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To: Members of the Executive Board

From: The Acting Secretary

Subject: **Czech Republic—Publication of Financial Sector Assessment Program Documentation—Detailed Assessment of Observance of Basel Core Principles for Effective Banking Supervision**

Attached for the **information** of Executive Directors is the detailed assessment of observance of Basel core principles for effective banking supervision that was completed in connection with the Financial Sector Assessment Program (FSAP) assessment of the Czech Republic.

It is intended that this paper will be published on the Fund's external website after July 13, 2012.

Questions may be referred to Mr. Prokopenko, MCM (ext. 38916).

This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities.

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FINANCIAL SECTOR ASSESSMENT PROGRAM UPDATE

CZECH REPUBLIC

BASEL CORE PRINCIPLES FOR EFFECTIVE BANKING
SUPERVISION

DETAILED ASSESSMENT OF OBSERVANCE

JULY 2012

INTERNATIONAL MONETARY FUND
MONETARY AND CAPITAL MARKETS DEPARTMENT

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GLOSSARY

AC	Additional criterion (in the assessment of the BCP)
AML/CFT	Anti-money laundering/Combating the Finance of Terrorism
BA	The Banking Act
BCP	The Basel Core Principles for Effective Banking Supervision
CEO	Chief Executive Officer
CFO	Chief Financial Officer
CNB	The Czech National Bank (Ceska Narodni Banka)
CP	Core Principle
CRD	Capital Requirements Directive (EU)
CRO	Chief Risk Officer
CUA	Credit Union Act
CZK	Czech korunas (the national currency, approximately 18 CZK to 1 USD)
DIF	Deposit Insurance Fund
EBA	European Banking Authority
EC	Essential criterion (in the assessment of the BCP)
ECB	European Central Bank
FINREP	Financial reporting standards which are based on IFRS.
FIU	Financial Intelligence Unit
FMS	Financial Market Supervision
GM	General meeting
IFRS	International Financial Reporting Standard
IRB	Internal ratings-based
KYC	Know your customer
MOF	Ministry of Finance
MOU	Memorandum of Understanding
NPL	Nonperforming loan
PEPs	Politically exposed persons
PRD	Prudential Rules Decree
RAS	Risk assessment system
TP	Technical provision

I. SUMMARY, KEY FINDINGS, AND RECOMMENDATIONS

1. **The compliance of the Czech Republic with the Basel Core Principles for Effective Banking Supervision (BCP) has improved markedly since the previous assessment, conducted some ten years ago.** Many earlier weaknesses have been addressed, either through domestic measures or by implementing European Union (EU)-wide rules and regulations. That said, further improvements are needed to achieve all the minimum requirements set by the Core Principles (CPs) and also to reach the best practices necessary to increase the resilience of the banking system.
2. **An overarching weakness is the insufficiency of staff resources for supervision.** This has led to inadequate supervision in several areas, such as too infrequent on-site inspections and delayed remedial action for identified weaknesses in banks. The responsible supervisory authority, the Czech National Bank (CNB), tries to compensate by laying emphasis on offsite monitoring, in order to identify potentially weak banks, for example, by stress tests or peer reviews, and by focusing on banks' corporate governance processes, taking the view that a strong governance environment will act as a shield against bank mismanagement.
3. **It is the view of the BCP assessors that while this is commendable, it must be supplemented by more frequent on-site supervision.** It should be noted that Czech banks did not experience any serious problems during the global financial crisis. They have capital adequacy ratios far above the regulatory minimum and also above the average of banks in comparable countries. The liquidity position of Czech banks is comfortable since there is a substantial surplus of retail deposits in relation to banks' lending and holding of other assets. However, to ascertain that the capital level is solid, the CNB supervisors must continuously verify, primarily through on-site inspections, that the level of loan-loss provisioning is adequate and also that the classification of nonperforming loans (NPLs) is strict, also covering loans for which the bank has granted some temporary relief.
4. **The sector of credit unions is still small, some 1 percent of the total amount of bank assets, but is growing rather rapidly and has experienced the default of several institutions in recent years.** Similar approaches to regulation and supervision are applicable to credit unions as well as to banks, albeit implemented through different laws and regulations. Being small, the credit unions have been subjected to less intense supervision than the banks.

A. Introduction

5. **This assessment of the current state of the Czech Republic implementation of the BCPs has been completed as a part of a Financial Sector Assessment Program (FSAP) undertaken by the International Monetary Fund (IMF) during the period October to December 2011, and reflects the regulatory and supervisory framework in place as of**

the date of the completion of the assessment.¹ An assessment of the effectiveness of banking supervision requires a review of the legal framework, both generally and specifically related to the financial sector, and detailed examination of the policies and practices of the institutions responsible for banking supervision. In line with the BCP methodology, the assessment focused on the major banks and banking groups, and their regulation and supervision, given their importance to the system.

B. Information and Methodology Used for Assessment

6. **The Czech authorities agreed to be assessed according to the CP Methodology issued by the Basel Committee on Banking Supervision (Basel Committee) in October 2006.** The assessment of compliance with each CP is made on a qualitative basis to allow a judgment on whether the criteria are fulfilled in practice. Effective application of relevant laws and regulations is essential to indicate that the criteria are met.

7. **To assess compliance, the methodology proposes a set of essential and additional criteria for each principle.** The essential criteria (EC) are the only elements on which to gauge full compliance with a core principle. The additional criteria (AC) are suggested best practices against which the Czech authorities have agreed to be assessed. The compliance with additional criteria are commented on, but are not reflected in the grading. A four-part grading system is used: compliant, largely compliant, materially noncompliant, and noncompliant. This is further explained in the Detailed Assessment section. The assessment team reviewed the framework of laws, rules, and guidance, and held extensive meetings with officials of the CNB, and also met the ministry of finance (MOF), and participants in the banking sector, including credit unions and building societies. They also met with an audit firm and the industry association representing banks. The team examined the CNB's practices in performing bank supervision. It had the benefit of being supplied with a very comprehensive, high-quality self-assessment completed by the authorities, enjoyed the strong cooperation of the authorities, and received the information it required. Reaching conclusions required judgments by the assessment team. Banking systems differ from one country to another, as do their domestic circumstances. Furthermore, banking activities are changing rapidly around the world after the crisis, and theories, policies, and best practices for supervision are swiftly evolving. Nevertheless, by adhering to a common, globally agreed methodology, the assessment should provide the Czech authorities with an internationally consistent measure of the quality of its banking supervision in relation to the CPs, which are internationally acknowledged as minimum standards.

¹ The assessment team comprised Susan Quill, Senior International Advisor, U.S. Office of the Comptroller of the Currency, and Göran Lind, Advisor to the Board of the Sveriges Riksbank.

C. Institutional and Macroeconomic Setting and Market Structure—Overview

8. **The Czech economy has weathered the crisis relatively well so far.** Limited external financing needs, a flexible exchange rate regime, credible monetary policy framework, healthy public and private balance sheets without currency mismatches, and the absence of major pre-crisis asset bubbles helped contain the external shock and limited output decline from peak to trough to about 5 percent. Monetary and fiscal easing also helped cushion the economic downturn. The CNB—the first central bank in Europe to start easing monetary policy in August 2008—cut the policy rate by a total of 325 basis points between August 2008 and May 2010. Automatic stabilizers and discretionary fiscal measures also helped soften the effects of the negative shock to the economy in 2009.

9. **Despite the relatively favorable initial conditions and supportive policies, the subsequent recovery has been mainly driven by external demand, and domestic demand has lagged behind.** The recovery in partner countries, in particular Germany, has underpinned a rapid export growth. In contrast, consumption has been lackluster, hovering just above its crisis trough. Efforts to stem the rise of public debt starting from 2010 on, a persistent level of low confidence, and limited labor income gains have weighed on the domestic demand.

10. **Growth stalled in early 2011, and risks to the outlook have intensified.** Domestic demand has weakened in 2011 led by decline in household consumption and government spending, and turned into a drag on the growth. As a result, in the second and third quarters economic activity has been effectively flat. The headwinds to domestic demand has not abated as the fiscal policy continues on a consolidation path, the lower bracket value-added tax rate is set to rise in 2012, and household and business confidence levels are very low. Moreover, the Euro Area growth prospects have worsened considerably, suggesting that net exports would not be able to continue to drive growth. Consequently, the 2012 growth is projected at about 0.5 percent down from an estimated 1.9 percent in 2010. The risks to this projection are slated mostly to the downside. A sharper than currently projected Euro Area slowdown and financial contagion from the Euro Area banking system can push the Czech economy into a recession. So far financial contagion has been limited, as the risk premiums on Czech assets have increased, but remain well below levels seen in the 2008–09 crisis and compare favorably with regional peers as well as Euro Area countries.

11. **The nonfinancial corporate sector's financial indicators are relatively sound, but the macroeconomic uncertainty weighs on the prospects.** The Czech nonfinancial corporate sector has a low indebtedness in international comparison, with financial liabilities at 46 percent of GDP. Following the 2008–09 crisis, the NPL ratio for the corporates rose sharply from about 3 percent in 2007 to about 9 percent in 2009. In the subsequent recovery, aggregate profitability indicators have improved led by export-oriented industries, and the NPLs have stabilized and entered a moderate downtrend over 2010–11. However, domestic demand has remained markedly weak during the recovery, which, coupled with the ongoing

slowdown in the Euro Area, have the potential to lead to a renewed bout of credit deterioration in the sector. Moreover, the aggregate figures tend to mask differences in the subsectors. In particular, loans to the real estate sector poses significant risk, as their weight in the overall portfolio has risen significantly during the boom period and unsold properties reportedly remain at an elevated level. In parallel, the exporters are facing unusually high uncertainty with respect to the traditional markets, but they are better positioned than in 2008 to capitalize from any potential currency weakening.

12. **The Czech household sector is characterized by a strong aggregate balance sheet, despite the rapid credit expansion in the run-up to the 2008–09 crisis.** As credit to households expanded at about 30 percent a year between 2003 and 2008, the household financial asset growth failed to keep pace with liabilities. As a result, the assets to liabilities ratio for the household sector has declined from about 480 percent in 2004 to stabilize around 300 percent since 2008. However, gross household debt to GDP, currently at about 35 percent, is still low by international standards. Moreover, the majority of the new household credit during the boom took the form of housing loans (about three-fourths between 2002–08), and while the data is not available, the households' financial position would look even stronger if one took into account housing assets.

13. **Property prices have substantially declined since 2008 reflecting subdued demand.** Property prices have increased substantially in the run-up to the financial crisis in line with the global trends and supported by rapid growth in housing credit, but the trend was reversed by the crisis and prices have declined by about 20 percent from its peak. Apartment prices in Prague, the category where the cycle has been the most pronounced, have risen by more than 70 percent between 2004 and 2008, followed by a fall of about 25 percent from their peak. The cycle was more moderate in other areas and property types. The decline continued in the residential segment as of late 2011, but the rate of decline has subsided recently to annual 1–3 percent range. While prices continue to decline, the dominance of owner occupiers among the borrowers, prudent loan-to-value ratios, and the low interest rates have limited the credit risks stemming from the mortgage loans for the financial system, and the NPLs for this category has risen to a peak of about 3 percent. The commercial property market saw partial recovery starting 2010, especially in the industrial sector but still face risk of price decline.

Financial sector developments

14. **The Czech financial system proved generally resilient to the effects of the global financial crisis.** The Czech banking sector is one of the few in the region where no exceptional state measures were needed, contrary to some parent banks. There was no need to recapitalize banks using public funds or to engineer some other type of exceptional support to banks. The relaxation of monetary policy was sufficient to ensure adequate liquidity. The provision of emergency liquidity by the European Central Bank (ECB) and support by their home governments benefitted some troubled parent banks and helped shield Czech

subsidiaries from induced financial distress.² However, credit growth dropped virtually to zero in late 2009, with interbank and corporate credit plummeting on weak loan demand and more cautious lending practices. Credit growth is presently some 6 percent on a yearly basis.

15. **Banks maintain strong capital, liquidity, and profitability buffers.** Although banks were affected by the weakened economy, with the NPL ratio climbing to 6.4 percent as of end-March 2011 (from 3.2 percent as of end-2008), the capitalization and profitability indicators remained solid. The capital adequacy ratio, which is mainly made up of Tier I capital, increased from 12.3 percent in 2008 to 15.9 percent in June 2011, reflecting profit retention, slower credit growth, higher share of claims on government, and some capital relief (especially on mortgage loans) arising from the move to Basel II. The aggregate liquidity ratios, which declined in 2008, have recovered and remained broadly stable or even improving.

16. **However, the system's loan loss provision to NPLs ratio is on the low side compared to other countries in the region.** While any shortfall in provisioning is deducted from capital, the mission encourages the CNB to review closely the adequacy of banks' provisions through on-site visits (especially for non internal-ratings based (IRB) banks). In addition, some banks reportedly are providing relief to some borrowers before they become NPLs to avoid taking the needed provisions, and some banks are selling NPLs to other entities, sometimes within the same group. The CNB special on-site visits could be used to review banks' compliance with classification requirements and to ensure that sale of loans are conducted on market terms.

17. **The performance of nonbank financial institutions has been mixed.** Insurance companies continue to report profitable results and adequate capitalization. The implementation of the EU Solvency II regulatory framework will facilitate a more risk-based approach to solvency assessment and supervision of the insurance sector. The pension funds received an important blow during 2008–09 due to redemptions as well as bond and equity market falls, and needed to be recapitalized by their shareholders. The capitalization of pension funds has subsequently stabilized at around 5 percent. The performance of the small but fast-growing credit union sector is weak, with a high share of NPLs and very low loan-loss provisioning ratios.

18. **The individual segments of the financial sector are interlinked.** These linkages are established through cross-sectoral loans and deposits and mutual ownership. In particular, large banks typically own various nonbank financial institutions, including financial institutions abroad. The CNB has been designated by the European Banking Authority (EBA) as the coordinator for one financial conglomerate operating in the EU—the PPF

² The Austrian bank Erste and the Belgian KBC, each of which owns a large Czech bank, received assistance in the form of public funds during the crisis.

Group, with group assets totaling approximately €12.4 billion as at end-2010. The PPF Group's operations span a wide range of financial (banking and insurance) and nonfinancial businesses (real estate, energy, metal mining, agriculture and retail) in nine countries (Central and Eastern Europe and Asia).

19. The following table shows the structure of the financial sector:

Table 1. Czech Republic: Structure of The Financial Sector

	2009				2010				Jun-11			
	Number	Total assets (in millions CZK)	% of total assets	% of GDP	Number	Total assets (in millions CZK)	% of total assets	% of GDP	Number	Total assets (in millions CZK)	% of total assets	% of GDP
Banks	39	4,094,626	84.2	112.9	41	4,188,929	83.5	114.2	44	4,266,749	83.6	115.3
<i>Cf which</i>												0.0
Four largest banks	4	2,361,651	48.5	65.1	4	2,431,669	48.4	66.3	4	2,458,335	48.1	66.4
Domestically-controlled ¹	5	542,413	11.1	15.0	6	567,703	11.3	15.5	6	581,088	11.4	15.7
Foreign-controlled	14	2,943,858	60.5	81.2	14	3,025,254	60.3	82.5	15	3,076,701	60.3	83.1
State-owned	2	111,868	2.3	3.1	2	122,942	2.4	3.4	2	130,965	2.6	3.5
Branches of foreign banks	13	496,487	10.2	13.7	19	473,030	9.4	12.9	21	477,996	9.4	12.9
Building Societies	5	457,084	9.4	12.6	5	470,200	9.4	12.8	5	464,576	9.1	12.6
Non Bank Financial Institutions	263	770,565	15.8	21.3	269	827,327	16.5	22.6	290	840,824	16.5	22.7
Insurance companies	52	396,432	8.1	10.9	52	426,474	8.5	11.6	53	429,899	8.4	11.6
<i>Cf which</i>												
Life insurance	7	n/a	n/a	n/a	7	n/a	n/a	n/a	7	n/a	n/a	n/a
Non Life insurance	29	n/a	n/a	n/a	30	n/a	n/a	n/a	31	n/a	n/a	n/a
Life and Non Life insurance	16	n/a	n/a	n/a	15	n/a	n/a	n/a	15	n/a	n/a	n/a
Pension funds	10	215,873	4.4	6.0	10	232,427	4.6	6.3	10	239,698	4.7	6.5
Investment funds ²	110	118,025	2.4	3.3	117	123,735	2.5	3.4	117	121,445	2.4	3.3
Investment companies (non banks)	23	22,587	0.5	0.6	25	24,758	0.5	0.7	22	25,300	0.5	0.7
Credit unions	17	17,649	0.4	0.5	14	19,934	0.4	0.5	14	24,481	0.5	0.7
Total Financial Institutions	302	4,865,191	100.0	134.2	310	5,019,608	100.0	136.9	334	5,106,175	100.0	138.0
Memo items: GDP (millions CZK)				3,625,865				3,667,429				3,700,700

Source: Czech National Bank

20. **Building societies face specific challenges.** In particular, they are vulnerable to changes in the institutional framework. Specifically, the fiscal cost of the subsidy scheme is not negligible, and as part of its consolidation efforts the government has passed a law to effectively reduce the government contributions in 2011. Given the role of government subsidies in attracting funding to the sector, changes should be implemented in a way that does not endanger the stability of the sector.

21. **Insurance companies continue to report profitable results and adequate capitalization.** While the insurance industry was not immune from the impact of financial crisis in 2008/09, the majority of insurers have since recovered. The solvency ratio for the

insurance sector was 354 percent as at end-2010, based on Solvency I computation.³ Insurers held 66 percent of their investments in debt securities as at end-2010 and the recovery of the bond market in 2010 had, therefore, stabilized their operating results. The CNB has amended the accounting rules in 2009 allowing insurers to value their held-to-maturity bond holdings at amortized costs if the bonds are rated equal to or higher than the sovereign rating of the Czech Republic. On the liabilities side, the CNB's current methodology for computing technical provisions (TP) resulted in 24 percent higher TP compared to the Solvency II basis, according to the Quantitative Impact Study 5. The CNB conducted a pilot round of stress test of selected insurers in 2010 which indicated "the sector as a whole has sufficient capital to withstand relatively significant changes in selected risk factors."

