from clients make up only 12.9% of total non-resident assets. Receivables from non-residents make up 6.3% of the total volume of receivables from clients.

Interbank business transactions are still a major component on the liabilities side as well. Liabilities vis-à-vis non-resident banks grew by 24.7% to CZK 211.7 billion in 2004, which resulted in a sharp rise in their share in total liabilities vis-à-vis non-residents of almost 10 percentage points to 60.8%. The volume of non-resident client deposits was little changed compared to a year earlier. It amounted to CZK 67.8 billion at the end of 2004, which represents almost 20% of total non-resident liabilities.

The bulk of non-resident assets (67.3%) are held by the group of large banks. These held a total of CZK 364.9 billion in non-resident assets at the end of 2004, which represents 23.2% of the total assets of this group. As regards the individual components of assets and liabilities, large banks record the largest share of non-resident client deposits, thanks mainly to the relatively extensive branch network of Československá obchodní banka in Slovakia. The second-largest volume is recorded by foreign bank branches with CZK 85.7 billion, which is 32.5% of their total assets. The figures in this group are affected most of all by interbank transactions. The non-resident assets and liabilities of building societies are negligible, making up less than 3% of their total assets and 1 per mille of their total liabilities.

CHART 37
NON-RESIDENT ASSETS AND LIABILITIES AS A PERCENTAGE OF TOTAL ASSETS AND LIABILITIES

for banks with licences as of 31 December 2004

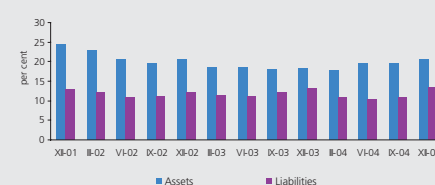


CHART 38
STRUCTURE OF ASSETS AND LIABILITIES VIS-À-VIS NON-RESIDENTS AS OF 31 DECEMBER 2004

for banks with licences as of 31 December 2004

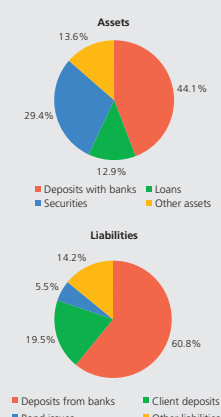


CHART 39
MARKET SHARES OF BANK GROUPS IN ASSETS AND SELECTED PRODUCTS VIS-À-VIS NON-RESIDENTS IN PER CENT

for banks with licences as of 31 December 2004

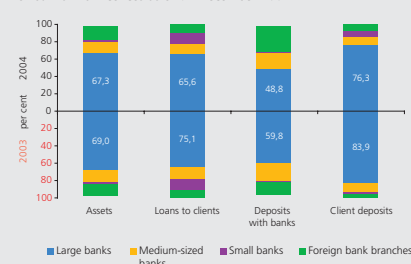


TABLE 11
PERCENTAGE SHARES OF NON-RESIDENTS IN TOTAL ASSETS, LIABILITIES AND SELECTED TYPES OF BANKING PRODUCTS AS OF 31 DECEMBER 2004

for banks with licences as of 31 December 2004

	Large banks	Medium-sized banks	Small banks	Foreign bank branches	Banks, total
Assets	23.2	16.9	19.1	32.5	20.6
Liabilities	9.3	19.9	16.1	40.9	13.2
Loans provided	7.1	4.0	27.0	8.7	6.5
Deposits and loans with banks	64.4	56.7	24.9	80.4	59.6
Securities	45.4	26.2	10.0	1.7	0.4
Deposits accepted	4.6	3.5	13.7	5.3	3.9
Deposits and loans from banks	50.5	63.7	37.2	65.6	58.6
Receivables from derivatives transactions	68.3	68.3	49.6	63.8	67.2

3.4.2 Activities vis-à-vis individual regions and countries

(for banks with licences as of 31 December 2004)

CHART 40
MARKET SHARES IN ASSETS AND SELECTED BALANCE-SHEET AND OFF-BALANCE-SHEET ITEMS INTERNATIONALLY IN PER CENT

for banks with licences as of 31 December 2004

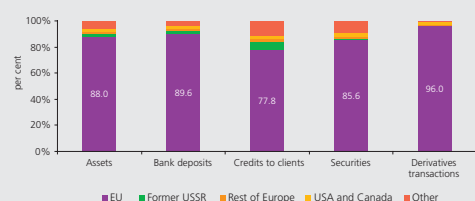


CHART 41
MARKET SHARES IN TOTAL LIABILITIES AND SELECTED LIABILITY ITEMS INTERNATIONALLY IN PER CENT

for banks with licences as of 31 December 2004

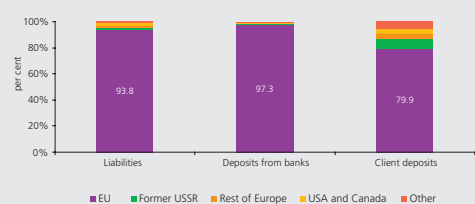


CHART 42
HERFINDAHL INDEX OF CONCENTRATION OF BANKING EXPOSURE TO EU MEMBER STATES

for banks with licences as of 31 December 2004



The ability to differentiate the level of exposure to specific countries is very important, as non-residents are a very inhomogeneous group of business partners in terms of their soundness. For a bank, therefore, it is much more meaningful to break down its international exposure in greater detail, either by regions sharing the same characteristics, or by specific countries if the countries concerned have specific features or trends or if the bank's exposure towards such countries is significant in absolute or relative terms.

The majority of balance-sheet and off-balance-sheet foreign transactions are conducted between the domestic banking sector and residents from the EU member countries. Assets from EU countries after the enlargement in 2004 represent 88.0% of total non-resident assets held by domestic banks and foreign bank branches. In terms of individual countries, the banking sector's largest exposure is vis-à-vis Germany, amounting to CZK 119.7 billion. Most of this exposure is attributable to receivables from banks and receivables from debt securities, while loans to clients who are residents of Germany are only around CZK 3 billion. Second position in terms of the volume of total non-resident assets is held by Slovakia, totalling CZK 101.1 billion. Slovakia, however, is constantly placed first in terms of non-resident client receivables (CZK 26.6 billion), thanks mainly to ČSOB's activities on the Slovak banking market. As regards derivatives transactions, Czech banks' largest exposures continue to be vis-à-vis residents of the United Kingdom, Germany, the Netherlands, Austria and France.

The share of transactions with EU residents on the liabilities side is even higher than in the case of assets, amounting to 93.8%. The largest partners here are again Germany, with liabilities totalling CZK 62.4 billion (again due mainly to interbank transactions), and Slovakia (CZK 52.6 billion). Deposits from Slovak non-bank clients stood at CZK 36.1 billion on 31 December 2004.

The values of, and trends in, the Herfindahl index in relation to selected products and countries allow us to evaluate, above all, the degree of concentration in the markets for these products within the framework of the individual countries of the EU. These values and trends at the same time indicate to what extent Czech banks are subject to country risk associated with the individual European economies for the selected products.

The concentration of banking exposure vis-à-vis the EU countries decreased in 2004 in the area of client transactions. This is related to the accession of the new Member States, particularly Slovakia, the residents of which are the most significant partners of domestic banks in client transactions. The Herfindahl index constantly records its highest values, i.e. the greatest concentration, in the area of non-resident client deposits, where just five countries share more than 90% of the total volume (Slovakia 68.8%, Germany 8.2%, Cyprus 5.1%, the Netherlands 5.0%, and the United Kingdom 4.3%). The share of the remaining EU countries is under 2%.

4. CAPITAL ADEQUACY

(for banks with licences as of 31 December 2004)

Capital adequacy is of key importance in banking regulation and supervision. Generally, capital adequacy means the ratio of capital to the risks undertaken by a given bank. This ratio should be high enough so that the capital covers all possible losses arising from the bank's activities or, to put it differently, so that any losses are borne by the owners of the capital and not directly by the creditors. Capital adequacy can theoretically be calculated for any entity. However, it is of practical importance in the regulation of entities that use a large amount of external funds in their activities as compared to their own funds. The main problem of capital adequacy is identifying the extent of the risks undertaken by the bank. It is easier to determine the size of its banking capital, although there are sometimes problems deciding whether or not certain items count as capital. Therefore, the concept of capital adequacy is subject to constant development and revision, with other types of banking risks being included in the calculation and so on. A new capital framework known as Basel II¹² is expected to take effect in 2007.

The capitalisation of the domestic banking sector, as measured by regulatory capital, rose by 2.1% in 2004. At the end of 2004, the overall regulatory capital (i.e. capital adjusted for the purposes of the capital adequacy calculation) amounted to CZK 146.7 billion.

The main source of growth in the capital of the individual banks remains the retention of previous years' profits in banks' balance sheets in the form of retained earnings and mandatory additions to reserves. In comparison with 2003, the rise in retained earnings was only slight in 2004 (CZK 3.2 billion, compared to CZK 17.6 billion in 2003). In particular, the three largest banks paid out most of their 2003 profits in dividends to their shareholders in the first half of 2004. The group of large banks thus saw a decrease in retained earnings of 5.3% and was the only group to record an annual decline in total regulatory capital (of 3.3%). In contrast, the medium-sized and small banks recorded a significant rise in retained earnings in 2004. The increase in the overall capital of the banking sector was also fostered by capital increases in two medium-sized banks.

Tier 2 capital continued to decline in 2004 as a result of an obligatory reduction of reserves for standard loans. Banks must dissolve these reserves completely by the end of 2005¹³. In 2004, the shareholders of two banks and one building society decided to strengthen their banks' capital in the form of subordinated debt. This resulted in an overall slight increase in this component of Tier 2 in the banking sector, despite a decrease in subordinated debt in some other banks.

Tier 3 capital is still not used in the domestic banking sector.

The capital requirements of the banking sector increased by almost 18% in 2004, with all the groups of banks recording increases. Banks' increased lending activity generated growth in risk-weighted assets of 15.1% to CZK 1,199 billion, and in the capital requirement for banking portfolio credit risk, which grew by

CHART 43
CAPITAL STRUCTURE
for banks with licences as of 31 December 2004

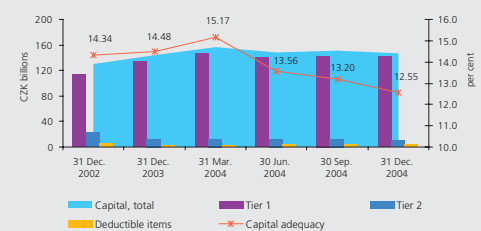
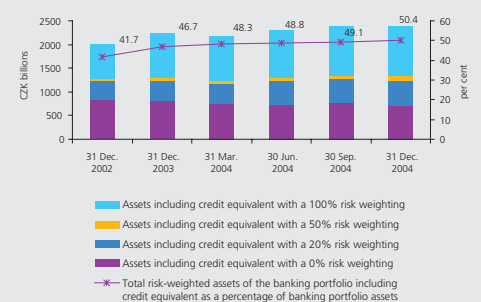


CHART 44
RISK-WEIGHTED ASSETS
for banks with licences as of 31 December 2004



¹² For more information on the new capital framework, see part A, section 3 of this publication.