22. The pension funds received an important blow during 2008–09 due to redemptions as well as bond market falls, and needed to be recapitalized by their shareholders. The capitalization of pension funds has subsequently stabilized at around 5 percent. As at end-June 2010, pension fund held CZK 186 billion or 84 percent of their assets in debt securities, of which 68 percent were invested in Czech government securities (CZK 150 billion). However, pension funds have not separated their shareholder' assets from planholders' assets, a critical pre-condition for the proper functioning of the private sector pension funds. The new pension legislation, which will become effective in 2013 will mandate the segregation of planholders' assets and introduce more robust prudential requirements.

D. Pre-conditions for Effective Banking Supervision

23. The CNB is an integrated supervisory authority with supervisory responsibility for banks as well as nonbank financial institutions. The CNB is also responsible for market conduct and consumer issues. For supervision, the CNB is organized in three separate departments: supervision, regulation, and enforcement. Overarching decisions on supervisory matters, as well as appeals on supervisory decisions, are taken by the CNB Board. As an EU-central bank, the CNB has its independence enshrined in the Czech Republic Constitution. The CNB has the power to issue secondary legislation within the scope of its mandate and to the extent allowed by the respective primary laws.

24. Macroeconomic and financial system soundness. As noted in paragraphs 4 to 14 above, the macroeconomic situation is generally strong. However, the high dependency on exports implies that the country, including the banks, is external demand shocks. Further, since many banks are parts of large foreign-domiciled groups there is a risk that weaknesses in the health of the parent bank may spill over to the Czech subsidiaries and branches.

³ Available solvency margin/required solvency margin.

25. **Legal and Judiciary System of the Czech Republic.** The legal system of the Czech Republic is a continental system. In May 2004, the Czech Republic joined the EU. As a member of the EU, much domestic legislation, including corporate and banking laws, derives from EU regulations, directives, and decisions which are frequently updated to keep pace with international standards. The business laws including corporate, bankruptcy, contract, a consumer protection, and private property laws are consistently enforced and support a well-developed business climate.

26. **The most relevant laws pertaining to the regulation and supervision of the banking system are the Act on Banks No. 21/1992 Coll., the Act on Credit Unions No. 87/1995 Coll., the Act No. 6/1993 Coll., on the CNB, and the Commercial Code and the Act on the Payment System No. 284/2009.** The CNB has the power to set, without having to obtain the consent of the government or the parliament, legally binding regulations (secondary legislation) in areas defined in the legislation.

27. **Independence of the judiciary is established by the Constitution.** The Czech Republic Constitution was adopted in 1992. Under the Constitution, the court system consists of the Supreme Court, the Supreme Administrative Court, and other lower courts. The courts of general jurisdiction (civil and criminal) are competent to decide on all disputes except those expressly reserved for the administrative courts or the Constitutional Court. The administrative courts are competent to judge on complaints against decisions made by administrative authorities, including the CNB. The Constitutional Court is charged with protection of constitutional rights, including property rights.

28. **Accounting and auditing.** Act No. 563/1991 Coll. on Accounting, as amended (“The Accounting Act”), stipulates the basic rules and regulations for accounting. Detailed decrees of the MOF set out detailed rules for various categories of firms, such as for bank and other financial institutions, insurance companies, non-profit organizations, and so on.

29. **The Czech Accounting Standards are in substance harmonized with the International Financial Reporting Standard (IFRS).** They are prepared by the MOF and published in its journal. Listed companies have to comply with the IFRS, and other companies may apply the IFRS on a voluntary basis. In practice, a large majority of banks (84 percent of the banking sector’s total balance sheets) apply the IFRS (although they also report according to local standard, e.g., to the tax authorities). The differences between the IFRS and the local standard are insignificant for banks. The Accounting Act defines the basic requirements for Annual Reports, but more detailed rules for listed companies are set out in the Capital Market undertakings Act.

30. **The auditing profession and statutory audits are governed by Act No. 93/2009 Coll. on auditors (“Act on Auditors”).** The Act transposed the relevant EU directives on auditing, in particular the Directive on Statutory Audits. A public oversight body (The Council for Public Audit Oversight) was established in addition to self-governing

professional organization such as the Chamber of Auditors of the Czech Republic. The Act on auditors sets out the rules for audit professionals, including requirements on the expertise and integrity of auditors and for providing audit services. Special regulatory rules have been established for so-called public-interest entities (banks, insurance undertakings, pension funds, other financial institutions, listed companies in general). The CNB has special powers in relation to such companies, for example, to ask auditors for information. Statutory auditors also have to inform the CNB about any substantial findings in a financial institution. The Act on auditors imposes on the auditors the obligation to comply with International Standards on Auditing accepted in the EU law.

31. **Payment and settlement system.** The legislation covering the area of payments is given by Act No. 284/2009 Coll. on Payment Systems, later amended by Act No. 139/2011. Additional clauses relevant to payments and settlements are part of The Banking Act (BA), the CNB Act, and the Commercial Code.

32. **The CNB owns and operates the real-time gross interbank clearing and settlement system called CERTIS.** It is the only interbank payment system in the Czech Republic, and conducts all types of interbank payments in CZK.

33. **Direct participants in the CERTIS are headquarters of the different financial institutions such as banks, building societies, and cooperative savings banks.** These are account holders within the system. The system also allows for the access of third parties (Central Securities Depository, card service providers), which are not account holders but have the right to initiate payments between two direct participants.

34. **The CNB may provide intra-day credits against collateral.** If such credit is not repaid by the end of the day, it is automatically converted into an overnight credit on other conditions but using the same collateral.

35. **Public safety net for banks and bank clients.** In the case of problems in nonsystemically important institutions, the authorities' preferred solution is regular liquidation or insolvency proceedings. In the case of failure of a systemic institution, other tools such as conservatorship, transfer to a bridge bank, and/or open financial support could be considered. The CNB may impose conservatorship only in a situation where shortcomings in a bank endanger the stability of the banking or financial system.

36. **The law does not prescribe hard triggers for the imposition of conservatorship nor for other restructuring methods.** The closest to a hard trigger is the obligatory intervention by the CNB should the bank's capital adequacy fall below two-thirds of its regulated requirements. The CNB may then select from a variety of remedial measures. If capital adequacy drops below one-third of the regulatory requirements, the CNB must withdraw the license, unless a conservator has already been appointed.

37. **The CNB may provide liquidity against collateral to a bank, a credit union or a branch of a foreign bank, or a state-owned bank (e.g., a bridge bank).** In addition, if a bank is under conservatorship, the CNB may render financial assistance to the bank to overcome any temporary shortage of liquidity.

38. **The sale of assets and the assumption of liabilities of a failed bank, or the sale of the whole bank, may occur during conservatorship.** The conservator is appointed by the CNB and acts in the capacity of the bank's statutory body. The BA allows for the creation of a 100 percent state-owned bridge bank to be created. The distressed bank may transfer its enterprise, or part thereof, to the bridge bank. The decision to make the transfer must be taken by the shareholders' general meeting or by the conservator.

39. **There are various forms of open bank assistance.** In addition to the CNB's rights to buy securities from a bank and to provide liquidity under certain conditions, the State may provide guarantees for a bank's liabilities. This would require an activation of a law. Upon the consent of the government the state may also become a bank shareholder by infusing capital into a bank.

40. **The Deposit Insurance Fund (DIF) is a "pay-box only"; that is, it can only be used to compensate insured depositors in a failed bank, credit union or building society.** The DIF is ex ante funded by a straight quarterly fee of 0.04 percent (0.02 for building societies) on insured deposits. Deposits up to 10,000 EUR per person per bank are protected. The current ratio of collected funds in relation to insured deposits is 0.9 percent. Should the fund prove insufficient, the DIF is entitled to raise funds by issuing securities in the market. Should that not be feasible on reasonable terms, the state may provide refundable or nonrefundable state aid. According to DIF rules, the DIF aims at a pay-out delay from the date of triggering the insurance of a maximum 20 working days.

Main findings

41. ***Supervisory authority independence, objectives, powers and resources (CP 1).*** The CNB is the central bank and also the integrated supervisory authority regulating all financial sectors, including banks, building societies, credit unions, insurance companies, and investment firms. There exists a comprehensive set of laws, supported by secondary legislation (regulations) and supervisory guidelines for regulating the banking sector. The independence of the CNB is enshrined in the Constitution. The BCP assessors did not find any interference from external parties into the CNB's conduct of supervision. The assessors found, however, a shortage of staff resources for regulation and supervision, which made supervision less effective in several areas, such as identifying and addressing bank problems at an early stage. While there is no explicit protection of supervisory staff against lawsuits, they are in practice shielded since all formal supervisory decisions are taken by the CNB as an institution and legal complaints must thus be addressed to the CNB. Finally, the CNB has entered into several Memorandums of Understanding (MOUs), both with the MOF and with

host-country supervisory authorities. The BCP assessors recommend that the domestic MOUs with the MOF are activated and are used as a transparent channel of communication between the two authorities.

42. ***Licensing and structure (CPs 2-5).*** The CNB is the sole authority for issuing and revoking licenses for banks (including credit unions and building societies). License applications are tested against a comprehensive set of requirements and criteria. The assessors saw examples of license applications and the vast amount of documentation and analysis which was compiled in each case. The CNB checks the plans for organization, management, and business strategy as well as the financial plan. It determines that the owners and managers are fit and proper (the assessors recommend that also key persons such as chief risk officer (CRO)/chief financial officer (CFO)/Compliance officer are subject to the fit and proper test as a formal rule) and that the funds to set up the bank are not compromised. In those cases where “the EU passport” is applicable, the CNB liaises with the responsible home-country authority. That is, it ensures that the home authority practices consolidated supervision for the banking group on a global basis.

43. **If a person holding a qualifying interest in a bank is found unsuitable, or if the CNB’s consent to his acquisition was based on false information, the CNB may prohibit the voting of his shares at a general shareholder’s meeting, and they can also prohibit him from calling such a meeting.** However, the CNB does not have the power to require the divestment of the shares.

44. **For certain investments in other financial institutions, the bank must obtain prior consent from the CNB.** Banks may not invest in nonfinancial assets generally, with the exception of transitory holdings of assets to protect the interest of the bank, such as foreclosed assets. However, there is no such requirement for investments in nonfinancial entities, which may amount to a maximum of 15 percent of the bank’s capital in each entity up to an aggregate limit of 60 percent of the capital. Nor is there a requirement for prior notice to the CNB of intended investments. This CNB policy is intended to avoid involving itself in banks’ decision-making processes. Instead, the CNB’s policy is to check the appropriateness of the investment or acquisition at its next onsite visit.

45. ***Prudential regulations and requirements (CPs 6-18).*** The Czech Republic has implemented the Basel II standard for bank capital, as set out in the relevant EU directives. The CNB cooperates, when relevant, with home country authorities; for example, on scrutinizing banks’ applications for using advanced model approaches. The actual capital adequacy of Czech banks is significantly above the EU average.

46. **The CNB generally applies a limit of 25 percent of a bank’s capital for large exposures to single or connected parties in the banking book.** However, exposures to parent companies and affiliates within the Czech Republic which are subject to consolidated supervision by the CNB are exempted from any limit. In addition, exposures to parent

companies, sister institutions, or investment firms within the EU, have a limit of 100 percent of bank capital. Exposures on a bank's trading book are not included in the limit for large exposures, since they are regarded as short-term, and are subject to a 600 per cent limit of bank capital. The assessors acknowledge that all these exemptions from the 25 limit are in line with EU regulations. Nonetheless, we recommend the Czech authorities to apply the globally agreed BCP, which sets a more stringent standard based on the negative experiences of concentration risks.

47. **Expectations for bank risk management systems are clear and comprehensive, however, more emphasis and focus should be placed on the role and power of supervisory boards.** The CNB should more formally evaluate the capability and participation of supervisory board members, through regular meetings with them and evaluation of minutes and board packages. Supervisory boards should to a higher extent than presently formally approve and monitor bank strategies and policies.

48. **Trends in credit risk and problem assets, as well as market, liquidity, interest rate, and operational risks, are monitored on an ongoing basis.** With the weakening Czech economy, the CNB is evaluating bank compliance with rules on restructurings and setting higher loss ratios in stress tests than warranted by experience. However, the ratio of provisions to NPLs is somewhat below the average of countries in the region and the assessors recommend targeted onsite visits to ensure that banks' provisioning and loan classification practices follow the CNB guidelines. In addition, the guidelines themselves may need to be strengthened. Czech banks' exposure to market risk is minimal; levels of liquidity are strong, interest rate risk is monitored through quarterly stress tests, and operational risk reports are monitored quarterly.

49. **In line with international standards, a broad range of individuals and legal persons which constitute "related parties" are defined in the Czech legislation.** The regulations also require that transactions with related parties must be on market terms and on arm's-length basis. However, there are no specific regulations or requirements from the CNB requiring banks to apply specific processes and policies on related party lending. For instance, the general conflict-of-interest rules apply rather than more restrictive rules suitable for related party lending. Exposures to related parties are generally only reported to the bank's Board and to the CNB if they fall within the definition of a "large exposure", that is, amount to at least 10 percent of the bank's capital. There is no dedicated process for dealing with delays in payments from related parties. The assessors find that the CNB should introduce rules and guidelines for the bank's policies and processes specifically regarding related party lending since the present situation does not provide adequate protection against abuse.

50. **The reliability of internal controls and internal audit are evaluated by the CNB's inspectors.** If considered reliable, the CNB inspectors can leverage off of internal audit and

adjust the scope of the inspection. All credit institution activities are subject to internal audit, including those that are outsourced.

51. **There are gaps in the requirements for preventing banks from being used for criminal activity, including anti-money laundering and combating the financing of terrorism (AML/CFT).** Importantly, bank compliance programs and reporting requirements should broadly address financial crime as well as AML/CFT and officers should be senior bank officials with responsibility for the institution's compliance program. AML/CFT inspections should be more frequent.

52. **Methods of ongoing banking supervision (CPs 19-21).** Supervisory techniques applied by the CNB include off-site and on-site programs. Staffing shortfalls have created deficiencies in both programs. Full-scope and targeted on-site inspections are infrequent, which is a particular concern given the need to verify that, i.e., the reported high capital ratio levels are backed by a conservative approach to the identification of NPLs and need for provisioning. Also, the CNB does not meet with audit committees and supervisory boards, unless there are exigent circumstances. Increased staffing levels are recommended to allow for more frequent on-site inspections, including for AML and for new and problem banks, and to allow for the rotation of off-site inspectors. The CNB should increase its interaction with audit committees and supervisory boards, particularly in large banks. In addition, more CNB staff is needed for regulation, not least in view of the vastly expanded international cooperation in various fora, and also for licensing and enforcement since the mandate of the CNB supervision has been expanded to include several new sectors of financial institutions.

53. **Banks submit monthly and quarterly reports to the CNB on a wide scope of activity.** Weekly liquidity reports are submitted by large banks. However, there are no signatory requirements on regulatory reports. The CNB should establish attestation guidelines or rules, along with the possibility of imposing penalties for late or inaccurate submissions. Further, monthly or quarterly peer analysis is suggested to facilitate more frequent comparative analysis.

54. **Accounting and disclosure (CP 22).** The large majority of Czech banks report in accordance with the IFRS. The local accounting standard does not differ significantly from the IFRS.

55. **Corrective and remedial powers of supervisors (CP 23).** The CNB identifies problems in banks that require remedial action as part of the supervisory program, but could better match the follow-up of the interventions to the seriousness of issues. Overall, the supervisory approach should move further from a reactive to a proactive stance. The CNB would benefit from introducing a structured (staged) early intervention framework which is based both on quantitative and judgmental criteria.

56. **The CNB has the necessary tools for corrective and remedial actions and the assessors saw evidence of their use in practice.** The tools include both recommendations

voluntarily agreed by the bank in a document presented to the CNB formal enforcement actions for more serious deficiencies or in cases of management inaction. The assessors noted some weaknesses in the timeliness of CNB enforcement actions, mostly due to the internally-imposed requirement to precede such actions with a new on-site review to assess the status of the deficiency.

57. **The CNB lacks the explicit power to dismiss unsuitable bank managers once they have been employed.** (Before that, the CNB can block their employment if they do not pass the fit and-proper test.) In practice, the CNB has been able to effect dismissals through other means, but the assessors find that explicit powers would be more appropriate, transparent and effective.

58. **With a few exceptions, there is scant legal support to issue monetary penalties to individuals.** The assessors find that the CNB could benefit from broader powers to set monetary penalties on individuals, as is the case in many other countries.

59. ***Consolidated and cross-border banking supervision (CPs 24-25).*** The CNB applies consolidated supervision and is, as noted, an integrated supervisory authority comprising banks, insurance companies, securities firms, and other financial companies. Hence, the CNB is in a good position, and has the general powers, to practice consolidated supervision of the banking group including its financial holding company. The CNB may conduct on-site visits to all regulated entities in a banking group and may, through the bank, request any information it needs also from the nonregulated entities. That said, consolidated supervision would become more effective if the CNB was given the general power also to directly require information, and to verify this information, through visits to nonregulated entities. The information here referred to would be such information that has relevance for the safety and soundness of the regulated entities in the group, notably the bank(s). Considering that the Czech banking sector is dominated by large groups, in which the parent institution is domiciled outside the Czech Republic, it is important that the CNB is provided insight into the situation and developments of the consolidated group. In practice, the CNB works with this aim, for instance by bilateral contacts with home-country supervisors and in multilateral contacts through the supervisory colleges. On a general level, the CNB benefits from, and shares information also on, specific banks through its participation in the European bank supervisory forum, the EBA.

60. The CNB has an extensive network of MOUs and informal arrangements with other home and host supervisors, as well as appropriate legal powers to share information and keep information confidential, as necessary.

61. **Table 2 offers, principle-by-principle, a summary of the assessment results:**

Table 2. Summary Compliance with the Basel Core Principles—ROSCs

Core Principle	Grading	Comments
1. Objectives, independence, powers, transparency, and cooperation	C	
1.1 Responsibilities and objectives	C	The authorities comply with this CP
1.2 Independence, accountability and transparency	LC	<p>The number of supervisory staff is inadequate. This has resulted in too infrequent on-site inspections. More intensive offsite monitoring and follow-up of requirements for remedial action also require more staff. On the policy side, the substantially increased international activity in rule-making calls for more staff not least to ensure the role of the Czech authorities in the international negotiations.</p> <p>The heads of the three supervisory departments at the CNB are subject to civil service contracts. They have no fixed term of office and may be dismissed on short notice without publication of cause.</p> <p>The MOF may take part in CNB Board meetings as an observer, but not in meetings on operational supervisory issues. Close contacts between the MOF and the CNB on regulatory and supervisory issues are recommended by the BCP assessors but should take place through other transparent channels.</p>
1.3 Legal framework	C	The authorities comply with this CP.
1.4 Legal powers	C	The authorities comply with this CP.

Core Principle	Grading	Comments
1.5 Legal protection	C	Supervisory managers and staff are expected to be protected by the collegial decision-making in supervisory matters implying that the complainant primarily must sue the CNB as a legal person. The BCP assessors deem the CNB as “Compliant” since the present processes seem to protect staff adequately for supervisory actions unless taken in bad faith.
1.6 Cooperation	C	For cooperation between the relevant authorities in financial stability and crisis management matters have been established but have not yet been activated.
2. Permissible activities	C	There is no formal requirement in the Credit Union Act (CUA) that all credit unions should be listed on the CNB website. (It is now done informally).
3. Licensing criteria	C	There is no requirement for the supervisory board to include independent members, except for one member in the Audit Committee. Although start-ups will be monitored off-site, there is no rule for the CNB to visit them at an early stage.
4. Transfer of significant ownership	C	The CNB has the power to block the voting rights and other rights of owners of qualified holdings, e.g., if the owner is unsuitable. However, the CNB has no right to require the owner to divest her holdings.

Core Principle	Grading	Comments
5. Major acquisitions	MNC	<p>There are no requirements for banks to request prior consent from the CNB for significant nonfinancial acquisitions or investments.</p> <p>In the case of an investment by a Czech bank in a foreign financial institution the CNB determines that the foreign supervisor practices consolidated supervision, but it does not explicitly assess the quality of such supervision.</p>
6. Capital adequacy	LC	<p>The trigger for mandatory supervisory remedial action is released when bank capital declines below two-thirds of the capital requirement. This is too late, since problems may then be ingrained. The law or regulations should prescribe a range of remedial action to be taken, including the possible revocation of the license, already when the capital ratio declines below 8 percent.</p> <p>The CNB must be provided the formal power to require banks to abrogate or amend flawed internal models for the calculation of risk-weighted capital.</p>

Core Principle	Grading	Comments
7. Risk management process	LC	<p>The CNB provides clear expectations and guidelines regarding risk management systems.</p> <p>More emphasis and focus should be placed on supervisory boards. For example, the CNB should more formally evaluate the capability and participation of supervisory board members, through regular meetings with them and evaluation of minutes and board packages.</p> <p>Supervisory boards should formally approve strategies and policies to a larger extent than at present.</p>
8. Credit risk	C	The authorities comply with this CP.
9. Problem assets, provisions, and reserves	C	The past due schedule of 360 days should be shortened as it applies to unsecured as well as secured loans and appears excessive to the assessors.
10. Large exposure limits	LC	<p>The definition of large exposures only encompasses exposures in the banking book. Exposures in the trading book are not subject to the large exposure limitations and are limited at 600 percent of a bank's capital.</p> <p>Temporary excesses over the 25 percent limit for large exposures should be fully offset by additional bank capital.</p> <p>Exposures to parent banks abroad, to sister banks, or to investment firms are exempted from the 25 percent limit and are subject to a limit of 100 percent of bank capital. This is too high and constitutes a risk to the bank.</p>

Core Principle	Grading	Comments
11. Exposure to related parties	MNC	<p>There is no rule that all banks must have a separate set of policies for related party transactions.</p> <p>Define in CNB guidelines in more detail how “conflict of interest-rules” should be applied for related party transactions.</p> <p>Banks should have rules for immediate reporting to their Boards of payment delays in significant related party exposures.</p> <p>Reporting (also to the CNB) of related party exposures should be separate from reporting on large exposures in general and should be on an individual basis, except for insignificant transactions.</p> <p>Aggregated exposures to all related parties, excluding exposures to group credit institutions and investment firms under consolidated supervision, should have a limit which should not exceed 25 percent of the bank’s capital.</p>
12. Country and transfer risks	C	The authorities comply with this CP.
13. Market risks	C	The authorities comply with this CP.
14. Liquidity risk	C	The authorities comply with this CP.
15. Operational risk	C	The authorities comply with this CP.
16. Interest rate risk in the banking book	C	The authorities comply with this CP.
17. Internal control and audit	C	The authorities comply with this CP.

Core Principle	Grading	Comments
18. Abuse of financial services	MNC	<p>Compliance programs should address AML/CFT and financial crime and include components for audit, training, and a designated compliance officer at the management level.</p> <p>Credit institutions should regularly report to the CNB or the Financial Intelligence Unit (FIU) suspected criminal activity, in addition to suspected AML/CFT activity.</p> <p>The frequency of inspections should increase.</p> <p>The Czech Republic should increase the maximum level of fines for inadequate AML/CFT programs under the money laundering act.</p> <p>Escalation procedures above the supervisor level are needed for high risk accounts.</p> <p>Know your customer (KYC) requirements or guidelines should be improved for low-risk customers and beneficial owners, and in particular address bearer share companies.</p> <p>Politically-exposed persons (PEPs) should be defined to include all relevant politicians (according to FATF definitions).</p>
19. Supervisory approach	C	The authorities comply with this CP.

Core Principle	Grading	Comments
20. Supervisory techniques	MNC	Full-scope and targeted on-site inspections are infrequent, and the CNB does not meet with audit committees and supervisory boards, unless there are exigent circumstances. Increased staffing levels are recommended to allow for more frequent on-site inspections, including for AML and for new and problem banks, and to allow for the rotation of off-site inspectors. The CNB should increase its interaction with audit committees and supervisory boards, particularly in large banks.
21. Supervisory reporting	C	The CNB should establish monthly or quarterly peer reports to facilitate more frequent comparative and trend analyses. Also, the CNB should establish guidelines or rules for signatories on financial statement and other submissions and the capacity to impose penalties on them on an individual basis.
22. Accounting and disclosure	C	The authorities comply with this CP.
23. Corrective and remedial powers of supervisors	LC	Introduce a structured framework for intervention in banks. Introduce procedures, which in relevant cases would imply narrowly targeted on-site visits to banks, to ensure timely implementation of remedial requirements. Broaden the powers of the CNB to apply monetary penalties also on individual persons.
24. Consolidated supervision	C	The CNB should be provided the power to physically inspect entities outside the consolidated banking group.

Core Principle	Grading	Comments
25. Home-host relationships	C	Although there is now Russian ownership in the Czech banking sector, there is no cooperative agreement with Russia, partly due to problems on the Russian side of ensuring the confidentiality of information. The Czech authorities must take compensatory measures to secure adequate consolidated supervision.

E. Recommended Action Plan and Authorities' Response

Recommended action plan

62. **Table 3 lists the suggested steps for improving compliance.** The recommendations are listed on a prioritized basis. Recommendations are also made in cases where the rating of the CPs were “compliant” but where the assessors identified possibilities for further improvements.

Table 3. Recommended Action Plan to Improve Compliance with the Basel Core Principles

Reference Principle	Recommended Action
CP 20	Increase CNB staffing levels to allow for more frequent on-site inspections, including for AML and for new and problem banks, and to allow for the rotation of off-site inspectors. Increase CNB interaction with audit committees and supervisory boards, particularly in large banks.
CP 23 (refers also partly to CP 6 and CP 20)	<p>Introduce a structured framework for intervention in banks.</p> <p>Introduce procedures, which in relevant cases would imply narrowly targeted on-site visits to banks, to ensure timely implementation of remedial requirements.</p> <p>Broaden the powers of the CNB to apply monetary penalties also on individual persons.</p> <p>Set a higher capital bar (than two-thirds of capital) for mandatory supervisory intervention.</p>
CP11	<p>Introduce rules that all banks must have a set of policies for related party transactions.</p> <p>Define in more detail how “conflict of interest-rules” should be applied for related party transactions.</p> <p>Banks should have rules for immediate reporting to their Boards of payment delays in significant related party exposures.</p> <p>Reporting of related party exposures should be separate from reporting on large exposures in general and should be on an individual basis, except for insignificant transactions.</p> <p>Aggregated exposures to related parties, if economically or otherwise connected (e.g., family), should have a limit which should not exceed 25 percent of the bank’s capital.</p>

Reference Principle	Recommended Action
CP5	<p>Introduce explicit requirements for banks to request prior consent from the CNB for significant acquisitions or investments.</p> <p>The CNB must assess the quality of the foreign supervisor, and not only the fact that it practices consolidated supervision, in the case of a Czech bank acquiring (a part of) a financial institution abroad prior to giving its consent.</p>
CP18	<p>Require credit institutions to regularly report information on significant criminal activity, trends, and possible threats to reputation.</p> <p>Increase the maximum level of fines for inadequate AML/CFT programs under the money laundering act.</p> <p>Require escalation procedures above the supervisor level for high risk accounts.</p> <p>Improve KYC requirements or guidelines for low-risk customers and beneficial owners, and especially for bearer share companies.</p> <p>Define PEPs to include all relevant politicians (according to FATF definitions).</p> <p>Require compliance officers to be senior officers with responsibility for the credit institution's financial crimes compliance program.</p> <p>Increase the frequency of inspections.</p>
CP7	<p>Require inspectors to evaluate the capability and participation of supervisory board members, and require supervisory boards approve strategies and policies.</p>
CP 10	<p>Exposures in the trading book should be included in "large exposures" and should be subject to the overall limit of 25 percent of capital.</p> <p>Temporary excesses over the 25 percent limit for large exposures must be fully offset by adequate collateral or bank capital.</p> <p>Exposures to parent banks abroad and to sister banks or investment firms should be capped at 25 percent of the bank's capital.(The globally agreed BCPs set stricter standards in these areas than the present EU legislation.)</p>

Reference Principle	Recommended Action
CP 1.2	Increase the number of supervisory staff in order to make possible more intensified supervision, e.g., more frequent on-site visits, more intensive offsite monitoring, and participation in international and domestic negotiations, e.g., on new regulations.
CP 24	The CNB should be given the powers to inspect entities outside the consolidated banking group.
CP 25	Conclude an arrangement with Russia to ensure information sharing and supervisory cooperation, and also protecting confidential information.
CP 6	Laws or regulations should set out a range of remedial actions to be considered, including revocation of the license, when a bank's capital ratio declines below 8 percent.
CP 4	Give the CNB the powers to require the divestment of a qualified holding in specified circumstances, e.g., if the owner proves unsuitable.
CP 1.6	The existing MOUs between the MOF and the CNB on cooperation and information sharing relating to financial stability and crisis management should be activated as a preparatory matter.

Authorities' response to the assessment

63. **The Czech National Bank (CNB) welcomes the assessment of the Czech regulatory and supervisory framework and acknowledges the extensive work done by the assessment team.** The CNB appreciates the recognition of the resilience and stability of the Czech financial system as well as the statement that compliance with the Basel Core Principles for Effective Banking Supervision has improved markedly since the previous assessment. However, in spite of the generally positive outcome, there are some findings and recommendations that bring up concerns about the objectivity of the assessment team and its willingness to consider and apply a country-specific approach as opposed to common prejudices and mindsets based on them. Furthermore, some procedural aspects (the repeated change of the head of the FSAP mission and the downward revision of the grade for core principle 1(2) during the written procedure without even mentioning it to the authorities) will not be considered standard and as such very likely had an impact on the continuity and consistency of the work. The CNB unfortunately considers that the above facts have reduced the potential value added of the extensive and costly FSAP exercise, namely, the provision of a valuable view of the financial sector and the quality of the legal framework.

64. **Concerning the substance of the assessment, the CNB agrees that there are some minor deficiencies and gaps in the bank regulations in the Czech Republic and accepts many of the recommendations.** Those could be incorporated into the Czech legislation in a reasonable timeframe. The CNB accepts the following recommendations in particular:

- **To grant the CNB the power to require divestment of a qualifying holding (Principle 4).** The purpose of this principle is to prevent unwanted persons from buying into a bank. If a person acquires a qualifying holding without the prior consent of the CNB, the CNB has adequate legislative means available to prevent that person from having an influence on the running of the bank. The CNB considers the existing measures to be adequate and to satisfy the desired purpose. Despite this, the CNB has already supported the idea to extend its rights and to require a person who is not trustworthy and has acquired a qualifying holding without prior consent to get rid of its share. Such a right would greatly strengthen the position of the CNB in this area. In the past, this attitude of the CNB was also presented to the Ministry of Finance, which is responsible for the primary legislation.
- **To widen the framework of remedial actions (Principle 23).** The CNB believes that/it currently has all the necessary tools and powers to impose almost any relevant corrective and remedial measure on banks. There will certainly be further adjustments made to the supervisory tools and powers following the adoption of the long-prepared EU Crisis Management Framework, which may introduce new powers such as the widely discussed bail-ins.
- **To set limits relating to exposures and further restrictions concerning intra-group exposures (Principle 10).** As regards large exposure limits, the CNB follows the relevant EU directive. Even if exposures in trading and investment portfolios are limited separately, most banks apply internal limits which normally aggregate exposures to the same client in the investment and the trading portfolio. All large exposure limits applied in the Czech Republic, including the intra-group limit for EU credit institutions, are fully in line with the requirements of the EU directive. The CNB also takes into consideration the internal market in the EU, the existence of which implies that stricter rules for institutions located in the Czech Republic could have a negative impact on their business and profitability. Despite evidence that most EU countries are much more liberal and do not limit exposures within groups at all, the CNB accepts the recommendation to reduce exposures to members of the same group. The CNB is preparing an amendment of the Prudential Rules Decree which would tighten exposures to foreign parent and affiliate institutions from the current 100% to 50% of the capital.

- **To broaden the definition of Politically Exposed Persons (Principle 18).** The CNB is aware that the definition of Politically Exposed Persons does not include all relevant politicians according to FATF definitions. However, it should be noted that the definition of such persons used in the Czech legislation is fully in line with the EU legislation. Despite the latter, the CNB will consider the recommendation and the same issue will probably be discussed as part of the review of EU rules in the AML area this year.

65. **The CNB is also considering incorporating the recommendation to set a higher capital bar for mandatory supervisory intervention (Principle 23).**

66. **At the same time, the CNB does not share some of the IMF team's recommendations** concerning BCPs. The CNB is convinced that many of these recommendations go beyond European standards and regulations. As most of these standards and regulations are designed under the regime of full harmonization, there is no room for the implementation of any measures which ultimately are in violation of this full harmonization. In addition, the CNB is convinced that many of suggested recommendations are in conflict with the policy and philosophy of the CNB's approach to bank regulation and supervision, which includes avoiding the micromanagement of banks. From the CNB's point of view, managers are primarily responsible for management. The prior consent or similar standpoint of the regulator can constitute unsubstantiated intervention, which can ultimately transfer risk to the regulator and conversely reduce managerial responsibility.

In some cases, the CNB therefore considers itself to be fully in line with the Principles and does not find substantive arguments for a recommendation to be made in this respect. These CNB objections apply in particular to:

- **increase of the number of supervisory staff (Principle 1(2), 20).** The CNB disagrees with the assessors' opinion regarding substantive deficiency relating to the adequacy of supervisory resources for the following reasons: i) the CNB follows the risk-based supervision approach, under which it focuses mainly on systemically relevant entities (representing the majority of the Czech banking system) and entities with high risk profiles or corporate governance deficiencies; ii) the Czech banking sector is smaller in relation to GDP than some of its Western European peers; iii) Czech banks follow a traditional banking model and their assets do not comprise substantial amounts of structured products that require time-consuming and costly supervision. On the liabilities side, Czech banks are primarily funded from local deposits and not from the wholesale market, which also reduces the complexity of the supervisory technique.
- **monetary fines on bank managers (Principle 23).** The CNB considers the national provisions to be equivalent. Individual persons can be punished directly and indirectly with a sufficient preventive effect. The application of monetary penalties by the CNB

would only lead to a further administrative burden and responsibility of the CNB without any corresponding benefit to the supervisory objectives.

- **additional supervision of non-regulated entities within a group (Principle 24).** The CNB has reservations about enlarging the power and responsibility to inspect non-regulated entities within a group. While it may be true that there are currently no on-site inspections of non-regulated entities in a group, the CNB has this power and any suggestion to the contrary is at best misleading. The Czech regulatory framework in this area is based on the relevant EU directive; the objective of this is the supplementary supervision of regulated entities which are part of a financial conglomerate. According to the present EU directive, the exercise of supplementary supervision at the level of a financial conglomerate shall in no way imply that the supervisor is required to play a supervisory role in relation to unregulated entities in a financial conglomerate on a stand-alone basis. The CNB has the legal power to supervise non-regulated entities if it is necessary for the supplementary supervision of regulated entities within a conglomerate.
- **arrangements with Russia (Principle 25).** To conclude a formal agreement with the Russia on the basis of a Memorandum of Understanding is not possible because the rules of secrecy in Russia are not compatible with EU standards. However, formal cooperation relating to the licensing procedure and financial sector supervision works and is adequate with respect to the presence of Russian banks in the Czech Republic. The CNB does not intend to take steps or initiate any change in the law for the time being.