¹³ Under an amendment to the 2002 Act on Reserves for the Purposes of Determining the Income Tax Base, banks are obliged to use the general reserves created before 2002 to cover losses from write-offs and transfers of receivables and to cover losses from guarantees provided. Banks are obliged to release the unused reserves in favour of income, reducing the balance for each taxation period starting from 2002 by at least 25% of the balance on 31 December 2001 in order to dissolve them entirely by 31 December 2005. This legislative adjustment was related to the alignment of Czech accounting standards with international accounting standards.

CZK 12.6 billion, or 17%, to CZK 86.3 billion. Owing to a decline in assets with a 0% risk weight and a rise in the other components of assets, the share of risk-weighted banking portfolio assets in total banking portfolio assets increased again in 2004, accounting for 50.4% on 31 December 2004, up by 3.7 percentage points on a year earlier. This indicator is highest in the small banks (60.2%), followed by the large and medium-sized banks (55.2% and 52%, respectively). Building societies record the lowest figure (27.2%).

The capital requirement for trading portfolio risks rose year on year by CZK 1.55 billion, or 27.6%, to CZK 7.2 billion. The capital requirement for general interest rate risk remains the most significant in the trading portfolio, representing 48.5% of total capital requirement B on 31 December 2004.

The shares of the capital requirement for banking portfolio credit risk and the capital requirement for trading portfolio risks in the overall capital requirement remained broadly unchanged year on year at 92.3% and 7.7% respectively on 31 December 2004.

As a result of a significant increase in the capital requirements and only a slight rise in regulatory capital, 2004 saw a decline in the capital ratio of the banking sector from 14.5% to 12.6%. Only the medium-sized banks recorded a slight increase in solvency ratio, as a result of having retained most of their 2003 profit.

All banks were compliant with the minimum prescribed capital ratio of 8% in 2004. On 31 December 2004, the capital adequacy of the individual banks ranged between 8.97% and 127.46%. Four banks recorded a ratio of less than 10%.

TABLE 12

BREAKDOWN OF BANKS BY CAPITAL ADEQUACY

for banks with licences as of 31 December 2004

	31 Dec. 99	31 Dec. 00	31 Dec. 01	31 Dec. 02	31 Dec. 03	31 Dec. 04
under 8%	0	0	0	0	0	0
8 to 12%	4	6	3	6	6	9
12 to 15%	9	5	7	8	6	7
15 to 20%	7	6	8	2	5	1
20 to 50%	1	4	4	7	5	6
over 50%	4	4	3	3	4	3

5. BANKING SECTOR PERFORMANCE

(for banks with licences as of 31 December 2004)

5.1 PROFIT FROM FINANCIAL ACTIVITIES

Profit from financial activities is the major component of the banking sector's overall profit before taxation. The long-term success of banks' financial management is fully dependent on the ongoing creation of profit from financial activities, the resulting level of which is influenced on the one hand by internal factors, which are completely in the hands of the banks' managements (for example allocation of assets into profitable business transactions, diversification of risks and the introduction of new technology) and on the other hand by the external economic environment (the environment of low interest rates, and hence also low margins, persisted in 2004). Other transactions, for example the sale of assets and the release of reserves, can also affect total earnings to a great extent. Such transactions, however, constitute extraordinary income and can only improve the overall picture of a bank's financial management in the short term.

The banking sector recorded net profit from financial activities of CZK 103.5 billion in 2004, up by 14.7% on 2003. All the components of profit from financial activities contributed to this result.

The four large banks accounted for almost 73% of the total profit from financial activities. Medium-sized banks accounted for around 16%, building societies for 5%, small banks for 2% and foreign bank branches for 4%.

The interest profit for 2004 was CZK 59.8 billion, up by CZK 5.5 billion (10%) year on year. This positive figure was due to an increase in interest income of CZK 3.0 billion accompanied by a decline in interest expenses of CZK 2.4 billion. On the interest income side, transactions with other clients (i.e. excluding banks and general government) dominate. These were also the main factor behind the increase in interest income, as they grew by CZK 3.5 billion (8.2%) year on year. The reason for this can be seen mainly in the increased lending activity of banks, which is mainly focused on the household segment. On the other hand, interest income from repo operations with the CNB and the National Bank of Slovakia and interest income from other banks and general government saw a decline. This was primarily due to an annual decline in the average volume of the banking sector's receivables from these segments. For example, the average monthly balance of receivables from general government decreased by 14.7% year on year (calculated from end-of-month stocks). Another factor was the fall in market interest rates, as rates in the first half of 2003 exceeded those charged in 2004. The reduction in market interest rates resulted in an annual decline in interest expenses recorded by all types of entities.

The share of interest profit in total profit from financial activities was 57.7% on 31 December 2004, compared to 60.1% a year earlier. Annual growth in interest profit was recorded for all groups of banks except foreign bank branches, whose interest profit decreased slightly in 2004 (by just under 5%).

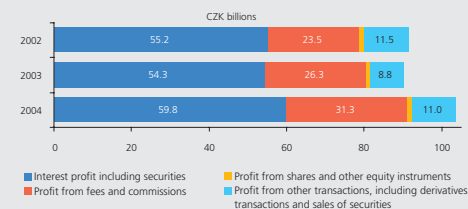
Profit from fees and commissions was CZK 31.3 billion in 2004, increasing by CZK 5.0 billion (18.9%) year on year. Underlying this was an increase of CZK 2.4 billion in the volume of fees received by banks accompanied by a decline of CZK 2.6 billion in the volume of fees paid.

Fees and commissions from payment activities account for one-half of fee income. Their volume, however, slightly decreased year on year. In 2004, income from fees

CHART 45

STRUCTURE OF PROFIT FROM FINANCIAL ACTIVITIES BY PROFIT TYPE

for banks with licences as of 31 December 2004



related to foreign exchange transactions continued to decline. In contrast, income from fees related to banks' lending activities recorded an increase of 7%.

The share of profit from fees and commissions in total profit from financial activities was 30.3% on 31 December 2004, compared to 29.2% a year earlier.

The group of large banks saw a rise in income from fees and commissions of 24.5%. Medium-sized and small banks and foreign bank branches recorded smaller increases – of 5.9%, 13.7% and 13.4% respectively. Only the building societies recorded a slight annual decline in net income from fees and commissions (1.5%), primarily due to the result of 2003, when building societies received an extraordinary volume of fees for new building savings contracts concluded before the building savings system changed on 1 January 2004.

The overall volume of profit from fees and commissions includes income from fees and commissions from transactions with clients as well as income and expenses related to transactions on the interbank market, which can take the form of one-off non-standard transactions.

Income from shares and participations amounted to CZK 1.4 billion in 2004, thus contributing to an annual increase in profit from financial activities of CZK 0.5 billion. Most of this income is attributable to large banks and consists mainly of dividends received from their subsidiaries and affiliates.

Profit from other financial operations for 2004 amounted to CZK 11.0 billion, compared to CZK 8.8 billion a year earlier. Nevertheless, its share in total profit from financial activities remained broadly unchanged, standing at 10.7% on 31 December 2004. The largest growth was recorded for profit from foreign exchange transactions (in particular valuation changes) and profits from trading debt securities and debt securities available for sale, which were, on the other hand, significantly offset by losses from currency and interest rate derivatives.

Unlike in the previous two years, when the ratio of profit from financial activities to assets had declined, this indicator increased by 0.3 percentage points to 3.9% in 2004, despite an annual rise in the average volume of the banking sector's assets.

In 2004, banks carried on their business activities in an environment of low interest rates, although the Czech National Bank did increase rates slightly in the course of the year. The adjustment of interest rates did not affect the behaviour of commercial banks. The income and cost ratios for banking transactions were affected by lower interest rates on new business as well as by higher rates on ongoing contractual relationships and the termination of payable transactions, concluded usually under higher interest rates. Average rates on all business shifted downwards only slightly (by 0.15 percentage points), both on loans provided and on deposits accepted (by 0.24 percentage points). The interest rate trends are being affected by the competitive environment on the domestic banking market. Owing to a faster decline in commercial interest rates on deposits accepted, 2004 saw another slight widening of the interest rate spread (of 0.09 percentage points to 2.14% at the end of the year). The interest rate developments in the period under review positively affected the banking sector's 2004 performance.

CHART 46
PROFIT FROM FINANCIAL ACTIVITIES AS A PERCENTAGE OF ASSETS

for banks with licences as of 31 December 2004

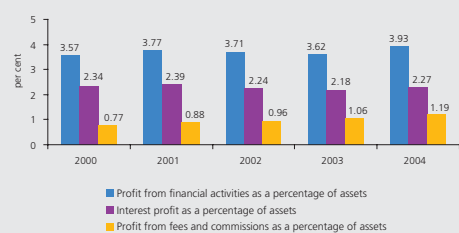
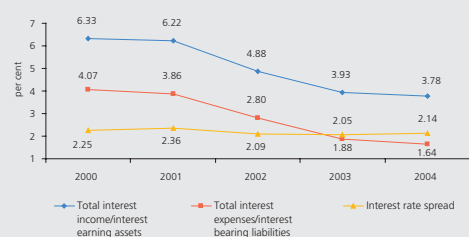


CHART 47
SELECTED PROFITABILITY INDICATORS

for banks with licences as of 31 December 2004



The banking sector recorded profit of CZK 904 billion on other operating activities in 2004. This item includes, in particular, income from the sale of banks' ownership interests, income from the sale of fixed assets, income from the sale of receivables and other specific transactions. On the other hand, a doubling of the banks'

contribution to the Deposit Insurance Fund¹⁴ had a negative impact on this item in 2004.

5.2 ADMINISTRATIVE EXPENSES, WRITE-OFFS, CREATION AND USE OF PROVISIONS

The administrative expenses of the domestic banking sector totalled CZK 48.8 billion in 2004, an increase of 2.7% compared to 2003. Most of the increase was due to personnel expenses, which amounted to CZK 24.5 billion in 2004, up by almost 5% on a year earlier.

The workforce in the banking sector was reduced by a further 844 in 2004, to 38,160 as of 31 December 2004. However, the trends in the number of employees differed in each group of banks. Large banks, which employ 74% of the workforce in the Czech banking sector, recorded a decline of 1,196 to 28,105 people. Building societies also saw a slight decline (of 56 to 1,699), although the individual building societies recorded mixed developments. On the other hand, medium-sized and small banks and foreign bank branches recorded slight annual increases in employee numbers.

Other administrative expenses developed positively in 2004, recording only a slight increase (of less than 1%) to CZK 24.3 billion, which is below last year's inflation level and, moreover, in a situation of increased VAT on services purchased by banks. Building societies even showed an absolute decrease in other administrative expenses of around 14%, mainly due to a year-on-year reduction in advertising costs. Before the building savings system changed, building societies had tried to attract as many clients as possible with massive advertising campaigns in the second half of 2003.

Write-offs and creation of provisions amounted to CZK 10.3 billion in 2004, compared to CZK 0.7 billion in 2003. However, the lower volume of write-offs and provisions in previous years was due to clean-up operations in some banks, connected with the release of reserves and provisions created in the past. The release of reserves and provisions for receivables in 2003 thus positively affected profit. For example, banks released excess reserves amounting to CZK 6.9 billion in 2003, compared to CZK 0.8 billion in 2004. In 2004, the impact of the creation and use or release of provisions and reserves for receivables on the banking sector's profit was practically zero (i.e. creation offset use and release). The full CZK 10.3 billion was thus attributable to write-offs of tangible and intangible assets (compared to CZK 10.3 billion in 2003). Once the mandatory dissolution of reserves for standard loans has been completed in 2005, banks can be expected to start showing net creation of provisions again, which will negatively affect their profitability. The amount will, however, depend mainly on the future development of their credit portfolio quality.