67. **Further, the CNB expresses serious reservations about the level of evaluation regarding the Principles** to which the grade “Materially noncompliant” was assigned. The CNB admits some of the deficiencies revealed. However, in the CNB’s opinion these deficiencies are only minor and partial. The CNB is convinced that the seriousness of these deficiencies is not such as to warrant an evaluation of “Materially noncompliant” and, conversely, it believes that it fully meets the conditions for assigning the grade of “Largely compliant” according to the document of the Basel Committee on Banking Supervision (Core Principles Methodology). This means that the observed deficiencies do not represent a fundamental shortcoming and there is no evidence that supervision has clearly not been effective and that practical implementation is weak. Furthermore, it is not entirely understandable to the CNB why the assessment of principles assessed as “compliant” or “largely compliant” in the previous assessment has been decreased when a number of steps have been taken to improve the situation. Specifically, this concerns the following principles:

- **Principle 5 (Major acquisitions).** The CNB fully understands the sense of protecting banks in connection with their activities in the area of investments and acquisitions, and also the IMF’s arguments stemming from negative experience in other countries. However the CNB considers the examination of the individual proposals to be controversial and problematic. The CNB believes that prior approvals for each

acquisition would de facto substitute for the business decisions of regulated entities, with all the resulting negative consequences for the regulator, i.e., the transfer of responsibility from the bank to the regulator. The CNB believes that the introduction of additional requirements already covered in the Act on Banks and the Prudential Rules Decree sufficiently replaces the prior approval of individual acquisitions and significantly reduces the risks. The CNB is consistently striving to strengthen this principle, so it cannot see why the evaluation of this principle has been downgraded given the steps that have been taken. The CNB prefers to set general rules rather than assess individual cases. The CNB considers the existing regulatory system relating to acquisitions to be sufficient, efficient, and effective for achieving the desired purpose, namely, to protect banks from the adverse effects of bad acquisitions. The CNB does not intend to take any steps or initiate any change of the law in this respect.

- Principle 11 (Exposure to related party).** The CNB is convinced that the IMF's evaluation of "materially non-compliant" is not right, because the Czech regulation sufficiently ensures that the goals of the principle are achieved, albeit by different means which are tailor-made to the nature of the Czech financial market and consistent with the overall Czech approach to regulation and supervision. The CNB has made progress in fulfilling this principle since the IMF 2001 assessment was conducted. Therefore, the CNB is not convinced that the downgrade from "largely compliant" in 2001 to "materially non-compliant" in 2011 is justified. The CNB did not self-assess this principle as compliant because the Act on Banks does not explicitly contain a requirement that Board members with conflicts of interest should be excluded from the approval process. On the other hand, the CNB is convinced that the objective of preventing abuses arising from exposures to related parties might be achieved by other means, namely, by a general requirement to avoid conflicts of interests in conjunction with some specific provisions stressing the institution's responsibility for identifying potential conflict areas and putting in place appropriate processes and mechanisms to avoid or mitigate the related risk. The CNB also took into consideration that some exposures to certain related parties are fully or partially excluded from the large exposure limits, in accordance with the EU legal framework. Additionally, the recommended tightening of the limits is being prepared. In contrast, the CNB does not agree with some of the IMF's other comments. Firstly, the CNB does not see any need to add an explicit power of the CNB to require all or some exposures to related parties to be collateralized. According to Annex 1 of the Prudential Rules Decree, the institution shall, within the system for executing transactions, evaluate relevant criteria (including the counterparty type) and use techniques and instruments designed to limit this risk, for example credit risk mitigation techniques such as collateralization. Secondly, the CNB is of the opinion that the recommended aggregation of exposures to all related parties could have only a non-material impact, since the exposures of Czech banks to members of the Board of Directors, the Supervisory Board, and senior management are not significant. In

the CNB's opinion, publishing these exposures on banks' websites does enough to eliminate the risks arising from these exposures. Thirdly, the CNB believes that the reporting of exposures to related parties incorporated into the reporting on large exposures allows the CNB to obtain appropriate information and there is no need for the recommended additional separate reporting on an individual basis.

- **Principle 18 (Abuse of financial services).** The CNB is convinced that the grade "materially noncompliant" is inappropriate and based on a possibly incomplete understanding of the Czech legal framework and methods of supervision. The vast majority of the required regulation is in place and implemented in banks, and compliance is duly supervised. The Czech Republic has fully implemented the EU legislative framework in the field of AML/CFT. It has also fully implemented the EU banking prudential regulation, which regulates risk more broadly than AML/CFT. The CNB tends to believe that the ethical and professional standards embedded in the common EU legislation alone are sufficiently high to meet the Basel criteria. Some of the IMF's observations and recommendations are thus not substantiated. This view is supported by the recent MONEYVAL evaluation. The Czech system was not found to be non-compliant with any of the evaluated FATF criteria. The CNB's arguments regarding some of the recommendations are as follows.

As regards compliance programs and officers, according to the existing legislation banks are already required to have effective management and control systems. The overall system also includes AML/CFT risks and other risks to which the bank is or can be exposed. For the AML/CFT area there is also a separate regulation in the AML-CFT Act and specific AML/CFT programs are also required. Yearly internal reviews of banks' AML/CFT programs are required by the CNB's AML-CFT Decree. Compliance officers in Czech banks typically hold senior positions. The CNB Prudential Rules Decree imposes requirements which place the compliance issue on the agenda of the banks' highest management and supervisory bodies. The CNB therefore does not find the recommendation to introduce further regulations in the area of compliance programs substantiated.

As regards the frequency of the targeted AML/CFT inspections, the CNB has already taken steps to improve the situation. The number of on-site visits has increased significantly between 2001 and 2011. In 2011, a total of 11 on-site AML/CFT visits were performed, compared to no such visits in 2001. The CNB plans to conduct 11 on-site AML/CFT visits again in 2012.

As regards the maximum level of fines, very severe penalties were introduced recently through the adoption of the Act on Criminal Liability of Legal Persons (effective since January 1, 2012). The range of penalties for money laundering, terrorist financing, and a number of other crimes is wide, e.g. a daily penalty of up to CZK 2 million (approx. EUR 80,400), confiscation of all the legal person's property, and dissolution of the legal entity.

As regards bearer shares, this issue is high on the government's agenda. The government coalition agreement states: "The government will propose legislation which will to the maximum extent possible restrict anonymous ownership of business corporations." The Ministry of Justice has prepared a legislative proposal which is now being discussed in the standard procedure and is supposed to become effective later this year.

- **Principle 20 (Supervisory techniques).** From the IMF's point of view, full-scope and targeted on-site inspections are infrequent and the CNB should increase its interaction with audit committees and supervisory boards, particularly in large banks. The CNB does not share the view of the IMF team that the frequency of on-site inspections performed by the CNB is inadequate to ensure a full understanding of developments in banks. The CNB follows the risk-based supervision concept, under which it focuses mainly on systemically relevant entities and entities with high risk profiles or corporate governance deficiencies. The number of on-site inspections also reflects the fact that the on-site inspections performed by the CNB are in most cases comprehensive and thorough, focusing on all key areas and activities of institutions. If shortcomings are identified, institutions are requested to implement corrective measures in a time frame which reflects the severity of the defects. In the case of significant shortcomings, the CNB usually performs an immediate follow-up on-site inspection. Nevertheless, the recommendation to introduce at least annual on-site inspections for large banks (or new banks) is practically difficult to implement due to the length of the inspection process and the fact that little time is left for institutions to implement corrective measures. In the previous IMF assessment, the principle related to on-site supervision was rated as "largely compliant". Since 2001, many qualitative and quantitative steps have been taken in the area of banking supervision. In CNB's view, a different opinion on the frequency of on-site inspections should not result in a negative rating of the principle as a whole.

To conclude, the CNB is convinced that some of the suggested recommendations are in conflict with the policy and philosophy of the CNB's approach to bank regulation and supervision. In addition, the CNB considers itself to be compliant with Principle 1(2), which prescribes the possession of sufficient operational independence, the performance of transparent processes, and sound governance. The CNB has adequate resources to discharge its duties accountably.

II. DETAILED ASSESSMENT

68. **The assessment of compliance of each principle should be made based on the following four-grade scale: compliant, largely compliant, materially noncompliant, and noncompliant.** A “not applicable” grading can be used under certain circumstances.

- **Compliant**—A country will be considered compliant with a Principle when all essential criteria applicable for this country are met without any significant deficiencies. There may be instances, of course, where a country can demonstrate that the Principle has been achieved by other means. Conversely, due to the specific conditions in individual countries, the essential criteria may not always be sufficient to achieve the objective of the Principle, and therefore other measures may also be needed in order for the aspect of banking supervision addressed by the Principle to be considered effective.
- **Largely compliant**—A country will be considered largely compliant with a Principle whenever only minor shortcomings are observed which do not raise any concerns about the authority’s ability and clear intent to achieve full compliance with the Principle within a prescribed period of time. The assessment “largely compliant” can be used when the system does not meet all essential criteria, but the overall effectiveness is sufficiently good, and no material risks are left unaddressed.
- **Materially noncompliant**—A country will be considered materially noncompliant with a Principle whenever there are severe shortcomings, despite the existence of formal rules, regulations and procedures, and there is evidence that supervision has clearly not been effective, that practical implementation is weak, or that the shortcomings are sufficient to raise doubts about the authority’s ability to achieve compliance. It is acknowledged that the “gap” between “largely compliant” and “materially noncompliant” is wide, and that the choice may be difficult. On the other hand, the intention has been to force the assessors to make a clear statement.
- **Noncompliant**—A country will be considered noncompliant with a Principle whenever there has been no substantive implementation of the Principle, several essential criteria are not complied with or supervision is manifestly ineffective.

69. **In addition, a Principle will be considered not applicable when, in the view of the assessor, the Principle does not apply given the structural, legal, and institutional features of a country.**

70. **The detailed Principle-by-Principle assessment should provide a “description” of the system with regard to a particular Principle, a grading or “assessment,” and a “comments” section (Table 4):**

- **The “description” section** of the template should provide information on the practice as observed in the country/group of countries being assessed. It should cite the relevant laws and regulations. This should be done in such a way that the relevant law or regulation can be easily located, for instance by reference to URLs, official gazettes, and similar sources. Insofar as possible and relevant, the description should be structured as follows: (a) banking laws and supporting regulations; (b) prudential regulations, including prudential reports and public disclosure; (c) supervisory tools and instruments; (d) institutional capacity of the supervisory authority; and (e) evidence of implementation and/or enforcement or the lack of it.⁴ The description should also highlight when and why compliance of a particular criterion could not be adequately assessed, such as when certain information was not provided, or when key individuals were unavailable to discuss important issues. Such requests for information or meetings should be documented in the “description”, to clearly demonstrate the assessor’s attempts to adequately assess a Principle. If the lack of information relates to a specific criterion, this can also be mentioned.
- **The “assessment” section** should contain only one line, stating whether the system is “compliant,” “largely compliant,” “materially noncompliant,” “noncompliant” or “not applicable” as described above.
- **The “comments” section** should be used to explain why a particular grading was given, in particular when a less than “compliant” grading was given. This reasoning could be structured as follows: (a) reasons related to the state of the laws and regulations and their implementation; (b) the state of the supervisory tools and instruments, for instance reporting formats, early warning systems, and inspection manuals; (c) the quality of practical implementation; (d) the state of the institutional capacity of the supervisory authority; and (e) enforcement practices. In case of a less than “compliant” grading, this section can be used to highlight which measures would be needed to achieve full compliance, or why, notwithstanding the system seems compliant based on laws, regulations and policies being in place, yet a less than “compliant” grading was given, perhaps due to weaknesses in procedures or implementation.

Table 4. Detailed Assessment of Compliance with the Basel Core Principles

⁴ The latter factor has gained considerably more importance as it has become clear that, without effective implementation of rules and regulations, even a well designed supervisory system will not be effective.

Principle 1.	Objectives, autonomy, powers, and resources. An effective system of banking supervision will have clear responsibilities and objectives for each authority involved in the supervision of banks. Each such authority should possess operational independence, transparent processes, sound governance and adequate resources, and be accountable for the discharge of its duties. A suitable legal framework for banking supervision is also necessary, including provisions relating to authorization of banking establishments and their ongoing supervision; powers to address compliance with laws as well as safety and soundness concerns; and legal protection for supervisors. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.
Description	
Assessment	Compliant
Comments	
Principle 1(1).	Responsibilities and objectives. An effective system of banking supervision will have clear responsibilities and objectives for each authority involved in the supervision of banks.
Description	<p>EC 1. The activities and supervision of banks are governed by the Act on the CNB (“CNB Act”) and Act No. 21/1992 Coll., on banks, as amended (“BA”). The activities and supervision of credit unions are subject to Act. No.87 /1995 Coll., on Credit Unions and Certain Related Measures (“CUA”) and on the Amendment of the Czech National Council Act No. 586/1992 Coll. On Income Tax, as amended (“CUA”) (e.g., relevant for tax deductibility for loss provisions). The few building societies that exist follow a special act, but are supervised as banks. Generally, building societies are “banks with a limited set of permissible activities”. Building societies and credit unions make up roughly 10 percent and 1 percent of total industry assets, respectively.</p> <p>The CNB is the only authority dealing with banking supervision. CNB is an integrated supervisor, also covering supervision of, e.g., securities markets and insurance companies.</p> <p>Banking supervision of the CNB shall:</p> <ol style="list-style-type: none"> a. Facilitate the sound operation and development of the financial market in the Czech Republic and contribute to the stability of the system as a whole. b. Be performed both on a solo and consolidated basis. c. Comprise a set of policies, processes, instruments, and other methods. <p>EC2. A comprehensive range of prudential standards and rules for banks and credit unions are included in:</p> <ol style="list-style-type: none"> i. Laws, mainly the BA, CUA, and Act No. 284/2009 Coll., the Payment System Act, as amended ii. Implementing legal regulations issued on the basis of law, i.e., in CNB decrees and provisions. iii. Directly applicable EU regulations. <p>EC 3. All relevant Acts have been amended and updated frequently since their inception in the 1990s, partly for domestic reasons, partly as a result of international, mainly EU, decisions.</p> <p>EC4. The CNB publishes on its website detailed information on the financial sector, such as quarterly data on assets and liabilities, off-balance sheet activities, profit, and effectiveness of the banking sector and the credit union sector, as well as selected</p>

	<p>prudential indicators on, e.g., liquidity, capital, impaired assets, and provisions.</p> <p>AC1. The CNB applies the principle of resource allocation depending on risks in the exercise of banking supervision. On-site inspections are carried out at intervals set according to the risk profile of the individual institution. The Risk Profile Assessment System (RAS) provides support to supervisory planning and execution.</p>
Assessment	Compliant
Comments	While it is clear from the CNB Act that the CNB is responsible for banking supervision, there is no overarching CNB mandate for prudential supervision. (The primary objective of the CNB is monetary stability). We recommend the CNB to introduce an appropriate mandate for prudential financial supervision.
Principle 1(2).	Independence, accountability and transparency. Each such authority should possess operational independence, transparent processes, sound governance, and adequate resources, and be accountable for the discharge of its duties.
Description	<p>EC 1. The operational and financial independence of banking supervision is stipulated by the Czech Constitution stating in Art. 98 that interventions in CNB activities are only permissible on the basis of law. According to Art. 9 (1) CNB Act, neither the CNB nor the Bank Board shall seek or take instructions from any other body. Protocols from CNB Board meetings are published. The assessors could not identify any indications of undue interference from outside parties in supervisory matters. Art. 11 CNB Act empowers the minister of finance or another nominated member of the Government to attend CNB Board meetings in an advisory capacity (without voting rights). In practice, the Minister, or a representative, has attended CNB Board meetings since the Czech financial crisis in the 1990s very rarely. In addition, the CNB has informed the BCP assessors that the minister does not have access to Board meetings in which operational supervisory issues are discussed. The CNB has necessary resources to fulfill its function of an integrated financial market supervisor and is financially independent of the state budget. A minor share of the budget is financed from fees levied on supervised entities. The CNB manages its finances in compliance with the budget approved by the Bank Board. Art. 1(4) CNB Act prohibits the CNB to send funds to the ministry of finance or any government-related entities. Art. 6 CNB Act sets the term of office for Bank Board members at six years (renewable once). The Act lists the reasons for which the governor or another Board member may be relieved from office. The President of the Republic may relieve Bank Board members (incl. the governor) in the cases specified in the Act. This includes the case of serious misconduct or if the member no longer fulfills the conditions required for the performance of his duties. The governor may also be relieved if he has failed to perform his duties for a period of six months. A decision to remove the governor is reviewable at the European Court of Justice. The Act does not stipulate that a decision of dismissal must be publicized, but it is deemed likely that the President would justify such a serious decision in public. In practice there are only two cases in which the governor has left his position prematurely. In one case the governor was appointed to a government position. In the other case, the governor left his position at his own request about six months before the end of his mandate. The BCP assessors did not find any indications that these premature moves were the result of any undue influences.</p> <p>EC2. Banking supervision is regarded as one of the key components of ensuring the sound operation and development of the financial market in the Czech Republic and contributing to the stability of the financial system as a whole. The CNB pursues the policy of transparency and openness to the public. For instance, the CNB has</p>

	<p>published “The Mission of the CNB for the Supervision of the Czech market” containing the CNB’s visions and missions and the values and principles governing its supervisory work. The CNB issues yearly various reports, such as the Financial Market Supervision Report (FMSR) and the Financial Stability Report (FSR). The FMSR is submitted to the Chamber of Deputies, the Senate and the government for information. It is also discussed by the Financial Market Committee, an advisory body to the CNB, which is entitled to append its opinion to the report. Each administrative decision by the CNB towards a supervised institution (such as licensing, decisions on qualified holdings, and so on) may be subject to appeal. Any appeals are first discussed in the Bank Board’s Appeals Committee, which consists solely of external experts, and then in the Board itself.</p> <p>EC3. According to external information from independent polls, the confidence of the public, as well as of the market participants, in the CNB as supervisor has increased in recent years. Industry representatives confirmed this view during the mission. Starting in 2003, the CNB issued The Code of Ethics of the Czech National Bank and has established an Ethics Committee. Among other things, the Code stipulates the conditions under which CNB staff may invest in the financial markets. For instance, staff members must report any intended acquisitions or selling of Czech shares 90 days before the trade (which then must take place within 30 days). However, foreign shares may be held provided insider information is not used. On another issue of integrity: CNB staff, also supervisory staff, may terminate their CNB employment and take up another job, e.g., in the private sector after a three-month quarantine.</p> <p>EC 4. The CNB manages its finances in compliance with the budget approved by the bank board (Art. 5(2) (b) CNB Act). The CNB defrays the costs of its operations from its income, and from fees on some supervisory services, such as licensing. The number and level of skills of applicants for jobs in CNB’s regulation and supervision department show that working at the CNB has become increasingly attractive and there is no problem in hiring staff, with the important exception of experienced persons from the financial sector. Turnover, also for key experts, is low at around 8 percent. A comprehensive training program is in place, also meeting the needs of lifelong learning as regards innovations in banking and banking supervision. The hardware and software of banking supervisors have the level corresponding to the needs of banking supervision, analytical and methodological activities and other related activities. The budget allocates sufficient funds for planned on-site examinations as well as necessary funds for extraordinary examinations, travel abroad for onsite inspections, international organizations, or supervisory colleges.</p> <p>AC1. Art. 6 CNB Act stipulates a six-year term, renewable once, for the CNB Governor and other Bank Board members.</p>
Assessment	Largely Compliant
Comments	<p>The number of supervisory staff is low relative to the size of the financial market and the number of supervised entities. The number was being reduced further by recent staffing cuts which amounted to slightly less than ten percent of total CNB staff. (The assessors understand that this was general across-the-CNB cut which was not preceded by a comprehensive analysis of workloads and objectives/expectations on the various CNB functions.) At the same time, the scope of staff work is increasing, inter alia, by the more intensive work in international fora and in particular by the work in European fora which will result in EU legislation, applicable also for the Czech Republic. The BCP assessors find that the shortage of staff has implied less intensive</p>

	<p>and less frequent supervision than warranted, e.g., large banks should receive onsite visits yearly. (Refer CP 19-20)</p> <p>The mission was informed that, the right of the MOF, or a person delegated by him, to attend the CNB Board meetings (albeit without voting rights) does not include meetings in which operational supervisory issues are being discussed. This being the case, the BCP assessors find that this right does not constitute a threat to supervisory independence. That said, the assessors encourage cooperation and information-sharing using other channels between the relevant authorities, such as the MOF, the CNB and the DIF on regulatory and supervisory matters, including on individual financial institutions, when warranted, such as when there may be an issue of state financial support. There are now many other channels, for instance those forums established by the MOUs on cooperation between the MOF and the CNB (see CP 1(6)), which could, and should, be actively used for information exchange and cooperation between the MOF and the CNB, also at their highest levels.</p> <p>In international practice, there is usually a longer quarantine (cooling-off) period when supervisors leave the authority to take up a position in the financial sector; such as one year. We recommend the CNB to consider such an amendment, which would strengthen the integrity of the CNB and its staff.</p>
Principle 1(3).	Legal framework. A suitable legal framework for banking supervision is also necessary, including provisions relating to authorization of banking establishments and their ongoing supervision.
Description	<p>EC 1. In accordance with Art 4 (2) BA, the CNB is the sole authority responsible for granting and withdrawing banking licenses. However, for those banks that benefit from the privileges of “the Single Market Passport” (EU) the home authority is also the licensing authority. Similar licensing authority for the CNB in respect of credit unions is stipulated in Art 2a CUA.</p> <p>EC 2. The CNB Act empowers the CNB to issue without any prior approval from the MOF, on the basis of the relevant laws and within their limits, implementing regulations stipulating prudential rules for credit institutions as well as for other financial market entities subject to its supervision or affected by financial market regulation. The CNB consults on all major changes to prudential rules with the MOF and with the interest group of credit institutions, such as the Czech Banking Association and the Association of Credit Unions, and where appropriate with professional organizations such as the Union of Accountants or the Chamber of Auditors. After the consultation, the final decision rests with the CNB. There is no “veto right” for the MOF or the private sector.</p> <p>EC 3. In accordance with, primarily, Art 41(2) CNB Act, the CNB is empowered to obtain information in the necessary form and frequency to conduct its duties from all credit institutions (incl. credit unions). In addition, Art. 41(5) of said Act stipulates that the CNB may request further detailed explanations or information if it doubts the correctness or completeness of provided information. The CNB is also empowered to request any information from supervised entities during on-site examinations.</p>
Assessment	Compliant
Comments	-
Principle 1(4).	Legal powers. A suitable legal framework for banking supervision is also necessary, including powers to address compliance with laws as well as safety and soundness concerns.

Description	<p>EC 1. Art 12 BA stipulates that banks shall carry on their activities with prudence and, in particular, pursue its business in a manner which is not detrimental to the interests of its depositors and which do not endanger the bank's safety and soundness. Art 1(5) (b) CUA is formulated similarly.</p> <p>The CNB is empowered to use qualitative judgment in supervision, and it exercises this power in practice. Pursuant to Art 25(3) BA and Art 28(1) (g) CUA, the CNB is entitled to review and evaluate whether the arrangements, strategies, processes, and mechanisms implemented by a bank or credit union ensure the safe and sound operation of the institution and coverage of the risks to which it may be exposed. Qualitative judgment is also applied to detect and evaluate shortcomings in the activities of entities subject to CNB supervision as well as imposing remedial measures. As an example, qualitative judgment may result in a requirement for the institution to apply a higher capital adequacy ratio than the 8 percent minimum.</p> <p>EC 2. As noted in CP 1(3), the CNB may require a bank to submit any information and documents, also those from the Bank's Board, necessary for the conduct of supervision both on a solo and consolidated basis and also to assess compliance with bank internal rules and limits. Thus, the relevant laws make it significantly easier for the CNB supervisors to access the Board and senior management of supervised entities.</p> <p>EC 3. Laws empower the CNB to require remedial action or impose a sanction when it detects shortcomings in the activities of credit institutions. The range of remedial measures and sanctions is broad, including fines, prohibition or restriction of some categories of licensed activities, imposition of conservatorship, or license withdrawal.</p>
Assessment	Compliant
Comments	Refer to the comment under CP 23 on the issue of taking timely and adequate remedial action.
Principle 1(5).	Legal protection. A suitable legal framework for banking supervision is also necessary, including legal protection for supervisors.
Description	<p>EC 1. Individual supervisors are protected since generally all decisions against the entities and persons within the powers of the CNB will formally be taken by the CNB and not by the supervisor. In the case of a lawsuit claiming wrongdoing by a supervisor, the CNB will resume any responsibilities versus the claimant.</p> <p>EC 2. Since the CNB itself will be the party attending the court proceedings, there is no cost for the staff member and the CNB will not request compensation for legal representation from the staff member, even in the case of an unsuccessful trial, unless the incorrect supervisory action was deemed criminal or otherwise intentional.</p>
Assessment	Compliant
Comments	<p>All cases of litigation in supervisory matters will be directed towards the CNB itself and not to the individual staff member. In this way, the staff member is protected against liability for actions taken (or omitted) in good faith. Should the court find that the action was criminal or executed in bad faith, the CNB may request compensation from said staff member</p> <p>This CP also requires that the CNB itself be protected from frivolous lawsuits through legislation to that effect. This is not presently the case and the assessors thus recommend an amendment in the legislation.</p>
Principle 1(6).	Cooperation. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.

Description	<p>EC 1. The CNB is an integrated supervisor of the Czech financial market and institutions and therefore the exchange of information on the various sectors of this market, as well as on supervision of these sectors, takes place within the CNB and is governed by the CNB's internal rules. There is a free flow of information within the CNB. The Act 2/1969 Coll., on the Establishment of Ministries and Other Central Agencies sets out the general responsibilities of the MOF vis-à-vis the financial system. For the CNB, the corresponding act is the CNB Act. The two laws stipulate among other things that the MOF and the CNB are among the authorities responsible for the soundness of the financial system. The legal basis for the cooperation and exchange of information between them is the CNB Act. The CNB Act also stipulates that the minister of finance or another nominated government member may attend CNB Board meetings in an advisory capacity and, vice versa, that the CNB governor or a deputy governor may attend government meetings. The CNB and the MOF have concluded three agreements on cooperation. The "Agreement on cooperation in the preparation of national legislation concerning the financial market and other regulation concerning the fields of competence of the parties to the Agreement" and the "Agreement on cooperation in the field of financial stability and resolving financial market crises" were both signed in 2006 and the "Agreement on cooperation in the exchange of information relating to the financial market" was signed in 2007. However, the BCP assessors were informed that the cooperative groups established under the above agreements are not active and have not met. Cooperation between the CNB and the MOF is conducted through other, more informal, channels. Nonetheless, cooperation is ongoing, i.e., on preparing new legislation.</p> <p>EC2. The legal basis of cooperation with foreign supervisors is defined in Articles 25 and 38c to 38j in the BA, which entitle the CNB to exchange information on all facts necessary for banking supervision. This governs the possibility to conduct on-site examinations via the home supervisory authority in the host country. Cooperation with foreign supervisors regarding credit unions is governed by virtually identical rules in Articles 22 and 22a CUA. The CNB cooperates with its partner supervisory authorities in the EU also on a multilateral basis, focusing on CNB's participation in the newly created European Supervisory Authorities. The CNB has signed MOUs on banking supervision with authorities from Belgium, France, Italy, Germany, the Netherlands, Austria, Slovakia, the US, and China. The CNB has also signed seven multilateral memoranda of understanding concerning the work within so called supervisory colleges encompassing cross-border groups.</p> <p>EC3. Provision of confidential information to other supervisory authorities is subject to confidentiality principles as laid down in Articles 25a BA and 25a CUA. These Acts stipulate, i.e., that such information may be used solely for supervisory purposes, conservatorship or for judicial proceedings concerning the exercise of supervision. Providing information to a foreign supervisory authority which is responsible for supervising a specific institution in the Czech market is not regarded as a breach of confidentiality. Information may only be provided if the receiving party has in place an information protection scheme at least within the scope of EU law, or if there is a public interest. Confidential information received from other parties may be used only for the purpose for which it was provided and may not be disclosed to any other person without the consent of the provider.</p> <p>EC 4. The confidentiality obligation requires the CNB to deny disclosure of any confidential information in its possession, with the exception of (a) its foreign partner</p>
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	<p>authorities responsible for banking supervision or financial market supervision, or to some other authorities and persons resident in the Czech Republic, to whom analogous provisions to those pertaining to supervisory authorities apply. In addition, information may be provided to EU bodies where necessary to meet international treaties; international bodies combating criminal activities and law enforcement authorities of foreign countries; various Czech and other EU country authorities which need the information to fulfill their duties (e.g., in the fields of bank liquidation or bankruptcy; a bank auditor; CFT or terrorist financing; operating a payment system, or a deposit insurance system).</p>
Assessment	Compliant
Comments	<p>The established fora for regular meetings between the MOF and the CNB should become active. Even in times where there are no acute specific cases to discuss, such meetings are useful, i.a., in order to build a cooperative atmosphere between the involved parties.</p>
Principle 2.	<p>Permissible activities. The permissible activities of institutions that are licensed and subject to supervision as banks must be clearly defined and the use of the word “bank” in names should be controlled as far as possible.</p>
Description	<p>EC1. Pursuant to Article 1(1) of the BA, banks are joint-stock companies having their registered offices in the Czech Republic which accept deposits from the public and provide loans and which have been granted a license to carry on banking activities. The term “credit union” is defined in Article 1(2) of the Act on Credit Unions as a cooperative which carries on economic activities to support its members, consisting above all in accepting deposits and providing loans, providing guarantees and various forms of payment services.</p> <p>EC2. The activities a bank may carry on are defined in the BA. In addition to accepting deposits from the public and providing loans (Article 1(1)), a bank may carry on other activities, listed in Article 1(3) of the BA, provided they are specified in its license. Pursuant to Article 1(4), a bank may not carry on business activities other than those permitted in its license. However, this does not apply to activities carried out for another entity, provided that they are associated with safeguarding its operation and the operation of other banks, financial institutions, and ancillary services undertakings controlled by the bank.</p> <p>An example of this is when the bank provides IT services to other parts of its financial group. Similar provisions apply to credit unions in accordance with the CUA. The CUA also allows credit unions to carry on activities for other than their members. Such entities include the state, regional authorities, and municipalities, as well as legal entities established by them. The scope of permitted activities for each individual bank and credit union is included in the information published on the CNB website. If a bank or credit union carries out activities not permitted in its license, it violates the law. The CNB will require the bank to cease the nonpermitted activity within a specified period. Further sanctions may be imposed, e.g. a fine of up to CZK 50 million. For credit unions the sanction is a fine of up to CZK 20 million, or, in accordance with Article 28 CUA, restrictions of the unlawful activities of the credit union.</p> <p>EC3. Article 3 BA stipulates that the term “bank” or “savings bank” or terms derived there from may only be used for a licensed institution, unless it is clear from the context that such entity is not engaged in the activities listed in Article 1(1) BA. Article 3 does not apply to legal entities whose commercial name is well established or recognized by</p>

	<p>law or pursuant to international treaty. Art. 1(3) CUA stipulates that only institutions which have been licensed as credit union may use these words in their names. Art. 26(9) BA defines the remedial action to be taken against unlawful use of the words “bank” or “savings bank.” The institution will be required to rectify the shortcoming and may be fined. If the situation is not rectified the CNB may take further action, including requiring the Commercial Court to wind up the institution (see Article 29 (6) of the Commercial Code. The same is applicable for credit unions.</p> <p>EC4. Only banks (Art. 2(1) BA) and credit unions (Arts 1(2) and 3 (1) CUA) may accept deposits. Should the CNB detect deposit taking by unauthorized institutions it will file a notification to the law enforcement authorities in accordance with Art. 251 of the Criminal Code Act. In some cases unregulated institutions issuing bonds but not receiving deposits may be regarded as taking deposits and thus fall under the regulations for deposit-takers.</p> <p>EC5. On its website, the CNB maintains an updated list of all banks and branches of foreign banks in the Czech territory. The list also includes basic information on these entities. Although there is no explicit corresponding requirement in the CUA, all credit unions are included in the website listing.</p>
Assessment	Compliant
Comments	Since credit unions are gaining market shares, the applicable rules should be updated to require similar CNB listing as for banks.
Principle 3.	Licensing criteria. The licensing authority must have the power to set criteria and reject applications for establishments that do not meet the standards set. The licensing process, at a minimum, should consist of an assessment of the ownership structure and governance of the bank and its wider group, including the fitness and propriety of Board members and senior management, its strategic and operating plan, internal controls and risk management, and its projected financial condition, including its capital base. Where the proposed owner or parent organization is a foreign bank, the prior consent of its home country supervisor should be obtained.
Description	<p>EC 1. Pursuant to Article 44(2) CNB Act, the CNB is the sole authority to decide on the licenses, permits, registrations and prior consents of banks and credit unions.</p> <p>EC2. The main criteria and conditions for granting a license are stipulated in the BA, Articles 4 and 5. The prerequisites of the license application are governed by CNB Decree No. 233/2009 Coll. The criteria and conditions for granting authorization to establish a credit union are defined in Article 2a (4) of the CUA. The prerequisites of the application for authorization of credit unions are governed by CNB Decree No. 233/2009 Coll.</p> <p>EC3. The criteria and procedures for issuing a license or authorization are consistent with those applied in ongoing supervision, i.e., the requirements must be met by the institutions on an ongoing basis.</p> <p>EC4. The submitted information from the applicant must be truthful, complete, and up-to-date. If the conditions for granting a license are not met, i.e., the applicant fails to provide all documents and information confirming fulfillment of the conditions required by law (Articles 4(5) and 5(4) BA and Article 2a (4) CUA—further specified in Decree 233/2009 Coll.), the application cannot be considered complete. If the applicant fails to provide the missing information, legitimate conditions are created for the application to</p>

be refused.

EC5. For banks and credit unions the conditions, information and documents showing compliance with the statutory conditions for the granting of a license are set so that the CNB can properly determine whether the proposed legal, managerial, operational, and ownership structures and the wider groups of which the entities are part will not hinder effective supervision on both a solo and consolidated basis. The BA imposes a duty to submit the draft articles of association of the proposed bank; these must set out the structure and organization of the bank, the powers and responsibilities of a bank's managers, the powers and responsibilities of other head office, or branch employees. A significant issue to be assessed is the proposed bank's ownership structure, including persons with direct or indirect shareholdings as well as persons or entities which otherwise have an influence on the banks (the close links principle). Information about such persons and entities must also be submitted in the license application, including the character of the business of the other entities. A necessary condition for granting a license is that the ownership structure, including so-called close links does not hinder effective supervision through legal or practical barriers.

Procedures for assessing an application to establish a credit union are very similar to those for banks, as set out in the CUA (Art. 2a (4)), the Commercial Code (Art. 221 and subsequent) and Decree 233/2009 Coll.