CHART 48
STRUCTURE OF ADMINISTRATIVE EXPENSES
for banks with licences as of 31 December 2004

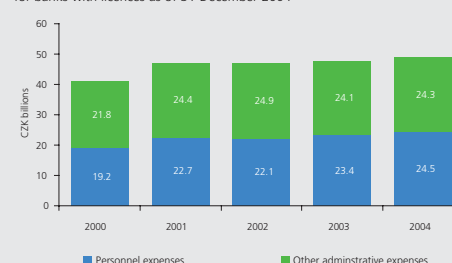
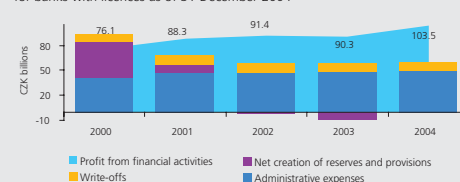


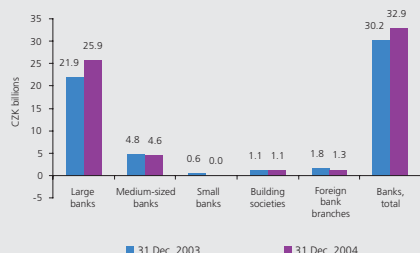
CHART 49
SUFFICIENCY OF PROFIT FROM FINANCIAL ACTIVITIES
for banks with licences as of 31 December 2004



¹⁴ The doubling of the banks' contribution to the Deposit Insurance Fund (DIF) ensues from Article 41k of the Act on Banks. In connection with compensation paid to clients of Union banka and Plzeňská banka, the DIF was forced to take out a loan from a bank syndicate which resulted in a doubling of the banks' contribution to the DIF under the aforementioned provision. Part of the money claimed by the DIF was recovered during Union banka's bankruptcy proceedings, thus allowing early repayment of the loan before the end of 2004. Therefore, the mandatory percentage contribution to the DIF returns to the original (standard) level in 2005.

CHART 50
COMPARISON OF NET PROFIT

for banks with licences as of 31 December 2004



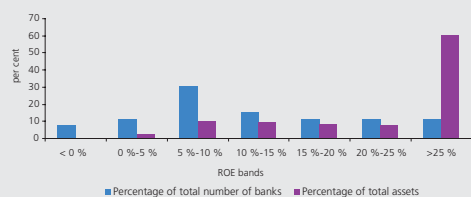
5.3 NET PROFIT

The banking sector generated net profit of CZK 32.9 billion in 2004, up by 8.8% on 2003. Summing up the aforementioned information, it can be said that this was due to growth in all components of profit from financial activities, the ongoing control of administrative expenses and the balanced creation and release of provisions and reserves for receivables.

The individual groups of banks, however, experienced mixed developments. The largest increase in net profit (18.1%) was recorded by the large banks. The net profit of these banks – amounting to CZK 25.9 billion – represents 78.8% of the net profit of the entire banking sector. Thanks to their profits, these banks had already become major income tax payers in previous years. All the other bank groups saw an annual decline in net profit, except for building societies, which recorded a stagnation. In 2004, two small banks and two foreign bank branches reported losses.

CHART 51
DISTRIBUTION OF RETURN ON TIER 1 AS OF 31 DECEMBER 2004

for banks with licences as of 31 December 2004



5.4 PROFITABILITY, EFFICIENCY AND PRODUCTIVITY

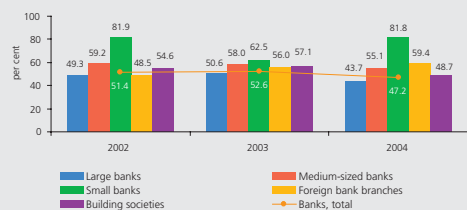
Return on average Tier 1 capital was 23.4% for the banking sector as a whole in 2004. This represents a year-on-year decrease of 0.4 percentage point, due to the rise in the volume of capital in the banking sector. Return on average Tier 1 capital gross of deductible items was 21.5% in 2004 (compared to 21.8% a year earlier).

The largest return on average Tier 1 capital continues to be recorded by the group of large banks, with 27.7%. This group showed a year-on-year increase of 2.2 percentage points. This was due to a rise in net profit accompanied by a decline in capital resulting from the payment of dividends in the first half of 2004.

In 2004, the return on assets was 1.26%, which represents a moderate increase of 0.05 percentage points in comparison with 2003. The highest return on assets continues to be recorded by the large banks, at 1.58% (up by 0.21 point on a year earlier).

CHART 52
RATIO OF ADMINISTRATIVE EXPENSES TO PROFIT FROM FINANCIAL ACTIVITIES

for banks with licences as of 31 December 2004

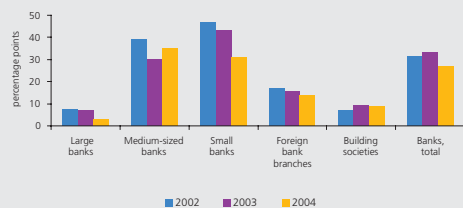


There was also a year-on-year improvement in the ratio of administrative expenses to profit from financial activities, which fell from 52.6% to 47.2% for the banking sector overall. Worsening ratios were recorded only by the small banks and foreign bank branches.

The ratio of administrative expenses to profit from financial activities is one of the basic indicators of the work efficiency of banking institutions. High values indicate less efficient use of resources by some banks. However, when assessing this indicator, differences in the business orientation of the individual banks have to be taken into account. The ratio is also affected by the time that has elapsed since the bank opened for business, as newly established institutions are capable of attaining adequate profits only after some time has elapsed.

CHART 53
COST-EFFECTIVENESS

for banks with licences as of 31 December 2004



Note: The figures express the difference between the group average and the most cost-effective bank in that group, as measured by the ratio of administrative expenses to profit from financial activities.

The continuing reduction in personnel numbers generated a further increase in administrative expenses per employee in 2004. Profit from financial activities per employee grew by 17.2% year on year to CZK 2.71 million, while net profit per employee was up by 11.2% to 0.86 million. On 31 December 2004, net assets per bank employee totalled CZK 69.1 million, up by 6.6% on a year earlier.

AMA	Advanced Measurement Approaches
ATM	Automatic Teller Machine
BAC	Banking Advisory Committee
BCBS	Basel Committee on Banking Supervision
BCPP	Prague Stock Exchange
BIS	Bank for International Settlements
BSC	Banking Supervision Committee
BSCEE	Group of Banking Supervisors from Central and Eastern Europe
CEBS	Committee of European Banking Supervisors
CEIOPS	Committee of European Insurance and Occupational Pensions Supervisors
CESR	Committee of European Securities Regulators
CNB	Czech National Bank
COREP	Common Reporting Group
CPLG	Core Principles Liaison Group
CRC	Central Register of Credits
CZK	Czech koruna
ČSOB	Československá obchodní banka, a.s.
ČT 1	Czech TV, Channel 1
EBC	European Banking Committee
EC	European Commission
ECB	European Central Bank
ECOFIN	Economic and Financial Affairs Council
EEA	European Economic Area
EEC	European Economic Community
EFTA	European Free Trade Association
EIOPS	European Insurance and Occupational Pensions Committee
ESC	European Securities Committee
EU	European Union
EU-15	The EU Member States prior to enlargement in 2004
EUR	euro
FIN-NET	Consumer Complaints Network for Financial Services
FSAP	Financial Services Action Plan
GdC	Groupe de Contact
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
IRB	Internal Ratings Based (approach to credit risk)
LTV	Loan to Value
MoU	Memorandum of Understanding
NBS	National Bank of Slovakia
OECD	Organization for Economic Cooperation and Development
PRIBOR	Prague Interbank Offered Rate
PX50	BCPP index
RoE	Return on Equity
TV Nova	TV Nova television station
USD	US dollar
VaR	Value at Risk
VAT	Value added tax
WB	World Bank
WGAA	Working Group on Accounting and Auditing
WGC	Working Group for Capital
WGCR	Working Group on Credit Registers
WGDB	Working Group on Developments in Banking
WGMA	Working Group on Macro-prudential Analysis

Survey of banks and foreign bank branches as of 31 December 2004

I. Banks

Bank	Start of operation	Equity capital in CZK millions (registered)	Number of banking outlets		Number of employees
			in Czech Rep.	abroad	
BAWAG Bank CZ, a.s.	1 Feb. 1991	1,709	1		130
BAWAG International Bank CZ, a.s.	12 May 1992	1,000	3		131
CALYON BANK CZECH REPUBLIC, a.s.	12 Nov. 1992	600	1		85
Citibank a.s.	24 Jun. 1991	2,925	4		663
Česká exportní banka, a.s.	1 Jul. 1995	1,650	0		119
Česká spořitelna, a.s.	1 Jan. 1969	15,200	647		11,128
Českomoravská hypoteční banka, a.s.	10 Jan. 1991	1,319	36		362
Českomoravská záruční a rozvojová banka, a.s.	1 Mar. 1992	2,132	6		264
Českomoravská stavební spořitelna, a.s.	8 Sep. 1993	1,500	0		595
Československá obchodní banka, a.s.	1 Jan. 1965	5,105	218	85	8,436
eBanka, a.s.	1 Jan. 1991	1,042	174		899
GE Capital Bank, a.s.	22 Jun. 1998	510	192		2,127
HVB Bank Czech Republic a.s.	1 Jul. 1992	5,125	25		1,265
HYPO stavební spořitelna a.s.	1 Oct. 1994	500	10		124
IC Banka, a.s.	6 Apr. 1994	500	1		37
J&T BANKA, a.s.	18 Dec. 1992	501	0		112
Komerční banka, a.s.	1 Jan. 1990	19,005	341		7,276
PPF banka, a.s.	1 Sep. 1993	500	2		108
Raiffeisen stavební spořitelna a.s.	7 Sep. 1993	650	0		195
Raiffeisenbank a.s.	1 Jul. 1993	2,500	48		1,109
Stavební spořitelna České spořitelny, a.s.	1 Jul. 1994	750	0		241
Volksbank CZ, a.s.	1 Jan. 1994	750	19	1	455
Všeobecná stavební spořitelna Komerční banky, a.s.	16 Dec. 1993	500	0		363
Wüstenrot - stavební spořitelna a.s.	11 Nov. 1993	550	0		181
Wüstenrot hypoteční banka a.s.	23 Dec. 2002	600	0		46
Živnostenská banka, a.s.	1868	1,360	36		811

II. Foreign bank branches

Bank	Start of operation	Home country	Number of local outlets		Number of employees
			in Czech Rep.	abroad	
ABN AMRO Bank N.V.	6 May 1993	Netherlands	1		117
COMMERZBANK Aktiengesellschaft, pobočka Praha	1 Dec. 1992	Germany	4		213
Deutsche Bank Aktiengesellschaft Filiale Prag, organizační složka	1 Dec. 1993	Germany	0		66
HSBC Bank plc - pobočka Praha	1 May 1997	United Kingdom	0		40
ING Bank N.V.	1 Sep. 1993	Netherlands	0		204
Oberbank AG pobočka Česká republika	20 Mar. 1995	Austria	6		56
Raiffeisenbank im Stiftland eG pobočka Cheb, odštěpný závod	2 Jan. 1995	Germany	2		35
Všeobecná úverová banka a.s., pobočka Praha	14 Jan. 1993	Slovakia	1		27
Waldviertler Sparkasse von 1842	1 May 1994	Austria	7		140

III. Banks in liquidation or in bankruptcy proceedings

Bank	Start of operation	Revocation of licence
AB Banka, a.s. in liquidation	1 Apr. 1991	15 Dec. 1995
Agrobanka Praha, a.s. in liquidation	1 Jul. 1990	2 Sep. 1998
COOP BANKA, a.s. in liquidation	24 Feb. 1992	6 May 1998

III. Banks in liquidation or in bankruptcy proceedings (continued)

Bank	Start of operation	Revocation of licence
Česká banka, akciová společnost Praha - in liquidation	28 Feb. 1992	15 Dec. 1995
EKOAGROBANKA, a.s. in liquidation	1 Nov. 1990	31 May 1997
Kreditní banka Plzeň, a.s. - in liquidation	1 Jan. 1991	8 Aug. 1996
Kreditní a průmyslová banka a.s.	1 Apr. 1991	31 Aug. 1995
Moravia Banka, a.s. in liquidation	2 Jul. 1992	9 Nov. 1999
Plzeňská banka a.s. – in liquidation	1 Oct. 1993	4 Jul. 2003
Pragobanka, a.s.	1 Oct. 1990	24 Oct. 1998
První slezská banka a.s., in liquidation	12 Jan. 1993	13 May 1996
Realitbanka, a.s.	1 Nov. 1991	17 Apr. 1997
Union banka, a.s. "in liquidation"	15 Nov. 1991	2 May 2003
UNIVERSAL BANKA, a.s.	15 Feb. 1993	10 Feb. 1999
Velkomoravská banka, a.s.	3 Nov. 1992	10 Jul. 1998

IV. Banks dissolved without liquidation

Bank	Start of operation	Termination of licence	Reason
Bank Austria (ČR) a.s.	1 Jan. 1992	30 Jun. 1998	merger
Bank Austria Creditanstalt Czech Republic, a.s.	1 Apr. 1991	1 Oct. 2001	merger
HYPO-BANK CZ a.s.	26 Feb. 1992	31 Dec. 1998	merger
Poštovní banka a.s.	1 Jan. 1991	1 Jan. 1994	merger
Westdeutsche Landesbank (CZ), a.s.	operation not started	20 Jan. 1998	operation not started

V. Banks dissolved with liquidation

Bank	Start of operation	Termination of licence	Completion of liquidation
Evrobanka, a.s.	1 Oct. 1991	30 Jun. 1997	7 Mar. 2001
Banka Bohemia, a.s.	1 Feb. 1991	not revoked	9 Oct. 2003
Baska a.s.,	13 Dec. 1990	31 Mar. 1997	4 Feb. 2004

VI. Former banks now operating only as joint-stock companies without a banking licence

Bank	Start of operation	Termination of licence
BANKA HANÁ, a.s.	11 Jan. 1991	1 Dec. 2000
Erste Bank Sparkassen (CR) a.s.	1 Feb. 1993	30 Sep. 2000
Foresbank, a.s.	7 Sep. 1993	1 Mar. 1999
IP Banka, a.s.	1 Jan. 1990	7 Aug. 2002
SOCIETE GENERALE BANKA, a.s.	15 Apr. 1991	18 Nov. 1999

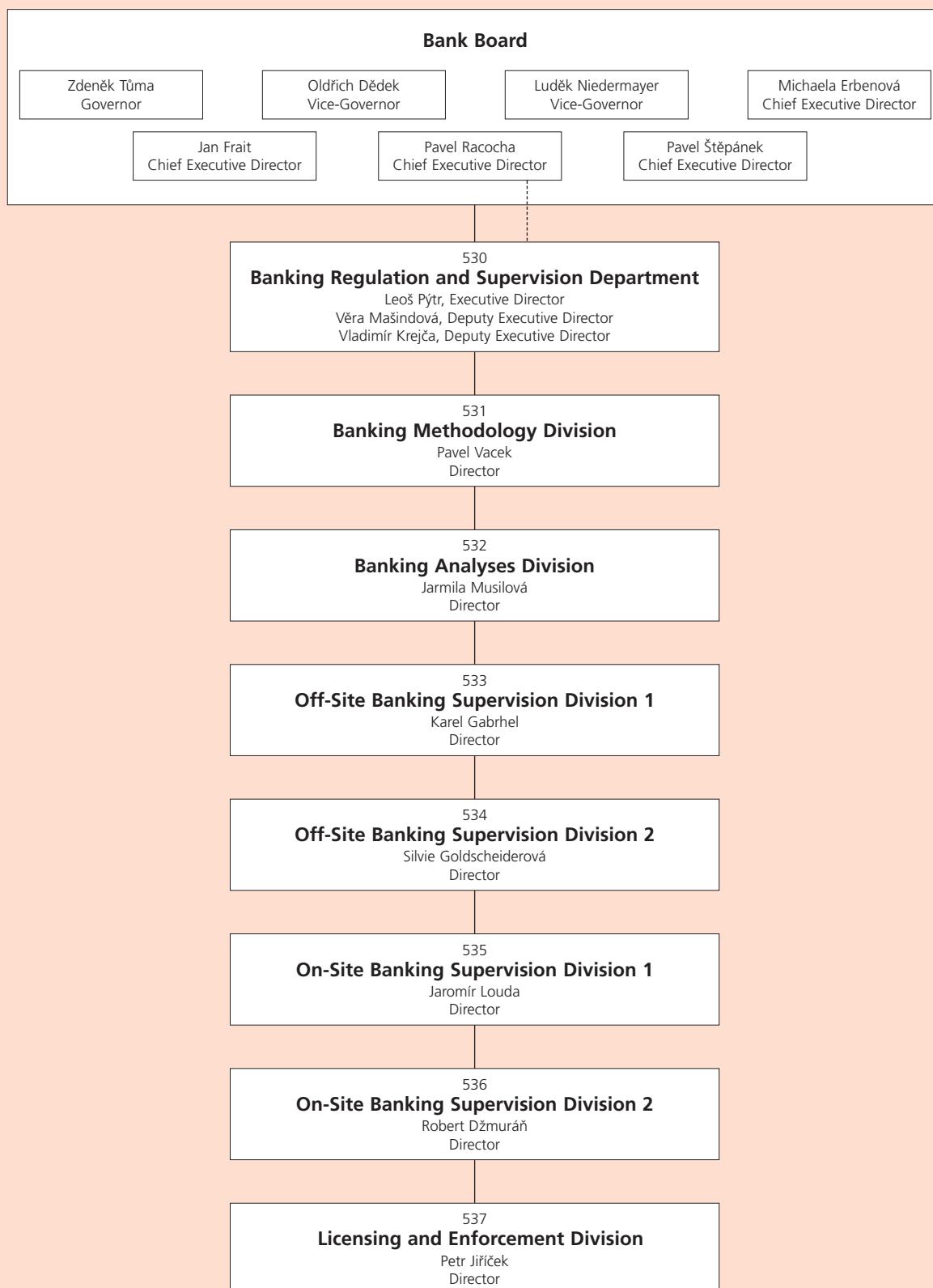
VII. Branches whose licences have terminated

Bank	Start of operation	Termination of licence	Reason
SOCIETE GENERALE, pobočka Praha	1 Jan. 1998	31 Mar. 2002	merger

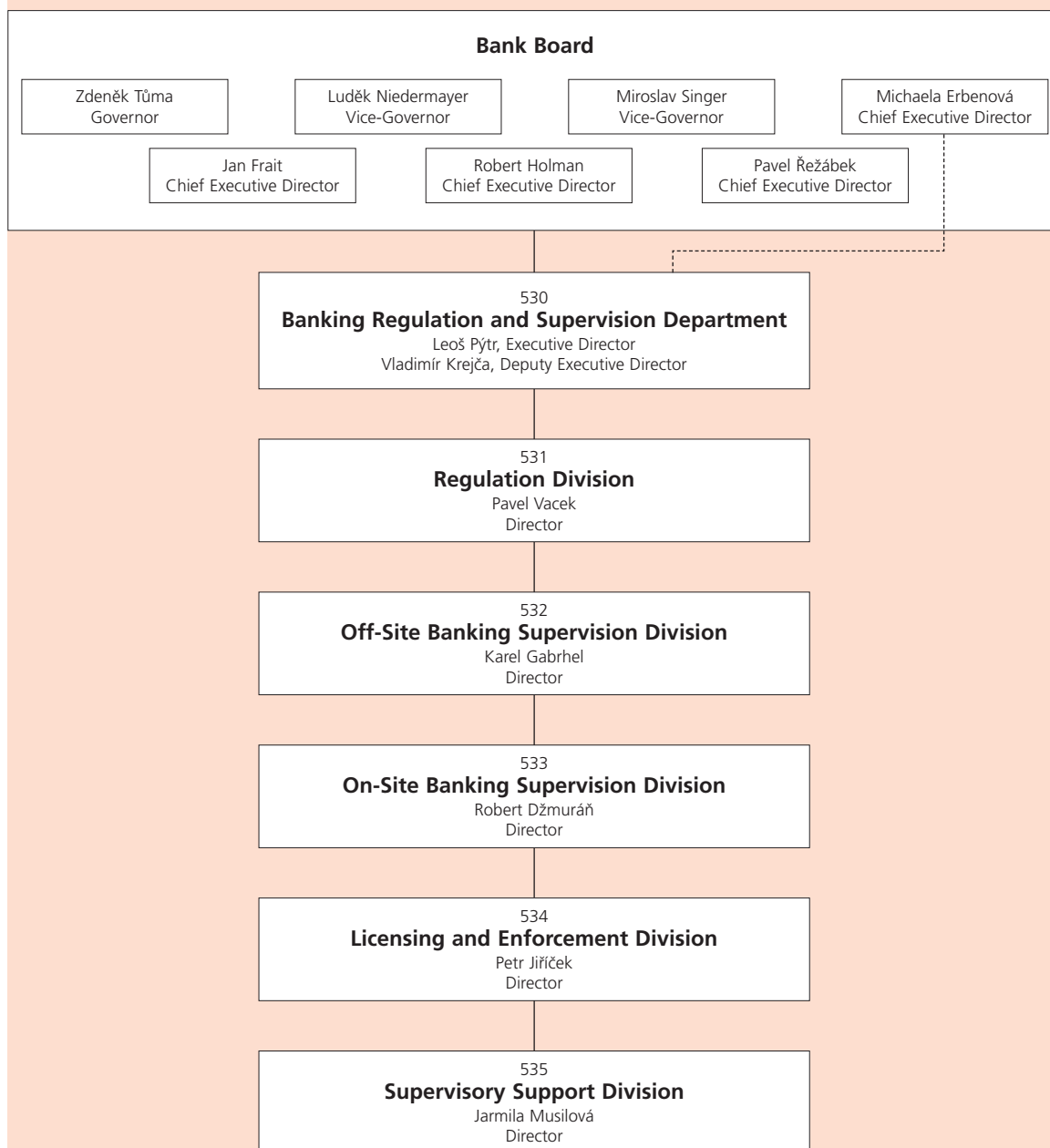
VIII. Former state financial institution (transformed into a non-banking institution)

Bank	Start of operation	Termination of licence
Konsolidační banka Praha, s.p.ú.	23 Feb. 1993	31 Aug. 2001

Organisational structure of CNB Banking Supervision
as of 31 December 2004



Organisational structure of CNB Banking Supervision
as of 1 February 2005



President Václav Klaus appointed the new members of the CNB Bank Board with effect from 13 February 2005.