EC6. Article 4 BA requires a determination of the suitability of persons with a qualifying holding (10 percent of registered capital or voting rights, or a holding that enable the exercise of a significant influence on the management). Decree 233/2009 Coll. states that the license applicant must supply further information, such as:

- A list of entities with qualifying holdings, including entities which have influence through concerted conduct. The list must contain a graph of relations between such entities.
- A questionnaire for each entity containing details on the acquisition of the qualifying holding and basic information about the persons that manages the entity, including questions to prove that such persons are fit and proper to exercise shareholder rights. (Unless the CNB cannot obtain such information by itself. The CNB has the right to request an extract from the Criminal Register for the purpose of proving the lack of a criminal record).
- Documents showing the license to do business for each entity specified in the list.
- Annual reports and audited financial statements for the entities;
- Information about closely linked persons and entities, such as registered name and location of the entity; identification data for the individual person as well as a description of the person's/entity's connections with the group and its activities.
- The written opinion of the responsible supervisor in the country of its registered office, on the plan to have a qualifying holding in the Czech Republic in the regulated business.

The proceedings will also include an assessment of the activities of every natural and legal persons of the applicant and its closely linked persons, e.g., whether they were active in companies against which an application for bankruptcy has been filed or that had financial problems in the past.

For credit unions corresponding rules apply, although it is necessary to take into account the specifics resulting from their legal ownership form (cooperatives).

The relevant rules when assessing qualifying holdings are contained in the CUA and Decree 233/2009 Coll. On their perusal of supervisory documentation, the BCP assessors found evidence that the CNB checks qualifying holdings in accordance with the law and other regulations, for instance the origin of the funds used for the acquisition of the holding.

EC7. The minimum amount of capital for a bank is set in Article 4, BA and is CZK 500 million (at current rates, some 30 million USD). The registered capital must be comprised of monetary contributions, which have to be paid-up before a license is granted. The minimum amount of funds provided by the parent bank to a third country branch located in the Czech Republic (however, at present no such branches exist) is set out in Decree 233/2009 Coll. and is CZK 150 million (some USD 10 million). According to the amendment of Decree 233/2009 Coll. (Decree 192/2011 Coll.) this amount was raised to CZK 500 million from January 1, 2012. Under Article 2 CUA, the amount of capital is no less than CZK 35 million (some 2 million USD). The sum must be paid-up, in the form of registered capital and/or a risk fund and reserve funds, before an authorization may be granted.

EC8. Article 4, paragraph 5, subparagraph d), and Article 5, paragraph 4, subparagraph c), BA stipulate for the granting of a licence that persons who are proposed for senior managerial positions with a bank with powers and responsibilities defined by the articles of association or who are proposed for the management of a branch of a foreign bank have to be fit, proper, and experienced. Decree No. 233/2009 Coll. sets out the documents that the proposed persons submit to the CNB to document they are fit, proper and experienced. A document showing a person is proper/has a clean criminal record is an extract from the Criminal Register or a similar document issued by the relevant authority of another country. Under the law, the CNB is also entitled to request a transcript from the Criminal Register for those who are proposed as a bank's managerial employees. A person proposed for management shall produce a professional curriculum vitae specifying all employments, business activities, and other independent gainful activities, as well as membership of professional associations and bodies of other companies. A person proposed for management shall also document the extent of the powers and responsibilities entrusted to him and the number of persons he managed. They should be commensurable with the bank's intended activities that will be within the remit of the proposed person. To increase the transparency of its procedures, the CNB issued a statement on the interpretation of the terms fit and proper and also an official statement on the assessment of managers of banks, branches of foreign banks from third countries, financial holding entities, and electronic money institutions.

The Act on Credit Unions, in Article 2a, paragraph 4, states that a condition for the granting of a permit to do business to a credit union is the fit and proper nature of the persons elected to the board of directors, control commission and credit commission, as well as the persons who are proposed for senior managerial positions in the credit union with which powers and responsibilities defined by the credit union's articles of association are linked. The procedure applied by the CNB when assessing whether a person is fit and proper is similar to that for managerial employees with banks—see Decree No. 233/2009 Coll.

EC9. Under Decree 233/2009 Coll., an applicant for a license submits a strategic intention and business plan for the next three years broken down in detail. The conditions for granting a license include the technical and organizational set-up for the performance of proposed banking activities, and the functional systems of governance at the bank. (It should be noted that there is no legal requirement for supervisory boards of banks to include independent members. (The Czech system is two-tier, with a supervisory board and a management board). However, the Audit Committee of the board must include at least one independent member). A proposal for a system of governance shall contain, in particular, a risk management strategy, a strategy related to capital and capital adequacy, an information strategy policy, and principles for an internal control system. This includes principles for preventing conflicts of interest and principles for compliance, and security principles, including security principles for information systems. The documents submitted by the applicant shall make it absolutely clear how the managerial structure of the future bank, including the operational structure is set up.

When assessing whether a bank's corporate governance is appropriate and functional, the CNB reviews how the shareholder's basic rights are ensured in the bank's articles of association, how the system of governance is set out, and in what ways serious facts concerning the bank, including its financial situation, the company's performance, the ownership, and management of the bank will be communicated. The governance system must also minimize the risks of abuse of the bank for money laundering and terrorism financing. The application for a license should also include whether the bank (or credit union) expects to outsource activities to another entity. It must ensure the CNB that such activities will be performed in accordance with relevant regulations, including reporting requirements to the CNB. The bank must arrange so that the CNB can perform supervision of the outsourcing provider.

EC10. When assessing the business plan of a bank, the CNB compares the amount of capital to the scope of the expected activities, as envisaged in the proforma financial plans for the coming three years. A bank's capital must have a transparent and stain-free origin, and must be adequate and of an appropriate nature with regard to the planned activities. In the case of a third country (non-EU) foreign bank branch, there must be sufficient funds provided by the foreign bank with regard to the branch's business. A third country (non-EU) bank must provide audited financial statements and annual reports for the last three years, as must a legal or physical person with a qualifying holding in a bank.

A prerequisite for the incorporation of a credit union is also the submission of a business plan for three years. It is assessed in the same way as for banks, i.e., that the amount of capital is sufficient compared to the risk character and extent of the intended activities. Entities with a qualifying holding in credit unions are assessed in the same way as such entities owning banks.

EC11. Under Article 4, para 3 BA, before deciding on a license to an applicant, controlled by an EU bank, EU investment firm or EU insurance company, or by a person which is controlling these mentioned entities, the CNB asks the supervisor of another EU member state for its opinion. This opinion shall include an assessment whether an entity with a qualifying holding in a bank is fit to exercise a shareholder's rights in the bank and whether the persons who are proposed for senior management

	<p>are fit, proper and experienced.</p> <p>In the case of a person/entity from a non-EU country intending to hold a qualifying holding in a bank in the Czech Republic, the applicant must produce the original opinion of the relevant supervisory authority regarding the legal entity's intention to have an interest in a bank's business in the Czech Republic.</p> <p>Article 5 BA requires, in the case of a branch of a foreign bank from a third country, a statement of the authority that supervises the foreign bank in the country of its registered office regarding the intention to establish a branch in the Czech Republic, including a statement that it will supervise the branch.</p> <p>EC12. Article 34 BA states when a license can be withdrawn. One of the reasons is that the license was obtained based on untruthful information. For credit unions, the right to withdraw a permit, if it was obtained on untruthful information, is contained in Article 28g CUA.</p> <p>EC13. As a part of an assessment whether a bank's top management is fit, proper, and experienced for the purpose of determining their specialist and other abilities, the CNB assesses whether the proposed candidate for a position has the necessary expertise and ability to identify problems in her area of responsibility. The same approach is taken for persons proposed as board directors, control, and credit positions and other persons who are proposed for managerial positions in a credit union. In its assessment, the CNB also considers whether the collective experiences and skills of the management and board are adequate to meet the demands of the credit institution in view of its size, complexity, and nature.</p> <p>AC 1. The CNB assesses the ability of a person/entity with a qualified holding to provide additional funding, if the situation so requires in the future. According to Article 5 BA the same requirement is applicable to a non-EU bank wishing to establish a branch in the Czech Republic. According to Article 2a CUA, the assessment also applies to persons with qualifying holdings in a credit union.</p> <p>AC2. A new bank or credit union is monitored, in particular, based on the mandatory regular reporting and from the viewpoint of the compliance with the strategic and business aims, and how it meets the conditions as set in the license or permit. Article 1 BA and Article 2a CUA enable the CNB to include conditions in its permit. These conditions must be fulfilled before the institution may start certain activities, and be maintained consequently.</p>
Assessment	Compliant
Comments	<p>The BCP assessors were given the opportunity to peruse license applications and relevant documentation for a sample of newly-licensed banks. Although impossible to verify in their details (the documentation for each license is quite voluminous), the assessors generally got the impression that all the components which are required in legislation and CNB regulations were present in the documentation and in the CNB assessments.</p> <p>According to globally accepted practices, bank (supervisory) boards have normally more than one independent member as required in the Czech Republic. Independent board members can contribute their skills to the overall competence of the board and</p>

	<p>they can also take an “outsider’s view”.</p> <p>Since it is important that new credit institutions make a good start, CNB should make it a rule to perform onsite visits to new start-ups within the first year of operations.</p>
Principle 4.	Transfer of significant ownership. The supervisor has the power to review and reject any proposals to transfer significant ownership or controlling interests held directly or indirectly in existing banks to other parties.
Description	<p>EC 1. In accordance with EU Directive 2006/48/EC a qualifying holding is regarded as a significant ownership interest. A qualifying holding is defined in the BA (Article 17a, paragraph 3) as a direct or indirect share in the registered capital or voting rights of a person or group of persons acting in concert (or the sum of it) that represent at least 10 percent or, if lower, enables the exercise of significant influence on its management. A similar definition of qualifying holding exists in the CUA.</p> <p>The term “controlling person” is defined in Article 66a, paragraphs 2 to 5 and 7 of the Commercial Code. A controlling person is an entity who actually or legally exercises, directly or indirectly, a decisive influence on the management or operation of another entity’s enterprise. If the controlling person is a company, it is a parent company and the company it controls is a subsidiary. An indirect influence shall be understood to mean an influence exercised through another person or other persons.</p> <p>EC 2. Article 20, para 3 BA sets out that a person or persons acting in concert must request the CNB’s prior consent:</p> <ul style="list-style-type: none"> - for the acquisition of a qualifying holding in a bank; - for the increase of a holding when exceeding 20, 30 or 50 percent; and - to become entities controlling a bank even in the event that such entities do not exercise voting rights linked to such interest in a bank. <p>The act also stipulates which interests in registered capital or voting rights that are included or not included for the purposes of calculating voting rights. For instance, ownership of less than 10 percent in other financial institutions is not included. CNB: Propose to delete or elaborate on this sentence.</p> <p>Changes to qualifying holdings are assessed by the CNB in the same way as license applications. The CNB decision on the application has to be issued (pursuant to the stipulation of the appropriate European Law and the BA) within 60 days after confirming the receipt of the request, provided that the application is complete. The application must provide all relevant information, such as whether third parties are involved or if there is “acting in concert.”</p> <p>The reduction or loss of a qualifying holding or the fact that the entity ceases to exercise a controlling interest must be reported to the CNB, such as when the residual holding falls below 50, 30, or 20 percent.</p> <p>Similar rules apply to credit unions.</p> <p>EC 3. The CNB will consent to an acquisition or qualifying holding provided that the conditions in the BA are fulfilled. These are similar to those for licensing a de novo bank, including requirements on the volume and transparency of the applicant’s funds and the requirement that the structure of the consolidated unit does not hinder effective supervision. In the case of both banks and credit unions, if an applicant does not meet</p>

	<p>the requirements or conditions set out by the BA or CUA, and Decree No. 233/2009 Coll., this is sufficient statutory reason to reject an application.</p> <p>EC 4. As a part of regular reporting banks submit to the CNB, quarterly, a list of all shareholders by name (in case of beneficial holders, the CNB demands to know the true owner) with the amount of their interests in the bank's registered capital, if higher than 5 percent. Further, the BA requires the publication of such information by all credit unions, banks and branches. The CNB is also entitled to (Art. 20a, paragraph 8 BA) request at any time an extract from the shareholding register. According to the BA, Art. 20a, paragraph 3, each bank must submit a list of all shareholders and administrators of shares acquired as of the day that is seven days before the general shareholders' meeting. Credit unions must similarly report quarterly about members with an interest of more than 5 percent of the registered capital. Under the CUA, art. 7b, para 1, a credit union must also publicize information about itself, including its members' qualifying holdings in a credit union.</p> <p>EC 5. The BA (Art. 20a, paragraph 1) entitles the CNB, e.g. in cases where a qualifying holding was acquired without the CNB's prior consent, to suspend the exercise of the related shareholder's rights. Thus, the CNB may suspend the right (a) to attend and vote at the general meeting; and (b) to request the convening of an extraordinary general meeting. In a similar way, the CNB can suspend the effect of a control situation. The control contract will then terminate on the nearest date allowed by the Commercial Code. The law does not empower the CNB to require the divestment of the holding, but the CNB may take other actions which limit the owner's benefits of the holding such as restricting the activities of the bank, restricting transactions with entities close to the (non-permitted) qualified shareholder, or ultimately revoking the bank license. As noted above, the CNB receives a list of all shareholders immediately before a general meeting (GM). The GM cannot be held unless the CNB has signed off on this list and the CNB has the power to mark, in the list, persons or entities which may not attend the general meeting. The CNB can also withdraw the bank's license. The CNB may also suspend members of credit unions from attending and voting on members' meetings. In addition, the CNB may impose a fine on a credit union member (natural or legal person) if she has obtained a qualifying holding without prior consent by the CNB.</p> <p>AC 1 There is no explicit legal provision that compels a bank or credit union immediately to report if they become aware of circumstances which may negatively affect the suitability of a major shareholder.</p>
Assessment	Compliant
Comments	<p>The CNB have effective procedures from stopping a nonpermitted qualified holder to vote on his shares or to call an extraordinary shareholders' general meeting. However, the CNB does not have legal powers to enforce the divestment of the same holding. The BCP assessors recommend that the CNB be given such powers. Even though a holder can be barred from voting there are other ways to use the shareholding to gain influence in the institution, in particular if the holding is large.</p>
Principle 5.	<p>Major acquisitions. The supervisor has the power to review major acquisitions or investments by a bank, against prescribed criteria, including the establishment of cross-border operations, and confirming that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.</p>
Description	<p>EC 1. The BA regulates investments and acquisitions in non-financial entities through quantitative limits (banks may not invest more than 15 percent of its own funds in one</p>

legal entity and no more than 60 percent of its own funds in aggregate acquisitions) and qualitative conditions/limitations. The conditions include that the investment is in accordance with the bank's overall strategy and that the bank manages the risks linked to the investment. Nor may the investment hinder the provision of information to the CNB for supervisory purposes. Banks also may acquire an interest in another legal entity, establish another legal entity or contribute to its establishment if (i) the bank does not become a member with unlimited liability; (ii) it is not an entity that has a qualifying holding in the bank, unless they are participatory securities of such person held for the short term for the purpose of trading and the bank complies with the rules for acquiring, financing, and assessing assets, set by the CNB under the BA. A bank needs prior consent by the CNB to conclude a contract to dispose of an enterprise or part thereof, or merge with another bank or split the bank. A bank is also under duty to inform the CNB of a plan to establish a legal entity abroad or to hold an ownership interest in such entity. The CNB has the power to review investments and acquisitions to ensure that the bank is not exposed to unreasonable risks. That said, there is no requirement of "prior consent" for acquisitions not specifically mentioned in the BA (e.g., mergers). Credit unions may not acquire interests in other legal entities. They cannot invest in assets, and can acquire them only in the process of collateral realization, and such assets may only be held for six months. The CNB's prior consent is required for a credit union merger or split.

EC2. As noted in EC1 there is no requirement and hence no criteria for the CNB to assess bank investments ex ante.

EC3. Under the BA (Article 12 paragraph 1) banks are under a general duty to proceed prudently, in particular to perform activities in a manner that does not damage the interests of their depositors and does not endanger the safety and stability of the bank. Limits for investments by banks are set in the BA. Under the BA a bank is also under duty to inform the CNB of a plan to establish a legal entity abroad or to hold an ownership interest therein. According to the BA, the conditions for granting a bank license include the transparency of the group of entities closely linked to the bank. Hence, if the investment or acquisition hinders effective supervision or information sharing this is a breach of the licensing requirements and the CNB may require the bank to take remedial action and it may also sanction the bank.

EC4. While performing its ordinary supervision, the CNB checks that banks comply with the BA and with the Prudential Rules Decree (PRD), including the risk management system. In the case of the acquisition of an ownership interest by a bank, the CNB usually requests the submission of detailed information about an acquired interest, including an analysis that assesses benefits and risks of the acquisition and its impact on the bank.

EC 5. Article 17, paragraph 7 BA requires banks to notify the CNB without undue delay of the bank's acquisition of a qualifying holding.

EC 6. While performing consolidated supervision, the CNB checks compliance with the BA and the PRD, including whether a bank is involved in nonbanking activities that could expose the banking group to risk. If the bank does not meet the requirements set on governance and risk management, the CNB may take remedial action. The BA contains a wide range of measures to be taken in such a situation including ring-fencing the bank through limiting or prohibiting the exercise of certain transactions and

	<p>operations.</p> <p>AC 1. As noted there is no requirement for prior consent by the CNB to an individual acquisition abroad, although there must be notification after the fact. Hence, the CNB does not assess the quality of supervision in the host country. That said, as noted under EC 3, the licensing requirements apply, so that any hindrances to conduct consolidated supervision constitute a breach of the licensing requirements and the CNB may thus call for remedies.</p> <p>Note: Most of these ECs do not apply to credit unions since those are, by law, severely restricted in making investments and acquisitions.</p>
Assessment	Materially noncompliant
Comments	<p>The Czech authorities follow the general principle of leaving the responsibility (pre-acquisition) of assessing non-financial investments and acquisitions to the bank (credit union, in those rare cases where applicable) concerned. A main reason for such policy, as stated by the authorities, is to avoid CNB involvement in the decision itself and thus responsibility in bank-internal issues risking supervisory capture. The relevant laws and regulations set out a range of quantitative and qualitative criteria and limits which banks must assess and adhere to. Should banks make investments/acquisitions without adequately assessing or fulfilling the criteria, this will be identified and criticized by the CNB in its ordinary supervision and be liable to remedial action and/or to sanctions.</p> <p>The BCP takes a different approach, based on negative experiences from countries, where banks have made investments/acquisitions without proper prior assessment by the supervisors, resulting in material damage to the bank and sometimes to financial stability overall. Hence, the BCP requires supervisors to take an active (pre-acquisition) role in assessing the effects on the bank (and credit union, where applicable) from major investments and acquisitions and the institution's capability to handle them from a managerial, organizational, and financial aspect. For less substantive investments notifications after-the-fact are deemed sufficient.</p> <p>Since the CNB does not subscribe to the BCP approach, and does not express any intention of doing so in the foreseeable future, the rating must be "Materially noncompliant". A higher rating would require that the CNB requires that all substantive investments and acquisitions are subject to prior consent by the CNB and that less substantive investments/acquisitions require a notification by the bank "after-the-fact."</p> <p>A higher rating also requires that the CNB assesses the quality of foreign supervisors before allowing Czech banks to make major acquisitions in financial institutions abroad. Since the quality of the foreign supervision affects the subsidiary of the bank, and hence the whole group, consolidated supervision by the CNB is not sufficient.</p> <p>The rating by the IMF assessors takes into account that the CNB assesses banks' investments/acquisitions after the fact during on-site inspections and may then apply restrictions or remedial actions if deemed needed.</p>
Principle 6.	<p>Capital adequacy. Supervisors must set prudent and appropriate minimum capital adequacy requirements for banks that reflect the risks that the bank undertakes, and must define the components of capital, bearing in mind its ability to absorb losses. At least for internationally active banks, these requirements must not be less than those established in the applicable Basel requirement.</p>

Description	<p>EC1. Article 12a, paragraph 1 BA instructs all banks and branches of foreign banks that do not enjoy the benefits of a single license under EU law to maintain capital adequacy on an ongoing “solo basis.” The BA further defines the banks (Article 12a, paragraph 2) that are under a duty to maintain capital adequacy also on a consolidated basis. Similar instructions are provided for credit unions in Article 8, paragraphs 2 and 3, CUA. The PRD sets rules for the calculation of capital adequacy that include the procedures as well as the rules for calculating the capital component and also the rules for determining the various elements of the capital requirements. The PRD also defines basic and advanced approaches for the calculation of capital requirements and sets the conditions for the use of such approaches. Articles 37 to 43 PRD require banks to maintain a capital adequacy ratio on a solo and, where applicable, consolidated basis at 8 percent. The Decree also defines the elements of capital. In accordance with Basel II it places marked emphasis on the elements of capital that have greater ability to absorb losses.</p> <p>In addition to the duty to maintain capital adequacy, the BA (Article 4) instructs banks to maintain registered capital at no less than CZK 500 million. The CUA sets the corresponding minimum capital for credit unions at CZK 35 million.</p> <p>EC2. The definition of the capital of a bank and credit union, as well as the requirements for the minimum capital adequacy of banks and credit unions on a solo and consolidated basis as set out by the PRD, generally corresponds to the definition of capital, the methods of calculation, and the minimum level of capital required in accordance with Basel II. The definition applies to internationally active banks and credit unions, as well as to banks and credit unions that are not internationally active.</p> <p>EC3. The CNB is entitled to, in connection with how it assesses the risk profile of an individual bank or credit union, ask the institution to maintain a capital adequacy ratio of more than the 8 percent minimum, e.g. as a result of assessed deficiencies, under Basel II Pillar 2. In practice, the CNB have used this power, e.g., to set higher capital requirements to compensate for an institution’s high concentration risk or as a result of stress tests.</p> <p>EC 4. The PRD regulates capital requirements for credit, market, and operational risks. The PRD instructs a bank or credit union that each exposure, which is understood to be an asset or an off-balance sheet item, be allocated to defined portfolios (trading or investment), and then to exposure classes, containing certain risk profiles, to be used as bases when calculating capital requirements for credit risk and market risks. In addition to this, capital must be allocated to operational risk (also under Pillar 1), as well as to other risks not covered by Pillar 1, such as for reputational and strategic risks. The capital requirements for the various categories of risk express the risk profile of the institution.</p> <p>EC5. The EC directive on capital adequacy provides some flexibility that enables a member state to choose between different approaches, called “national discretion”. The Czech authorities have used this flexibility in both directions: (a) Stricter rules (than the EC directive) are applied, e.g., in not applying the Basel II-allowed lower risk weights for loans against collateral in the form of commercial real estate; (b) less strict rules, for instance when permitting banks to use unsolicited ratings for setting the risk weights.</p> <p>EC6. Article 26a BA states that if a bank’s capital, on a solo basis, falls below two-</p>
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thirds of the 8 percent capital requirements, one or more of the measures specified in this Article is imposed on the bank. At the same time, the CNB can impose other remedial measure under Article 26, paragraph 1, subparagraphs b) to i), on a bank. Under Article 34, paragraph 3 BA, the CNB is under duty to withdraw a license if it finds that a bank's capital, on a solo basis, is less than one-third of the sum of the various capital requirements, with the exception of a bank in compulsory administration (conservatorship) or a specially designated bank, such as a bridge bank. Should a bank's capital adequacy fall below the regulatory minimum by any amount, this constitutes a violation of legal rules and would lead to some form of action from the CNB. It is likely that the first action would be a request to the bank's shareholders to supply new capital. In practice, the CNB would start such discussions with the bank before the capital declines to the minimum level.

EC 7. Banks or credit unions can use special approaches (internal risk assessment) for the purpose of calculating capital requirements. In practice five bank groups, amounting to 80 percent of the sector's aggregate balance sheets apply IRB for credit risk (for some or all of their credit portfolios) and two banks apply advanced measurement approach for operational risk. The large banks also apply market risk models rather than the standardized approach. They can do this (i) based on a decision by the CNB or (ii) based on an approved joint application submitted by the bank and its parent to the competent supervisory authority of another EU member state performing supervision on a consolidated basis, where the foreign authority cooperates with the CNB as defined in the capital adequacy directives when dealing with the application. In practice, such cooperation is governed by agreements that the CNB has concluded with foreign supervisors from EU member states. The PRD sets out the prerequisites of an application for using internal risk assessments or changing existing internal risk assessments based on prevailing EU rules. If a bank or credit union stops meeting the qualification standards, the CNB can impose a remedial measure. Even though the BA and the CUA do not allow for the withdrawal of consent to use special approaches, the CNB has a wide range of other remedial measures, such as applying extra capital requirements under Pillar 2. (Note: When the EU regulation "CRD IV" enters into force, the CNB will get the powers to withdraw its consent to a bank to use the advanced approaches). The CNB also requires banks to apply for CNB consent to any significant amendments to their internal models. In such cases, the CNB will reassess the models.

ACs 1 and 2. As noted under EC 2 above, the capital adequacy rules apply to internationally active as well as to all other banks and credit unions. The rules are based on EU Directives, which are generally aligned with the Basel II standard.

AC3. Under the BA and the CUA, the CNB is entitled to review and assess whether the arrangements, strategies, procedures, and mechanisms introduced by a bank or credit union, and its capital ensure safe and reliable operations and coverage of risks that it is or could be expected to become exposed to. Hence, the CNB has the power to require banks to adopt a forward-looking approach to capital management and set capital levels in anticipation of possible events or changes in market conditions that could have an adverse effect. Regularly performed stress tests by the CNB and/or the bank are an often-used tool applied during an assessment of the adequacy of the capital from the viewpoint of possible future risks.

AC4. In accordance with Article 12 BA and Article 8 CUA, all credit institutions, as well as branches of banks from non-EU jurisdictions must maintain capital at least in the

	<p>amount of the sum of the various capital requirements. The CNB has the legal right to require the location of capital directly with a bank or credit union that is part of a banking group, or regulated consolidated unit, with regard to the risks that the entity is exposed to. The CNB is presently drafting guidelines for the capital adequacy requirements on branches of third country banks (currently there are no such branches).</p> <p>AC5. Under the BA (Article 26) and the CUA (Article 28), the CNB is entitled to, after assessing the specific circumstances, request that an individual institution or group raises its capital adequacy above 8 percent. The CNB can proceed in such a manner in particular if an institution has ineffective arrangements, strategy, procedures, or mechanisms, if other remedial measures seem insufficient to achieve a correction over a reasonable period of time.</p>
Assessment	Largely compliant
Comments	<p>Refer to CP 23 about raising the capital adequacy threshold for CNB enforced remedial action. The BCP assessors take the view that when a bank's capital ratio declines below 8 percent, laws and regulations should explicitly set out a range of remedial actions that might be taken, including the possible revocation of the bank's license unless the capital situation can be remedied in the near term.</p> <p>The Czech Republic is applying Basel II in line with EU regulations, with few exceptions (allowed under the "national discretion") which do not significantly weaken implementation. The authorities stand prepared to also implement the coming EU-directives to update Basel II to "Basel III", such as CRD IV.</p> <p>The Czech banking sector is well capitalized in relation to the minimum requirements and also in an international comparison.</p> <p>The assessors note that the CNB does not have the explicit power to withdraw its consent or require modifications to a bank's use of Basel II advanced approaches if reviews, e.g., on on-site visits, should indicate that the approaches over time do not produce the envisaged results.</p>
Principle 7.	<p>Risk management process. Supervisors must be satisfied that banks and banking groups have in place a comprehensive risk management process (including Board and senior management oversight) to identify, evaluate, monitor, and control or mitigate all material risks and to assess their overall capital adequacy in relation to their risk profile. These processes should be commensurate with the size and complexity of the institution.</p>
Description	<p>EC 1. Laws and implementing decrees require that banks, third country branches, and credit unions have, on a solo and consolidated basis, adequate governance, and risk management systems to cover relevant risks, such as credit, market, operational, liquidity, concentration, reputation, and strategic risks and risks from related entities. Such systems must include consideration of external factors, establishing strategies and limits, and requiring board approval and formal monitoring procedures. The CNB evaluates bank risk management processes during off and on-site supervision, and the CNB can impose remedial measures (e.g., fines, license withdrawal) to address shortcomings.</p> <p>EC2. Management boards establish strategies and limits, assess regular reports and extraordinary audit findings, regularly discuss matters of concern, annually assess</p>

overall effectiveness, and remedy shortcomings. Supervisory boards regularly monitor the activities of the credit institution and the management board. There is no requirement that they approve strategies and policies.

Regular internal and external audits are required. During on-site exams, the CNB checks that risk management strategies are approved by the management board, regularly monitored, commensurate with risk, and appropriately implemented by management. Onsite reviews include transaction testing (e.g., 100 commercial loan files and 100 retail loan files selecting large and high risk accounts) and interviews with bank staff (front and back office and risk management staff) to evaluate management's compliance with policy and legal requirements, form an opinion on the quality of risk management and usefulness of policies, identify systemic issues, and evaluate policy exception processes, etc. Exams can last two months in a large bank and have 30 inspectors; a small bank exam could be 3 weeks long.

EC3. Credit institutions are required to document risk management strategies, limits and procedures and maintain records for five years. Management and staff are required to be familiar with risk management policies and comply with them. Credit institutions must have policies that establish exception processes, and define which exceptions must receive prior approval and at what level the approval must be obtained. Exceptions are reported to the management board and serious exceptions (e.g., where risk tolerance is endangered; and marked, unfavorable changes in liquidity) are reported to the supervisory board and audit committee. During on-site exams, the CNB determines whether risk management policies are documented, updated, disseminated and complied with in practice. It also evaluates exception practices, trends in exceptions, and approvals.

EC4. Credit institutions are required to provide boards and staff with current, reliable, and comprehensive information for decision making, including risk exposures and the relationship between the institution's risk profile and capital. Senior management and management boards must regularly verify the information, which is accomplished through the audit function. The CNB examiners evaluate management and board familiarity with the nature and level of risk and capital support, and knowledge of information limitations. The assessment is more difficult for supervisory boards, as there are no minutes kept and the CNB does not meet with them except in extraordinary circumstances.

EC5. Every credit institution must set, maintain, and regularly check an internal capital adequacy assessment performed on an ongoing basis and at all organizational levels. The highest tier bank is responsible for the ICAAP assessment, and for holding companies, the highest level bank performs a capital adequacy assessment of the group. The credit institution must annually inform the CNB of its assessment system.

EC6. The CNB stipulates which approaches and related models can be used and requires that, if used, they be periodically (at least annually) and independently validated (e.g., internal audit) using the CNB standards for credit and market risk validation. Operational risk models must be regularly validated, and data and processes must be transparent and available. In approving bank advanced approaches, the CNB evaluates the independence and frequency of testing.

EC7. The CNB rules set out detailed requirements for systems for measuring, assessing, reporting, and recording the size, composition and quality of exposures

	<p>broken down by risk (e.g., credit, market, operating, liquidity, concentration), and credit institutions are obligated to provide such information to appropriate staff/board. Onsite examiners evaluate whether information systems are appropriate, effective, and timely.</p> <p>EC8. The CNB rules define procedures for checks and approvals on new products and activities and require management board or board-committee approval prior to roll-out. The CNB examiners evaluate new product procedures, strategies, and approvals.</p> <p>EC9. The CNB rules provide general requirements to divide incompatible functions and prevent conflicts of interest. All banks, including foreign-owned, must have independent control functions or processes, including internal audit. In the case of large banks, parent audits provide an auxiliary function. Business line and risk management independently provide to the management board qualitative and quantitative information on credit, market, liquidity, and concentration risks. The head auditor typically reports to the audit committee or the supervisory board, and the risk manager to a management board member. In large banks there are usually three control functions: risk management, audit, and compliance (with at least one staff member each). In small banks, control functions may be outsourced. The head auditor must be allowed to attend board/audit committee meetings at his or her discretion.</p> <p>EC10. The CNB rules provide standards for managing credit, market and interest rate, liquidity, and operational risks. Standards are updated on an as needed basis.</p> <p>AC1. The CNB has the authority to require dedicated risk management units for large and complex banks. It has not deemed it necessary to impose such a requirement, however, on the basis that Czech banks do not have the size or structure to be large, internationally active banks. Typically, however, large banks have independent risk management, compliance, and audit functions.</p> <p>AC2. When assessing capital adequacy, credit institutions are required to use stress tests for credit, market, and operational risk. The CNB rules provide guidance in these three areas.</p> <p>AC3. Credit institutions are required to have adequate governance and risk management systems to cover relevant risks, such as credit, market, operational, liquidity, concentration, reputation, and strategic risks and risks from related entities. While there are no standalone standards for reputational and strategic risks, they must be incorporated in bank risk management strategies and ICAAP assessments with capital add-ons for reputational and strategic risk in each of the risk areas (e.g., credit, market, liquidity, operational risks).</p>
Assessment	Largely compliant
Comments	<p>The CNB provides clear expectations and guidelines regarding governance and risk management systems that must cover all relevant risks, such as credit, market, operational, liquidity, concentration, reputation, and strategic risks and risks from related entities. On-site inspections focus on evaluating risk strategies, feasibility, and proper implementation.</p> <p>While inspectors evaluate the role and input from the supervisory boards, more emphasis and focus should be placed on supervisory boards. For example, the CNB should more formally evaluate the capability and participation of supervisory board members, through regular meetings with them and evaluation of minutes and board packages. Supervisory boards should formally approve strategies and policies.</p>

Principle 8.	Credit risk. Supervisors must be satisfied that banks have a credit risk management process that takes into account the risk profile of the institution, with prudent policies and processes to identify, measure, monitor, and control credit risk (including counterparty risk). This would include the granting of loans and making of investments, the evaluation of the quality of such loans and investments, and the ongoing management of the loan and investment portfolios.
Description	<p>EC1. Laws and implementing decrees require that banks, third country branches, and credit unions have, on a solo and consolidated basis, adequate credit risk management systems and strategies that define risk, assess risk, provide principles to set and manage risk, including permissible products, currencies, geographies and counterparties, and outline requirements for stress testing. The management board must regularly approve and assess credit risk strategies, and they (or a board committee) must approve new products and activities and set limits. Credit institutions are required to provide boards and staff with relevant, reliable and complete information. Senior management is responsible to the board for proper implementation. The CNB on-site examiners verify that credit institutions have appropriate, board-approved strategies and control systems, and that the board regularly evaluates implementation. Through sampling of loan and investment files and interviews with bank staff, inspectors evaluate credit quality, loan administration, compliance with policy and limits and the exception process, risk tolerance, and management oversight. On-site reviews, for example, include transaction testing (e.g., 100 commercial loan files and 100 retail loan files selecting large and high risk accounts) and interviews with bank staff (front and back office and risk management staff) to evaluate management's compliance with policy and legal requirements, form an opinion on the credit quality and usefulness of policies, identify systemic issues, evaluate the loan approval process and policy exception process, evaluate provision levels, etc. Inspections can last 2 months in a large bank and have 30 inspectors; a small bank inspection could be 3 weeks long.</p> <p>EC2. Credit institutions must have clearly defined criteria for approving, amending, and renewing loans and investments that include assessing purpose, source of repayment, collateral, and financial condition. They must also ensure continued monitoring of individual credits and of the portfolio, showing major sources of risk, impact on revenue, and proper valuations. The CNB provides rules on classifying loans, identifying impairment in the investment portfolio, and creating reserves for off-balance sheet items (see BCP 9). On-site examiners verify the adequacy of credit risk strategies and their every-day implementation.</p> <p>EC3. The CNB requires credit institutions to have separate, independent functions for credit risk management, credit administration, collateral valuation, funds disbursement, valuation systems and modeling, and information system development. Czech law prohibits lending on preferential terms (non arms-length). Loan officers, for example, would be expected to disclose possible conflicts of interest on loan proposals which would be subject to supervisory approval. On-site examiners verify that credit institution organizational structures and practices are appropriate and comply with requirements.</p> <p>EC4. The CNB officials have complete access to credit information, on a solo and consolidated basis. They also have access to the Central Credit Register.</p> <p>AC1. While the CNB rules require credit institutions have adequate credit risk management policies and strategies, there are no specific requirements regarding large</p>