Breakdown of banks into groups

I. Large banks		4. J&T BANKA, a.s.
1. Česká spořitelna, a.s.		5. PPF banka a.s.
2. Československá obchodní banka, a.s.		6. Wüstenrot hypoteční banka a.s.
3. HVB Bank Czech Republic a.s.		
4. Komerční banka, a.s.		
II. Medium-sized banks		IV. Foreign bank branches
1. BAWAG International Bank CZ a.s.		1. ABN AMRO Bank N.V.
2. Citibank a.s.		2. COMMERZBANK Aktiengesellschaft, pobočka Praha
3. CALYON BANK CZECH REPUBLIC, a.s.		3. Deutsche Bank Aktiengesellschaft Filiale Prag, organizační složka
4. Česká exportní banka, a.s.		4. HSBC Bank plc - pobočka Praha
5. Českomoravská hypoteční banka, a.s.		5. ING Bank N.V.
6. Českomoravská záruční a rozvojová banka, a.s.		6. Raiffeisenbank im Stiftland eG pobočka Cheb, odštěpný závod
7. GE Capital Bank, a.s.		7. Oberbank AG pobočka Česká republika
8. Raiffeisenbank a.s.		8. Všeobecná úverová banka a.s., pobočka Praha
9. Volksbank CZ, a.s.		9. Waldviertler Sparkasse von 1842
10. Živnostenská banka, a.s.		
III. Small banks		V. Building societies
1. eBanka, a.s.		1. Českomoravská stavební spořitelna, a.s.
2. IC Banka, a.s.		2. HYPO stavební spořitelna a.s.
3. BAWAG Bank CZ a.s.		3. Raiffeisen stavební spořitelna a.s.
		4. Stavební spořitelna České spořitelny, a.s.
		5. Všeobecná stavební spořitelna Komerční banky, a.s.
		6. Wüstenrot - stavební spořitelna a.s.

Main indicators of monetary and economic developments in the Czech Republic

		2000	2001	2002	2003	2004
Gross domestic product ^{1) 2)}	Volume (in CZK billions)	1,576.3	1,617.9	1,642.0	1,703.0	1,771.7
	Increase (in per cent)	3.9	2.6	1.5	3.7	4.0
Output - percentage increase ²⁾	Industry	1.5	10.6	4.8	5.8	9.9
	Construction	5.3	9.6	2.5	8.9	9.7
Prices ³⁾	Inflation rate (in per cent)	3.9	4.7	1.8	0.1	2.8
Unemployment ⁴⁾	Unemployment rate (in per cent)	8.8	8.9	9.8	10.3	10.3
Foreign trade	Exports (in CZK billions)	1,121.1	1,269.6	1,254.4	1,370.9	1,713.7
	Imports (in CZK billions)	1,241.9	1,386.3	1,325.7	1,440.7	1,736.0
	Balance (in CZK billions)	-120.8	-116.7	-71.3	-69.8	-22.3
Average wage ²⁾	Nominal (in per cent)	6.4	8.7	7.3	6.6	6.6
	Real (in per cent)	2.4	3.8	5.4	6.5	3.7
Balance of payments	Current account (in CZK billions)	-104.9	-124.5	-136.4	-160.6	-143.3
	Financial account (in CZK billions)	148.0	172.9	347.8	157.1	180.9
Exchange rate ⁵⁾	CZK/USD	38.59	38.04	32.74	28.23	25.7
	CZK/EUR	35.61	34.08	30.81	31.84	31.9
Average interbank	7-day	5.29	5.15	3.61	2.30	2.23
deposit rate (PRIBOR)	3-month	5.36	5.18	3.55	2.28	2.36
	6-month	5.48	5.21	3.56	2.28	2.48
Discount rate (in per cent) ⁴⁾		5.00	3.75	1.75	1.00	1.50
Lombard rate (in per cent) ⁴⁾		7.50	5.75	3.75	3.00	3.50
2W repo rate (in per cent) ⁴⁾		5.25	4.75	2.75	2.00	2.50
PX50 capital market index ⁵⁾		662.1	533.4	558.2	668.8	917.5

1) At constant 1995 prices
 2) Percentage increase on a year earlier
 3) Inflation rate in December of the given year

4) End-of-period figures
 5) Annual averages from monthly averages

Liabilities
(for banks with licences as of 31 December 2004)

	31 Dec. 2002	31 Dec. 2003	2004			
			31 Mar.	30 Jun.	30 Sep.	31 Dec.
in CZK millions						
Liabilities to banks	304,705	285,320	276,025	274,080	292,271	361,134
of which: liabilities to banks payable on demand	29,560	45,943	92,186	93,176	91,060	65,187
central banks	2,659	28	7	11	7	2
other banks	26,901	45,915	92,179	93,166	91,053	65,185
other liabilities to banks	275,145	239,377	183,838	180,904	201,212	295,948
central banks	114	106	604	92	79	77
other banks	275,031	239,271	183,234	180,811	201,133	295,870
Liabilities to clients	1,608,747	1,665,887	1,718,085	1,814,642	1,825,630	1,731,850
of which: payable on demand	661,729	792,201	787,958	828,967	845,651	844,625
other liabilities	947,018	873,686	930,127	985,675	979,979	887,224
Liabilities from debt securities	167,457	201,680	236,206	223,246	220,204	214,619
of which: issued debt securities	160,746	196,310	227,702	214,530	208,094	201,466
short-term	92,123	107,554	131,941	123,794	125,960	115,536
long-term	68,623	88,756	95,761	90,736	82,134	85,931
other payables	6,711	5,370	8,505	8,716	12,110	13,153
Other liabilities	171,010	152,534	113,265	127,350	95,977	107,874
Deferred revenues and accrued expenses	5,558	12,538	11,854	6,321	5,533	4,130
Reserves	37,624	23,643	23,829	22,141	22,768	16,509
Subordinated liabilities	25,334	7,829	8,068	8,528	8,771	8,158
Equity capital	69,461	68,272	68,855	69,010	70,356	70,416
Own shares	560	617	34	31	0	3
Share premium	8,036	8,609	9,238	9,235	11,098	11,296
Reserve funds and other funds created from profit	28,805	30,456	29,830	31,197	31,234	31,105
Reserve fund for new valuation	0	0	0	0	0	0
Capital funds	1,039	524	524	508	508	525
Valuation differences	1,636	1,273	2,253	-775	-393	2,886
Retained profits (accumulated losses) from previous periods	21,309	38,948	69,090	43,432	42,879	42,185
Profit (loss) for the accounting period	30,396	30,193	7,870	16,001	23,795	32,865
Total liabilities	2,481,118	2,527,707	2,574,991	2,644,917	2,650,631	2,635,554
in per cent						
Liabilities to banks	12.28	11.29	10.72	10.36	11.03	13.70
of which: liabilities to banks payable on demand	1.19	1.82	3.58	3.52	3.44	2.47
central banks	0.11	0.00	0.00	0.00	0.00	0.00
other banks	1.08	1.82	3.58	3.52	3.44	2.47
other liabilities to banks	11.09	9.47	7.14	6.84	7.59	11.23
central banks	0.00	0.00	0.02	0.00	0.00	0.00
other banks	11.08	9.47	7.12	6.84	7.59	11.23
Liabilities to clients	64.84	65.91	66.72	68.61	68.88	65.71
of which: payable on demand	26.67	31.34	30.60	31.34	31.90	32.05
other liabilities	38.17	34.56	36.12	37.27	36.97	33.66

Income and expenses
(for banks with licences as of 31 December 2004; in CZK millions)

	31 Dec. 2002	31 Dec. 2003	2004			
			31 Mar.	30 Jun.	30 Sep.	31 Dec.
Interest income	121,162	99,603	24,981	50,017	76,221	102,644
Interest expenses	65,962	45,300	10,578	20,981	31,705	42,885
Interest profit (including securities)	55,201	54,303	14,403	29,037	44,516	59,760
Income from fees and commissions	29,647	35,657	8,701	17,466	26,208	38,085
Expenses from fees and commissions	6,133	9,314	1,555	3,056	4,555	6,760
Profit from fees and commissions	23,514	26,343	7,146	14,410	21,653	31,326
Interest profit (including fees and commissions)	78,715	80,645	21,549	43,446	66,169	91,085
Profit from shares and other equity instruments	1,122	824	24	1,109	1,215	1,369
Profit from foreign exchange transactions	5,441	6,347	2,642	5,197	7,430	9,567
Profit from other transactions (including derivatives transactions and sales of securities)	6,088	2,436	-324	-685	-312	1,464
Profit from financial activities	91,367	90,252	23,892	49,067	74,503	103,486
Administrative expenses	46,975	47,513	11,642	24,060	35,859	48,819
Creation of reserves and provisions, write-offs and receivables transfer losses (net)	8,537	733	3,228	5,438	8,117	10,256
Other operating income (+) / expenses (-)	5,763	-744	1,594	1,504	1,147	904
Gross operating profit	39,914	41,251	10,603	21,110	31,724	45,366
Extraordinary income (+) / expenses (-)	1,705	11	13	3	-8	-10
Pre-tax gross profit	41,619	41,262	10,616	21,113	31,716	45,355
Taxes	11,223	11,068	2,746	5,112	7,921	12,490
Net profit	30,396	30,193	7,870	16,001	23,795	32,865

Profitability and efficiency
(for banks with licences as of 31 December 2004)

	31 Dec. 2002	31 Dec. 2003	2004			
			31 Mar.	30 Jun.	30 Sep.	31 Dec.
Profit from banking activities/assets in per cent	3.71	3.62	3.75	3.81	3.83	3.96
Gross profit/assets in per cent	1.69	1.65	1.67	1.64	1.63	1.74
Net profit/assets in per cent	1.24	1.21	1.24	1.24	1.22	1.26
Net profit/Tier 1 in per cent	27.41	23.80	22.45	22.80	22.60	23.35
Total interest income/interest earning loans in per cent	4.88	3.92	3.73	3.68	3.73	3.78
Total interest expenses/interest bearing deposits in per cent	2.80	1.88	1.60	1.58	1.61	1.64
Interest rate spread in per cent	2.09	2.04	2.13	2.10	2.12	2.14
Net interest margin in per cent	2.34	2.26	2.33	2.31	2.33	2.36
Number of employees in banking sector	39,493	39,004	38,862	38,659	38,644	38,160
Per employee in CZK thousands:						
total assets	62,824	64,806	66,260	68,417	68,591	69,066
profit from financial activities	2,313	2,314	2,459	2,538	2,571	2,712
net profit	770	774	810	828	821	861
administrative expenses	1,189	1,218	1,198	1,245	1,237	1,279
personnel expenses	559	600	149	302	463	643
General operating expenses/assets in per cent	1.91	1.90	1.83	1.87	1.84	1.87

Loans

(for banks with licences as of 31 December 2004; gross loans granted in the Czech Republic; in CZK millions)

	31 Dec. 2002	31 Dec. 2003	2004			
			31 Mar.	30 Jun.	30 Sep.	31 Dec.
Total loans	875,315	950,685	957,294	975,431	998,527	1,010,321
of which: short-term	255,227	251,185	248,821	251,780	254,411	258,943
medium-term	245,217	286,104	266,780	259,985	265,928	258,262
long-term	374,871	413,396	441,692	463,666	478,187	493,116
Total loans	875,315	950,685	957,294	975,431	998,527	1,010,321
of which: non-financial sector	420,495	427,572	435,345	441,101	466,146	459,502
financial sector	66,694	83,016	80,932	84,803	78,597	81,126
government sector	167,585	158,731	150,927	138,977	125,337	114,877
small businesses	20,949	24,677	23,403	25,216	26,402	28,530
households	156,568	210,810	220,991	239,636	256,716	283,319
other	43,024	45,879	45,696	45,698	45,329	42,967
Total loans	875,315	950,685	957,294	975,431	998,527	1,010,321
of which: agriculture and forestry	18,402	20,399	19,918	22,536	23,238	22,869
manufacturing	147,669	148,962	154,387	150,685	156,572	154,164
construction	12,588	13,368	14,584	16,655	17,648	16,648
financial intermediation and insurance	156,560	159,330	144,948	136,729	122,875	111,984
transport	24,667	23,001	22,031	21,432	20,706	20,838
wholesale and retail trade; hotels and restaurants	108,353	110,327	117,798	117,238	118,354	119,266
other	407,076	475,298	483,629	510,155	539,134	564,552

Deposits

(for banks with licences as of 31 December 2004; deposits received in the Czech Republic; in CZK millions)

	31 Dec. 2002	31 Dec. 2003	2004			
			31 Mar.	30 Jun.	30 Sep.	31 Dec.
Total deposits	1,549,601	1,596,381	1,657,540	1,738,230	1,760,838	1,668,895
of which: demand	652,951	780,503	778,702	818,877	835,011	832,648
time	896,650	815,878	878,839	919,353	925,827	836,247
of which: short-term	664,302	550,640	610,378	638,814	645,091	553,667
medium-term	217,008	260,356	263,346	275,086	274,250	275,292
long-term	15,340	4,882	5,115	5,453	6,485	7,288
Total deposits	1,549,601	1,596,381	1,657,540	1,738,230	1,760,838	1,668,895
of which: non-financial sector	329,720	362,076	323,447	360,848	329,172	384,490
financial sector	87,112	93,986	85,205	89,077	89,101	78,004
government sector	160,493	117,426	209,003	243,001	230,858	124,765
small businesses	54,200	60,502	69,228	73,636	76,409	66,645
households	849,017	897,288	909,423	928,552	936,976	952,661
other	69,059	65,103	61,233	43,117	98,320	62,330
Total deposits	1,549,601	1,596,381	1,657,540	1,738,230	1,760,838	1,668,895
of which: agriculture and forestry	11,562	11,822	12,332	13,361	12,226	13,147
manufacturing	87,087	92,370	85,460	106,387	100,276	100,226
construction	29,020	34,437	24,743	24,917	26,333	33,721
financial intermediation and insurance	153,656	104,891	86,433	92,955	93,220	99,763
transport	17,921	23,586	22,146	24,480	25,821	21,749
wholesale and retail trade; hotels and restaurants	94,062	99,293	100,519	100,108	100,359	88,588
other	1,156,293	1,229,982	1,325,909	1,376,022	1,402,602	1,311,700

Classified and non-performing loans
(for banks with licences as of 31 December 2004)

	31 Dec. 2002	31 Dec. 2003	2004			
			31 Mar.	30 Jun.	30 Sep.	31 Dec.
Classified loans in CZK millions	147,102	114,009	116,212	114,190	111,358	118,826
as a percentage of total loan volume	15.78	11.15	11.20	10.82	10.18	10.84
of which: watch loans	71,332	64,400	66,257	67,063	64,211	74,320
substandard loans	27,515	19,298	19,416	18,371	19,376	19,344
doubtful loans	11,689	6,913	7,375	6,886	5,772	5,306
loss loans	36,566	23,398	23,165	21,869	21,998	19,857
Non-performing loans, in CZK millions	75,770	49,608	49,955	47,127	47,147	44,506
as a percentage of total loan volume	8.13	4.85	4.81	4.46	4.31	4.06
Classified loans taking into account collateral,						
in CZK millions	97,074	82,140	82,555	80,490	78,656	81,124
as a percentage of total loan volume	10.41	8.04	7.96	7.63	7.19	7.40
Weighted classification in CZK millions	51,480	32,299	32,352	30,492	30,143	27,913
as a percentage of total loan volume	5.52	3.16	3.12	2.89	2.75	2.55
Weighted classification taking into account collateral,						
in CZK millions	40,264	25,348	25,275	24,343	24,325	22,379
as a percentage of total loan volume	4.32	2.48	2.44	2.31	2.22	2.04
Reserves and provisions in CZK millions	58,689	38,265	38,385	37,356	36,712	31,205
Surplus (+) / shortfall (-) of reserves,						
provisions and collateral, in CZK millions	18,425	12,917	13,109	13,013	12,387	8,826
as a percentage of total loan volume	1.98	1.26	1.26	1.23	1.13	0.80

Quick assets

(for banks with licences as of 31 December 2004; in CZK millions)

	31 Dec. 2002	31 Dec. 2003	2004			
			31 Mar.	30 Jun.	30 Sep.	31 Dec.
Cash	37,247	37,503	29,411	30,565	31,174	34,011
Deposits and loans with CNB	496,592	484,836	535,705	517,397	508,727	449,971
of which: required reserves	27,950	21,215	23,367	26,330	67,865	20,897
Current accounts with banks and 24 hour time deposits	35,593	37,772	62,688	71,362	68,256	47,690
Treasury bills	238,043	334,424	352,036	373,643	332,435	313,462
CNB bills	3,213	13,161	8,922	0	12,833	18,972
Total quick assets	810,687	907,696	988,763	992,966	953,425	864,106
Trading securities	17,081	25,428	24,810	23,863	23,053	22,439
of which: bonds	16,107	23,937	20,714	19,853	18,730	17,065
equity securities	395	1,491	4,089	3,907	3,918	3,981
bills of exchange	580	0	7	103	405	1,393
Total liquid assets	827,768	933,124	1,013,573	1,016,829	976,478	886,545
Percentage share in total assets:						
quick assets	32.67	35.91	38.40	37.55	35.97	32.79
liquid assets	33.36	36.92	39.36	38.44	36.84	33.64

Assets and liabilities by residual maturity as of 31 December 2004
(for banks with licences as of 31 December 2004; in CZK millions)

	Total	under 1 week	1 week to 1 month	1 to 3 months	3 to 6 months	of which 6 months to 1 year	1 to 2 years	2 to 5 years	over 5 years	non-specified
Total assets	2,635,554	485,029	377,506	158,258	127,874	198,688	176,603	431,206	420,195	260,196
Total liabilities	2,635,554	1,419,874	245,777	130,454	73,901	93,337	118,947	212,375	58,355	282,535
Net balance sheet position	x	(934,845)	131,730	27,804	53,973	105,350	57,656	218,831	361,841	(22,339)
Cumulative net balance sheet position	x	(934,845)	(803,116)	(775,312)	(721,339)	(615,989)	(558,332)	(339,501)	22,339	(0)
as a percentage of total assets	x	(35.47)	(30.47)	(29.42)	(27.37)	(23.37)	(21.18)	(12.88)	0.85	(0.00)
Liabilities taking into account demand										
deposit liquidity	2,635,554	510,064	336,758	221,436	255,863	229,809	255,418	348,846	194,826	282,535
Net balance sheet position	x	(25,035)	40,749	(63,177)	(127,989)	(31,121)	(78,815)	82,359	225,369	(22,339)
Cumulative net balance sheet position	x	(25,035)	15,714	(47,464)	(175,453)	(206,574)	(285,389)	(203,030)	22,339	(0)
as a percentage of total assets	x	(0.95)	0.60	(1.80)	(6.66)	(7.84)	(10.83)	(7.70)	0.85	(0.00)

Assets and liabilities by residual maturity as of 31 December 2003
(for banks with licences as of 31 December 2004; in CZK millions)

	Total	under 1 week	1 week to 1 month	1 to 3 months	3 to 6 months	of which 6 months to 1 year	1 to 2 years	2 to 5 years	over 5 years	non-specified
Total assets	2,527,707	431,452	375,826	165,175	167,831	234,847	176,299	376,117	352,648	247,512
Total liabilities	2,527,707	1,332,674	228,173	131,286	99,944	91,910	124,736	164,580	70,748	283,655
Net balance sheet position	x	(901,222)	147,654	33,888	67,886	142,936	51,563	211,537	281,900	(36,143)
Cumulative net balance sheet position	x	(901,222)	(753,569)	(719,680)	(651,794)	(508,858)	(457,295)	(245,758)	36,143	0
as a percentage of total assets	x	(35.65)	(29.81)	(28.47)	(25.79)	(20.13)	(18.09)	(9.72)	1.43	0.00
Liabilities taking into account demand										
deposit liquidity	2,527,707	494,559	311,984	215,098	267,567	217,627	250,453	290,297	196,465	283,655
Net balance sheet position	x	(63,107)	63,842	(49,923)	(99,737)	17,219	(74,155)	85,820	156,183	(36,143)
Cumulative net balance sheet position	x	(63,107)	735	(49,188)	(148,925)	(131,705)	(205,860)	(120,040)	36,143	0
as a percentage of total assets	x	(2.50)	0.03	(1.95)	(5.89)	(5.21)	(8.14)	(4.75)	1.43	0.00

Capital, capital requirements and capital adequacy
(for banks with licences as of 31 December 2004; in CZK millions)

	31 Dec. 2002	31 Dec. 2003	2004			
			31 Mar.	30 Jun.	30 Sep.	31 Dec.
Tier 1	113,323	133,910	146,819	139,250	142,539	141,328
Tier 2	21,702	11,993	12,207	12,521	12,491	9,402
Deductible items	4,976	2,227	2,576	3,637	3,696	4,033
Total capital	130,049	143,676	156,450	148,134	151,334	146,696
Total capital requirement	72,544	79,392	82,488	87,371	91,712	93,512
Capital requirement A - banking portfolio	67,338	73,776	76,469	81,380	85,133	86,346
Capital requirement B - trading portfolio	5,207	5,616	6,020	5,992	6,579	7,166
Capital adequacy in per cent	14.34	14.48	15.17	13.56	13.20	12.55

Foreign exchange activities
(for banks with licences as of 31 December 2004))

	31 Dec. 2002	31 Dec. 2003	2004			
			31 Mar.	30 Jun.	30 Sep.	31 Dec.
Assets						
in CZK millions						
Loans granted (gross)	160,526	158,115	164,975	165,828	165,612	161,984
Securities (gross)	64,896	99,111	103,768	104,982	123,717	130,549
Deposits and loans with banks (gross)	164,846	105,114	110,915	149,542	151,256	167,474
Other (gross)	52,680	63,668	36,231	32,727	35,344	40,159
Total assets (gross)	442,948	426,008	415,889	453,080	475,929	500,165
as a percentage of foreign exchange assets						
Loans granted (gross)	36.24	37.12	39.67	36.60	34.80	32.39
Securities (gross)	14.65	23.27	24.95	23.17	25.99	26.10
Deposits and loans with banks (gross)	37.22	24.67	26.67	33.01	31.78	33.48
Other (gross)	11.89	14.95	8.71	7.22	7.43	8.03
Total assets (gross)	100.00	100.00	100.00	100.00	100.00	100.00
as a percentage of the total in foreign currencies and CZK						
Loans granted (gross)	17.22	15.43	15.86	15.67	15.09	14.73
Securities (gross)	14.04	18.41	19.27	18.77	22.73	24.54
Deposits and loans with banks (gross)	41.68	35.01	34.80	37.72	39.72	41.70
Other (gross)	4.47	6.07	3.35	2.94	3.23	3.68
Total assets (gross)	17.21	16.31	15.64	16.59	17.39	18.37
Liabilities						
in CZK millions						
Deposits received	200,240	203,138	198,998	211,197	218,150	205,202
Deposits and loans from banks	117,262	133,434	147,429	128,731	131,877	208,228
Bond issues	26,993	34,735	38,328	44,397	46,478	38,094
Other	64,805	67,616	24,033	26,390	23,110	23,145
Total liabilities	409,301	438,922	408,789	410,715	419,615	474,668

Foreign exchange activities (continued)
(for banks with licences as of 31 December 2004; in CZK millions)

	31 Dec. 2002	31 Dec. 2003	2004			
			31 Mar.	30 Jun.	30 Sep.	31 Dec.
Liabilities						
as a percentage of foreign exchange liabilities						
Deposits received	48.92	46.28	48.68	51.42	51.99	43.23
Deposits and loans from banks	28.65	30.40	36.06	31.34	31.43	43.87
Bond issues	6.59	7.91	9.38	10.81	11.08	8.03
Other	15.83	15.40	5.88	6.43	5.51	4.88
Total liabilities	100.00	100.00	100.00	100.00	100.00	100.00
as a percentage of the total in foreign currencies and CZK						
Deposits received	12.45	12.19	11.58	11.64	11.95	11.85
Deposits and loans from banks	38.84	46.79	53.53	46.99	45.13	57.67
Bond issues	16.79	17.69	16.83	20.69	22.34	18.91
Other	15.82	17.78	6.79	7.72	7.12	6.78
Total liabilities	16.50	17.36	15.88	15.53	15.83	18.01
Off-balance-sheet assets						
in CZK millions						
Derivatives transactions	761,466	1,049,812	1,104,115	1,152,403	1,158,904	1,085,762
Other off-balance-sheet transactions	140,883	119,148	144,494	166,203	162,638	122,813
Total off-balance-sheet assets	902,350	1,168,960	1,248,609	1,318,605	1,321,542	1,208,575
as a percentage of foreign exchange off-balance-sheet assets						
Derivatives transactions	84.39	89.81	88.43	87.40	87.69	89.84
Other off-balance-sheet transactions	15.61	10.19	11.57	12.60	12.31	10.16
Total off-balance-sheet assets	100.00	100.00	100.00	100.00	100.00	100.00
as a percentage of the total in foreign currencies and CZK						
Derivatives transactions	24.99	31.68	31.37	27.81	27.10	27.35
Other off-balance-sheet transactions	24.04	20.23	26.18	28.30	26.55	22.54
Total off-balance-sheet assets	24.84	29.95	30.66	27.87	27.03	26.77
Off-balance-sheet liabilities						
in CZK millions						
Derivatives transactions	785,754	1,021,878	1,093,403	1,194,164	1,221,805	1,110,788
Other off-balance-sheet transactions	215,354	149,679	183,510	189,949	192,865	153,116
Total off-balance-sheet liabilities	1,001,109	1,171,557	1,276,913	1,384,113	1,414,670	1,263,904
as a percentage of foreign exchange off-balance-sheet liabilities						
Derivatives transactions	78.49	87.22	85.63	86.28	86.37	87.89
Other off-balance-sheet transactions	21.51	12.78	14.37	13.72	13.63	12.11
Total off-balance-sheet liabilities	100.00	100.00	100.00	100.00	100.00	100.00
as a percentage of the total in foreign currencies and CZK						
Derivatives transactions	22.26	27.17	27.41	25.87	25.86	25.84
Other off-balance-sheet transactions	44.19	32.68	37.49	38.62	41.08	42.64
Total off-balance-sheet liabilities	28.35	31.14	32.01	29.99	29.94	29.40

Activities vis-à-vis non-residents
(for banks with licences as of 31 December 2004)

	31 Dec. 2002	31 Dec. 2003	2004			
			31 Mar.	30 Jun.	30 Sep.	31 Dec.
Assets						
in CZK millions						
Loans granted (gross)	58,273	67,915	70,956	72,295	73,125	69,645
Securities (gross)	137,560	134,591	137,300	135,787	151,637	159,460
Deposits and loans with banks (gross)	230,558	171,881	194,164	259,060	245,170	239,163
Other (gross)	79,458	83,213	53,781	45,293	51,019	73,603
Total assets (gross)	505,849	457,600	456,201	512,434	520,952	541,870
as a percentage of assets vis-à-vis non-residents						
Loans granted (gross)	11.52	14.84	15.55	14.11	14.04	12.85
Securities (gross)	27.19	29.41	30.10	26.50	29.11	29.43
Deposits and loans with banks (gross)	45.58	37.56	42.56	50.55	47.06	44.14
Other (gross)	15.71	18.18	11.79	8.84	9.79	13.58
Total assets (gross)	100.00	100.00	100.00	100.00	100.00	100.00
as a percentage of the total vis-à-vis residents and non-residents						
Loans granted (gross)	6.25	6.63	6.82	6.83	6.66	6.33
Securities (gross)	29.76	25.00	25.50	24.28	27.86	29.98
Deposits and loans with banks (gross)	58.30	57.25	60.93	65.35	64.39	59.55
Other (gross)	6.74	7.93	4.98	4.07	4.66	6.75
Total assets (gross)	19.66	17.52	17.16	18.77	19.03	19.91
Liabilities						
in CZK millions						
Deposits received	64,197	66,710	63,407	67,692	68,889	67,843
Deposits and loans from banks	143,971	169,795	165,797	148,965	168,602	211,729
Bond issues	14,306	15,672	18,502	17,703	18,202	19,267
Other	79,425	81,005	33,520	40,959	32,674	49,526
Total liabilities	301,899	333,182	281,226	275,318	288,366	348,364
as a percentage of liabilities vis-à-vis non-residents						
Deposits received	21.26	20.02	22.55	24.59	23.89	19.47
Deposits and loans from banks	47.69	50.96	58.96	54.11	58.47	60.78
Bond issues	4.74	4.70	6.58	6.43	6.31	5.53
Other	26.31	24.31	11.92	14.88	11.33	14.22
Total liabilities	100.00	100.00	100.00	100.00	100.00	100.00
as a percentage of the total vis-à-vis residents and non-residents						
Deposits received	3.99	4.00	3.69	3.73	3.77	3.92
Deposits and loans from banks	47.68	59.54	60.20	54.37	57.70	58.64
Bond issues	8.90	7.98	8.13	8.25	8.75	9.56
Other	19.39	21.30	9.47	11.98	10.06	14.52
Total liabilities	12.17	13.18	10.92	10.41	10.88	13.22

Activities vis-à-vis non-residents (continued)
(for banks with licences as of 31 December 2004)

	31 Dec. 2002	31 Dec. 2003	2004			
			31 Mar.	30 Jun.	30 Sep.	31 Dec.
Off-balance-sheet assets (excluding memorandum accounts)						
in CZK millions						
Derivatives transactions	2,156,608	2,311,561	2,460,348	2,853,966	2,836,022	2,668,386
Other off-balance-sheet transactions	109,576	83,630	106,833	119,851	124,197	80,494
Total off-balance-sheet assets	2,266,184	2,395,191	2,567,181	2,973,817	2,960,219	2,748,880
as a percentage of off-balance-sheet assets vis-à-vis non-residents						
Derivatives transactions	95.16	96.51	95.84	95.97	95.80	97.07
Other off-balance-sheet transactions	4.84	3.49	4.16	4.03	4.20	2.93
Total off-balance-sheet assets	100.00	100.00	100.00	100.00	100.00	100.00
as a percentage of the total vis-à-vis residents and non-residents						
Derivatives transactions	70.78	69.75	69.89	68.87	66.32	67.22
Other off-balance-sheet transactions	18.70	14.20	19.36	20.41	20.27	14.77
Total off-balance-sheet assets	62.37	61.37	63.04	62.85	60.55	60.89
Off-balance-sheet liabilities (excluding memorandum accounts)						
in CZK millions						
Derivatives transactions	2,159,498	2,299,093	2,428,303	2,820,782	2,817,681	2,672,677
Other off-balance-sheet transactions	199,639	158,170	183,818	196,334	183,179	127,128
Total off-balance-sheet liabilities	2,359,138	2,457,263	2,612,122	3,017,116	3,000,861	2,799,805
as a percentage of off-balance-sheet liabilities vis-à-vis non-residents						
Derivatives transactions	91.54	93.56	92.96	93.49	93.90	95.46
Other off-balance-sheet transactions	8.46	6.44	7.04	6.51	6.10	4.54
Total off-balance-sheet liabilities	100.00	100.00	100.00	100.00	100.00	100.00
as a percentage of the total vis-à-vis residents and non-residents						
Derivatives transactions	70.96	69.59	69.39	68.41	66.22	67.83
Other off-balance-sheet transactions	40.96	34.53	37.55	39.92	39.02	35.40
Total off-balance-sheet liabilities	66.82	65.32	65.48	65.37	63.51	65.12

Selected bank group indicators
(for banks with licences as of 31 December 2004)

	31 Dec. 2002	31 Dec. 2003	2004			
			31 Mar.	30 Jun.	30 Sep.	31 Dec.
Large banks						
Total assets (in CZK millions)	1,556,412	1,569,840	1,638,962	1,657,727	1,662,671	1,575,296
Loans granted (net) (in CZK millions)	553,614	608,082	610,697	622,459	647,601	641,695
Deposits received (in CZK millions)	1,112,761	1,139,463	1,169,567	1,215,688	1,212,312	1,117,473
Total off-balance-sheet assets (in CZK millions)	1,987,690	2,303,095	2,418,051	2,864,373	2,911,316	2,613,087
Receivables from derivatives transactions (in CZK millions)	1,612,764	1,921,196	2,082,370	2,496,185	2,531,252	2,264,119
Profit from financial activities (in CZK millions)	67,790	64,508	17,191	35,091	53,375	75,217
Net profit (in CZK millions)	23,154	21,934	5,707	12,043	18,006	25,899
Non-performing loans / total loans (in per cent)	10.13	5.15	5.12	4.66	4.38	4.00
Capital adequacy (in per cent)	13.41	13.56	14.62	12.33	11.76	11.04
Quick assets / total assets (in per cent)	33.17	36.51	39.83	38.12	36.05	32.19
Medium-sized banks						
Total assets (in CZK millions)	430,249	400,238	420,898	424,535	431,081	418,744
Loans granted (net) (in CZK millions)	180,584	205,912	215,055	216,761	218,387	223,222
Deposits received (in CZK millions)	227,985	192,432	200,946	203,777	209,209	192,073
Total off-balance-sheet assets (in CZK millions)	839,086	831,876	822,187	958,954	1,004,125	950,560
Receivables from derivatives transactions (in CZK millions)	711,221	705,734	700,507	835,227	875,275	836,707
Profit from financial activities (in CZK millions)	12,907	14,818	3,925	8,384	12,589	16,898
Net profit (in CZK millions)	3,132	4,788	1,325	2,363	3,620	4,608
Non-performing loans / total loans (in per cent)	6.44	5.75	5.59	5.47	5.80	5.98
Capital adequacy (in per cent)	15.98	16.29	16.32	16.90	17.70	17.10
Quick assets / total assets (in per cent)	34.66	29.71	31.50	29.11	30.70	23.11
Small banks						
Total assets (in CZK millions)	47,586	50,592	52,712	55,077	58,142	61,902
Loans granted (net) (in CZK millions)	11,940	21,258	23,469	25,145	27,788	30,142
Deposits received (in CZK millions)	31,973	26,807	29,385	32,727	33,899	32,978
Total off-balance-sheet assets (in CZK millions)	7,794	20,089	15,223	21,810	30,166	26,929
Receivables from derivatives transactions (in CZK millions)	2,178	9,277	5,949	7,721	9,611	17,040
Profit from financial activities (in CZK millions)	1,292	2,120	461	977	1,553	2,040
Net profit (in CZK millions)	61	572	-2	24	-44	-31
Non-performing loans / total loans (in per cent)	16.30	9.50	8.70	7.31	5.54	5.33
Capital adequacy (in per cent)	37.19	29.02	26.07	22.16	18.68	19.42
Quick assets / total assets (in per cent)	49.27	39.14	43.00	43.25	41.92	33.74

Selected bank group indicators (continued)
(for banks with licences as of 31 December 2004)

	31 Dec. 2002	31 Dec. 2003	2004			
			31 Mar.	30 Jun.	30 Sep.	31 Dec.
Foreign bank branches						
Total assets (in CZK millions)	241,556	241,357	183,867	224,096	206,285	263,689
Loans granted (net) (in CZK millions)	93,036	85,319	82,022	79,455	82,575	79,354
Deposits received (in CZK millions)	48,010	58,451	62,853	96,430	98,410	91,814
Total off-balance-sheet assets (in CZK millions)	789,572	739,051	805,290	875,471	931,138	912,316
Receivables from derivatives transactions (in CZK millions)	720,920	677,932	731,286	804,911	860,089	851,809
Profit from financial activities (in CZK millions)	4,722	3,958	966	1,959	2,943	3,973
Net profit (in CZK millions)	2,473	1,769	467	732	998	1,282
Non-performing loans / total loans (in per cent)	1.34	1.84	2.12	2.01	2.08	1.45
Capital adequacy (in per cent)	0.00	0.00	0.00	0.00	0.00	0.00
Quick assets / total assets (in per cent)	17.91	33.19	29.86	32.27	27.96	35.41
Building societies						
Total assets (in CZK millions)	205,314	265,678	278,552	283,481	292,451	315,924
Loans granted (net) (in CZK millions)	51,583	75,629	80,301	86,257	92,924	99,445
Deposits received (in CZK millions)	188,017	248,734	255,333	266,021	271,800	297,511
Total off-balance-sheet assets (in CZK millions)	9,055	9,036	11,236	10,768	12,066	11,597
Receivables from derivatives transactions (in CZK millions)	0	0	0	0	0	0
Profit from financial activities (in CZK millions)	4,656	4,849	1,349	2,655	4,044	5,358
Net profit (in CZK millions)	1,576	1,129	372	839	1,215	1,108
Non-performing loans / total loans (in per cent)	1.77	1.92	1.93	1.87	1.86	1.78
Capital adequacy (in per cent)	13.59	13.28	13.36	12.40	11.72	10.81
Quick assets / total assets (in per cent)	38.31	43.58	45.16	49.90	47.71	46.21

Concentration

(for banks with licences as of the given date; classified loans exclude credit to Slovak Collection Unit)

	31 Dec. 2002	31 Dec. 2003	2004			
			31 Mar.	30 Jun.	30 Sep.	31 Dec.
Percentage share in banking sector						
3 largest banks						
Total assets (net)	57.18	56.88	58.19	57.25	56.59	54.35
Loans granted to clients (net)	53.51	52.88	52.45	52.17	52.28	51.84
Deposits and loans with banks (net)	47.07	43.87	44.90	44.55	47.84	43.35
Securities excluding Treasury bills and CNB bills (net)	81.60	77.97	73.71	74.85	74.68	76.43
Tangible and intangible assets	80.06	81.86	81.38	81.44	81.23	80.44
Deposits received from clients	64.24	64.14	63.84	62.90	62.00	60.46
Issues of short-term and long-term bonds	53.81	49.30	49.38	51.74	48.24	50.88
Total off-balance-sheet assets	48.71	51.12	51.50	53.77	53.19	52.85
Receivables from derivatives transactions	51.64	52.49	52.97	55.68	55.22	52.85
Profit from financial activities	68.24	66.87	67.36	67.10	67.22	68.04
Administrative expenses	65.81	64.32	66.01	64.40	63.39	63.09
Net profit (profitable banks only)	76.27	66.99	65.71	68.63	69.78	63.09
Classified loans	67.96	65.68	66.20	65.31	63.21	58.24
Quick assets	59.25	59.38	62.45	60.57	58.40	55.70
Tier 1	58.01	59.41	62.15	56.92	55.78	55.94
Total capital	57.48	56.34	59.04	53.81	52.79	52.09
Foreign exchange assets	56.32	54.57	57.94	53.68	57.42	55.32
Assets vis-à-vis non-residents	66.36	65.24	66.96	61.88	66.47	63.65
5 largest banks						
Total assets (net)	65.75	65.77	67.51	66.49	66.63	63.97
Loans granted to clients (net)	65.47	64.45	63.94	64.25	64.57	64.05
Deposits and loans with banks (net)	58.08	55.23	56.05	56.53	60.80	57.90
Securities excluding Treasury bills and CNB bills (net)	89.82	87.80	86.88	86.99	85.79	86.59
Tangible and intangible assets	85.06	86.55	86.17	86.21	86.11	85.52
Deposits received from clients	72.29	73.55	73.15	72.19	71.68	70.54
Issues of short-term and long-term bonds	70.08	65.95	66.64	71.15	69.55	71.66
Total off-balance-sheet assets	74.35	74.53	74.63	77.05	77.46	76.36
Receivables from derivatives transactions	75.60	75.41	76.28	78.66	79.34	77.89
Profit from financial activities	77.44	77.74	77.94	78.15	78.13	78.98
Administrative expenses	74.82	74.77	75.27	74.38	73.83	73.46
Net profit (profitable banks only)	86.54	79.23	79.40	82.75	83.47	85.63
Classified loans	80.80	77.40	77.66	76.97	74.98	70.64
Quick assets	69.50	66.99	69.72	68.62	67.19	65.07
Tier 1	72.12	73.40	74.92	73.02	71.52	71.06
Total capital	71.14	70.38	71.96	69.75	68.38	67.29
Foreign exchange assets (gross)	70.66	73.08	74.30	70.68	73.70	74.62
Assets vis-à-vis non-residents (gross)	79.29	77.02	74.68	72.05	75.85	76.07

Concentration (continued)

(for banks with licences as of the given date; classified loans exclude credit to Slovak Collection Unit)

	31 Dec. 2002	31 Dec. 2003	2004			
			31 Mar.	30 Jun.	30 Sep.	31 Dec.
Percentage share in banking sector						
10 largest banks						
Total assets (net)	79.78	79.38	79.75	78.64	79.14	77.96
Loans granted to clients (net)	79.96	79.50	78.98	79.45	79.42	79.48
Deposits and loans with banks (net)	77.91	78.18	77.25	79.33	79.32	77.81
Securities excluding Treasury bills and CNB bills (net)	95.88	97.84	97.63	96.70	96.87	97.19
Tangible and intangible assets	92.33	92.60	92.24	92.16	92.04	91.86
Deposits received from clients	85.41	86.98	86.46	84.86	84.62	84.56
Issues of short-term and long-term bonds	94.27	89.93	90.53	93.65	94.29	94.74
Total off-balance-sheet assets	94.43	94.45	94.22	95.40	95.19	94.68
Receivables from derivatives transactions	96.22	96.16	95.98	97.00	96.92	96.37
Profit from financial activities	86.86	87.65	88.14	88.05	88.01	88.76
Administrative expenses	85.94	86.72	86.79	86.38	86.26	86.63
Net profit (profitable banks only)	98.98	90.07	90.88	90.58	91.27	93.02
Classified loans	91.90	89.66	89.67	89.54	88.67	89.04
Quick assets	83.78	81.09	82.69	81.27	81.59	81.31
Tier 1	86.60	87.02	87.66	86.86	87.01	86.67
Total capital	86.67	86.21	86.91	85.82	85.67	84.80
Foreign exchange assets (gross)	88.44	89.66	88.81	88.43	88.92	89.49
Assets vis-à-vis non-residents (gross)	91.70	88.99	88.15	88.87	89.68	89.68

Box 1**Lamfalussy process¹⁵**

European Commission (Commission)			
Level 1 Core principles	ECOFIN Council of Economics and Finance Ministers		European Parliament
Level 2 Technical details Comitology	BAC (EBC)	ESC	EIOPC
Level 3 Supervisory convergence	CEBS	CESR	CEIOPS
Level 4 Enforcement	Monitoring of compliance with EU legislation	Monitoring of compliance with EU legislation	Monitoring of compliance with EU legislation

Abbreviations:

BAC	Banking Advisory Committee, to be replaced by the new ESC (European Banking Committee)
CEBS	Committee of European Banking Supervisors
ESC	European Securities Committee
CESR	Committee of European Securities Regulators
EIOPC	European Insurance and Occupational Pensions Committee
CEIOPS	Committee of European Insurance and Occupational Pensions Supervisors

¹⁵ Financial Integration – Bank of Finland Studies A:108. 2004

Box 2

Active participation of CNB Banking Supervision staff in EU committees and working groups

Name of committee	Description	Name of group	Description
CEBS Committee of European Banking Supervisors	Co-operation between banking supervisors; convergence of supervisory practices		
		Groupe de Contact (GdC)	Pillar 2 principles – Basel II (assessment by supervisors; assessment of capital adequacy by banks; outsourcing principles; governance of banks)
		Sponsor Group Home/Host Issues (GdC)	Principles of co-operation between home and host supervisory authorities – Basel II
		Common Reporting Group (COREP)	Defining the content and scope of common reporting on capital adequacy in compliance with Basel II
		Working Group on Accounting and Auditing (WGAA)	Defining the content and scope of financial statements; requirements for auditors
BAC Representative – Ministry of Finance Technical expert – CNB	Technical details of banking directives		
Representatives of the Ministry of Finance and the CNB		Own Funds (since 2005)	Conceptual criteria for new definition of own funds
BSC Banking Supervision Committee (a committee of the European System of Central Banks)	Measures to promote banking and financial stability in the EU		
		Working Group on Macro-prudential Analysis (WGMA)	Analyses and data collection to promote financial stability
		Working Group on Developments in Banking (WGDB)	Analyses and projects to monitor developments in banking sectors in the EU
		Task Force on Crisis Management (joint group with the CEBS)	Development of recommendations and standards for effective cross-border co-operation between supervisors and central banks in crisis management situations
BCBS Basel Committee on Banking Supervision			
		Core Principles Liaison Group (CPLG)	Development and updating of Core Principles for Effective Banking Supervision (part of FSAP); Basel II issues
		Working Group for Capital	Principles of implementation of Basel II – co-operation between home and host supervisors; discretion

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Produced by: Studio Press
Design: Jerome s.r.o.