	<p>or unusual credits. In practice, however, credit institutions in the Czech Republic use escalation procedures for loan approvals.</p> <p>AC2. Under the CNB rules, credit risk monitoring systems must capture all significant sources of risk and provide an undistorted picture of risks taken. Also, the central credit register records all exposures, on and off-balance sheet, extended to the corporate sector (nonindividuals). Credit institutions regularly perform credit analyses of borrowers and portfolios of like-credits which include consideration of future exposures.</p> <p>AC3. The CNB requires credit risk monitoring systems, and total indebtedness is considered a major parameter.</p>
Assessment	Compliant
Comments	Credit institutions are required to have appropriate and suitable credit risk management programs. Through transactional testing, the CNB inspectors verify the proper functioning of the program.
Principle 9.	Problem assets, provisions and reserves. Supervisors must be satisfied that banks establish and adhere to adequate policies and processes for managing problem assets and evaluating the adequacy of provisions and reserves.
Description	<p>EC1. The CNB rules require credit institutions to have strategies and procedures for administering credits, including problem credits. Borrowers are classified in two categories: not in default (standard and watch) and in default (substandard, doubtful, and loss). Default is where the borrower is unlikely to repay the debt in full and on time or 90 days delinquency (unless the amount is insignificant to the borrower after write-down). Borrowers as well as portfolios with similar characteristics are classified. IFRS and similar Czech accounting rules require credit institutions to identify impairment and apply appropriate reserves for securities, derivatives, and off-balance sheet exposures (the loan classification system is not used for them). At least quarterly reviews of classifications and provisions are required, with adjustments made as appropriate. Credit institutions must regularly check statistical models used to estimate losses in portfolios of like assets.</p> <p>EC2. During on-site reviews and transaction testing, the CNB examines the systems for classifying assets and calculating provisions along with compliance with rules and accounting procedures. External experts are not used.</p> <p>EC3. Credit institutions are required to monitor off-balance sheet items and apply provisioning rules at least quarterly.</p> <p>EC4. Credit institutions can use one of three methods to determine loss amounts: coefficient method, discounted future cash flows, or statistical models method as set out by the CNB rules. The coefficient method is used by smaller institutions and applies fixed percentages against loan classifications (1 percent watch, 20 percent substandard, 50 percent doubtful, and 100 percent loss). Larger banks use discounted cash flow calculations on large loans and historical loss performance on portfolios of like-assets. Two banks have been approved to use the advanced approaches which use Basel II-aligned probability of default and loss given default methodologies.</p> <p>EC5. Credit institutions are required to have appropriate credit risk management systems that include identification and management of problem assets and for collection. Banks use behavior models, financial statement reviews, public registries,</p>

	<p>and news reports, among other things to identify emerging problems.</p> <p>EC6. Credit institutions report monthly to the CNB with information on classified loans, past due loans, large classified credits, newly past due large loans, and a reconciliation of provisions and reserves.</p> <p>EC7. The CNB inspectors evaluate discounted cash flow assumptions and parameters used in back-testing portfolios. Inspectors have, and frequently use, the statutory power to require credit institutions to raise provisions and reserves or to worsen loan classifications.</p> <p>EC8. Onsite exams of asset quality, provisioning, and problem asset administration are conducted every two to three years. Problem banks will be monitored more intensively off-site, through reviews of compliance with action plans. However, on-site frequency does not necessarily increase because of problem bank status.</p> <p>EC9. The CNB rules provide qualitative guidelines for valuing risk mitigants, and credit institutions must establish appropriate policies including the frequency of revaluation. Values must be assessed quarterly for provisioning purposes. Where valuations are old or collateral is illiquid, higher provisions will be expected.</p> <p>EC10. Substandard, doubtful, and loss classifications are assigned to borrowers (not on a loan-by-loan basis) when full payment is uncertain, highly improbable, or impossible, respectively or nonpayment is 90 to 180, under 360, or over 360 days past due, respectively. Repayment from collateral is not considered in assigning a classification; it is considered when determining provision amounts. As a result, if there is expectation of some repayment from sources other than collateral, substandard or doubtful is assigned. If no such repayment is expected or if payment is 360 days past due (even when there is collateral value), the loan is considered loss. Collateral values are taken into account in the provisioning amounts. Impairment of a homogenous portfolio is determined through objective criteria such as changes in unemployment, property prices, and payment behavior.</p> <p>With the recent problems in the commercial real estate sector, loan restructurings are taking place. The CNB is evaluating bank compliance with the rules regarding such reschedulings whereby banks must classify the loans as defaulted and create appropriate provisions. However, infrequent on-site inspections is a concern (see BCP 20), as is below-average regional provisioning levels. Also, the CNB stress tests have set higher loss-given-default ratios despite low loan-to-value ratios and satisfactory recovery rates.</p> <p>EC11. Banks must regularly report to the management board current, reliable, and complete credit risk information as well as promptly report exceptions to limits that endanger acceptable levels of risk.</p> <p>EC12. Classifying portfolios of assets is only permitted on portfolios comprised of individually insignificant assets. Other assets are classified individually with provisions assigned, as appropriate.</p> <p>AC1. Loans are required to be classified at 90, 180 and 360 days past due, however, they may be classified (impaired) even without delinquency (see EC 10). Loans can be</p>
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	<p>upgraded when they are no longer impaired (full repayment of principle and interest) and there is a record of performance (usually six months). Refinancing of problem assets does not result in an upgrade in classification. Any restructuring, or change, in a loan where the bank has sustained loss is considered a forced restructuring and is considered impaired and classified substandard, doubtful, or loss (until it is no longer considered impaired).</p>
Assessment	Compliant
Comments	<p>Credit institutions must have appropriate problem asset programs which are reviewed by the CNB inspectors. It is suggested that the past due schedule of 360 days be shortened as it applies to unsecured as well as secured loans and appears excessive to the assessors.</p> <p>The ratio of loan-loss provisioning in relation to the total amount of NPLs is far lower for credit unions than for banks (approximately 15 percent versus 50). While this at least partly might be explained, e.g., by a higher degree of collateralization, the only way to ensure correctness is for the CNB to conduct onsite visits. The BCP assessors recommend narrowly targeted thematic onsite visits to all credit unions during a short period. This recommendation is also motivated by the high NPLs of credit unions and the much higher default frequency of credit unions as institutions compared to banks.</p> <p>A further reason to make targeted checks not only on credit unions but also on banks is the reported increase in loan restructurings. It is important that these are transparent and reported as NPLs (which may require provisioning) and not disguised in the form of “ever-greening” which is sometimes practiced by banks in various countries.</p>
Principle 10.	<p>Large exposure limits. Supervisors must be satisfied that banks have policies and processes that enable management to identify and manage concentrations within the portfolio, and supervisors must set prudential limits to restrict bank exposures to single counterparties or groups of connected counterparties.</p>
Description	<p>EC1. Article 2 PRD defines a group of connected counterparties as two or more natural or legal entities that unless proven otherwise represent a single risk because (i) they are mutually interconnected due to their relation of controlling entity and controlled entity, or (ii) their mutual relations are of such a nature that the financial difficulties of one of the entities may cause solvency problems to at least one of the other entities. The issues of connected counterparties are also regulated by the CNB Official Information, supplementing and specifying the above quoted Decree. The broad character of the legal definition makes it possible for the CNB to exercise discretion on applying the definition on a case-by-case basis.</p> <p>EC2. Article 13 BA stipulates that a bank shall observe the regulatory and bank-internal limits of assets and off-balance sheet exposures in relation to a single counterparty or group of counterparties relative to the bank’s capital on a solo basis. Article 189 PRD stipulates that a large investment portfolio exposure including all exposures to connected counterparties (with the exception of trading portfolio assets) shall mean an exposure whose value is equal to or higher than 10 percent of the bank’s capital funds reduced by deductible items. The PRD also provides for which scope and what exposures that can be fully excluded from the investment portfolio exposure calculations, for instance exposures to the government, the central bank, against cash, and to parent, subsidiary or sister credit institutions or investment firms if under consolidated supervision in the Czech Republic and controlled by the liable bank. The exemption also applies to exposures to persons with registered offices in the Czech</p>

Republic which control the bank or investment firm. (Example: A Czech bank's exposure to its Czech parent). The CNB noted that banks and, in particular credit unions, do not always adequately identify connected counterparties. This will then be challenged on the onsite examinations. The BA also require banks (with the exception of parent banks domiciled within the EU for which home country rules apply) to comply with the exposure rules on a consolidated basis. The PRD sets exposure limits for investment portfolios. Assets, liabilities, and off-balance sheet items are included. The general responsibilities for senior managers of a bank for performing and monitoring the strategies and rules set by the board of directors apply also for concentration risk management. In addition, senior management must comply with detailed requirements for concentration risk management as laid out in Annex 1 of the PRD. A bank shall establish and maintain a set of limits for credit risk management and corresponding procedures. The limits must be commensurate with the nature, scope, and overall complexity of the bank. The board of directors shall regularly assess reports and extraordinary findings on concentration risk. Banks and credit unions must report to the CNB on a monthly basis all large exposures, i.e., exceeding 10 percent of the bank's own funds. Any violation of regulatory concentration limits must be reported to the CNB without undue delay. Similar rules on concentration risk apply to credit unions.

When exceptions to the limits are found, the CNB will require credit institutions to correct, within a short period of time, the breach by reducing the exposure to within the limit. Large or significant breaches are referred to the enforcement division.

The regulatory limit for exposures in the trading book is set at 600 percent of the bank's capital (since this is regarded as short term). Such exposures shall also be offset by additional capital requirements which, however, are less than 100 percent of the exposures. However, most banks apply internal limits which normally aggregate exposures to the same client in the investment, loan, and trading portfolios and in the trading portfolio.

EC3. Article 21 PRD obliges banks to ensure that the relevant bodies, internal as well as supervisory and other, have access to up-to-date, reliable, and comprehensive information. This fully applies also to concentration risk, and it includes the actual monitoring of the exposures on a solo and consolidated basis.

EC4. Article 25 PRD requires banks and credit unions to establish limits for risk management. The limits are approved by the board of directors, or a designated committee thereof. The set of limits shall always include the limits for credit, market, concentration, and liquidity risk. In compliance with the PRD, the board of directors is regularly informed of the compliance with the rules of exposure and the risk of concentration. All exposures above the bank-internal limit, usually 5 or 10 percent of capital, are reported to the management board.

EC5. The Provision of the CNB requires banks to report monthly on a solo basis and quarterly on a consolidated basis a list, item-by-item, of all exposures exceeding 10 percent of the bank's capital, both to a single counterparty and to groups of connected counterparties. Banks must also report quarterly on the 15 debtors or creditors with the largest volumes of debts or claims. Currency concentration risk must be reported without undue delay if the absolute value of the net foreign exchange position for a single currency exceeds 15 percent of the bank's capital or if the total foreign exchange net position exceeds 20 percent of the bank's capital. Corresponding

	<p>reporting requirements apply for credit unions, with the exception that the currency structure of assets and liabilities is not monitored. The CNB assesses the reports from banks and credit unions by off-site monitoring. On on-site inspections, the supervisors confirm that the systems used by banks are reliable and that reported information is reliable. In the PRD there is a general statement that “Banks should consider all concentration risks”. This is interpreted to include sectoral and geographical risks and banks are expected to identify and manage such risk as a part of their business plans.</p> <p>AC 1. The PRD decree sets the limit for a large exposure in the banking book to 25 percent of capital funds. As noted in EC 2 above, the limit for large exposures in the trading book is 600 percent. According to an EU Directive exposures to parent or sister banks or investment firms located in EU member states and supervised by those on a consolidated basis, may also be fully or partially exempted from the application of the large exposure limits (Example: A Czech bank’s exposures to parent banks abroad, or sister banks or investment firms. The PRD allows partial exemption so that these exposures are limited at 100 percent of the bank’s capital funds.). The same applies to exposures to investment firms’ parents or sisters in third countries, provided that these countries are deemed to have as strict regulation and supervision as in the Czech Republic.</p>
Assessment	Largely compliant
Comments	<p><i>The deficiencies mentioned below mainly, with the exception of not having a sufficiently broad definition of an exposure to a counterparty, which should include trading book items, refer to the additional criteria, which according to the BCP Methodology are not taken into account in the rating of compliance. However, the BCP assessors are of the view that the weaknesses increase the risks to the Czech banking system, in particular considering the structure of the system which is dominated by a small number of large foreign-owned groups. The assessors recognize that the Czech rules are fully in line with EU regulations. However, other EU countries have used the available legal room for “national discretion” and have set stricter requirements.</i></p> <p>Common international practice is that all exposures to one counterparty or connected group of counterparties are aggregated under the limit for concentration risk (usually 25 percent of the credit institution’s capital funds). The rules may allow for temporary violations of the limit, e.g., due to short-term movements in the exposures in the trading portfolio. Such violations would then be fully offset by additional capital requirements (koruna-by-koruna against the excess exposure). The Czech practice of not limiting trading exposures and not offsetting them by capital to the full extent is thus not in line with international practices as set by the globally agreed BCP (even though it is in line with the relevant EU regulation). The BCP assessors recommend that the rules be changed accordingly.</p> <p>Although the regulatory intra-group limit for EU credit institutions (100 percent of capital funds) is fully in line with the minimum requirements of the EC Directive, the BCP assessors find this high and would recommend the CNB to try to cap this to the globally agreed limit of 25 percent of capital or lower which is also applied by several EU countries. The timing of such a change in regulations should take into account the overall situation and vulnerabilities of the banking sector. As an intermediate measure, the CNB might strengthen the expectations on risk management practices by banks, for instance by requesting banks to set lower internal limits, e.g., for long-term exposures, or unsecured exposures, to other group members outside the Czech Republic. (The BCP assessors note that the CNB is aware of those risks to Czech subsidiaries of</p>

	<p>cross-border groups and have strengthened its monitoring, e.g., by requiring frequent reporting of liquidity developments and transactions within the group.) Similarly, the unlimited possibility for intra-group exposures to regulated entities in the Czech Republic might lead to excessive risk taking. The BCP assessors suggest that the CNB issues guidelines to banks interpreting the BA on what could be considered to be “prudent” in this respect.</p> <p>Credit institutions have experienced problems in correctly identifying “connectedness” of counterparties. This has sometimes led to inappropriate exposure concentrations. The CNB should therefore issue further guidance on the interpretation of the definition provided in the existing regulations, e.g., elaborating on the EBA guidelines, which the CNB apply in its supervision.</p>
<p>Principle 11.</p>	<p>Exposures to related parties. In order to prevent abuses arising from exposures (both on-balance sheet and off-balance sheet) to related parties and to address conflict of interest, supervisors must have in place requirements that banks extend exposures to related companies and individuals on an arm’s length basis; these exposures are effectively monitored; appropriate steps are taken to control or mitigate the risks; and write-offs of such exposures are made according to standard policies and processes.</p>
<p>Description</p>	<p>EC1. Article 129 BA defines a wide range of related parties to a bank and the scope is in line with international standards. The list includes members of the board of directors, the supervisory board, the bank officers, and the persons controlling the bank; persons close to any of the aforementioned (family members); entities controlling the bank, persons having qualifying holdings in those entities, and members of the management of those entities; legal entities in which board members, bank officers, or controlling persons have a qualifying holding; persons having qualifying holdings in the bank, and any legal entities controlled by them; members of the Bank Board of the CNB; and entities which the bank controls. It is important to note that risks from related party transactions in the Czech Republic is somewhat reduced because board members, bank management, and bank employees are prohibited from engaging in business activities other than their bank employment. This rule does not, however, apply to credit union managements.</p> <p>Article 8b CUA stipulates that for credit unions, members of the credit union, or of its elected bodies, managerial persons and persons close to them under the Civil Code should be regarded as related parties. Since credit unions may not acquire holdings in other legal entities, those will not be part of related parties.</p> <p>The CNB as a supervisor does not have, by operation of law, the power of exercising discretion beyond the statutory enumeration of related parties to banks or credit unions, on a case-by-case basis. However, the regulation includes “close persons to the related parties”. This will provide room for some judgment on the part of the supervisors, although it may be difficult to prove the close relationship in some cases.</p> <p>EC2. Article 18 BA stipulates that a bank may not enter into transactions with related persons on terms, considering the nature of the transaction and its risk, which would not be entered into with other clients. Any violation would meet the criteria of Article 26 BA of a so-called shortcoming in the activities. One of the remedial measures to rectify such shortcoming is the prohibition or restriction of transactions with related parties (Article 26 BA). Similar provisions apply to credit unions. Furthermore, the PRD stipulates that banks’ and credit unions’ transactions with related parties must be concluded according to the conditions customary to the relevant market (Annex 1</p>

PRD).

EC3. Article 18 BA stipulates that a bank may provide loans to, and secure the commitments of, related parties only if its board of directors so decides after analyzing the financial transaction in question and the applicant's financial standing. The BA does not explicitly require that board members with conflict of interest be excluded from this approval process but provide general principles about banks having to avoid "conflicts of interest." Hence, it is expected by the CNB that bank-internal governance rules require such exclusion.

EC4. Article 8b BA stipulates that a bank shall have a system of governance, within which conflicting duties shall be defined, as well as the procedures for preventing potential conflicts of interest. Areas of possible conflict of interest must be subject to ongoing independent monitoring and actual conflicts must be identified so that preventive measures may be applied. When performing supervision, the CNB checks whether an institution applies such an organization of the entire credit process. It concerns particularly the examination of the adequate division of powers and the limit system with respect to loan approvals. That said, the CNB allow banks to use the same procedures for related lending as for any other lending. The condition of arms-length lending (at terms which are normal and not favorable to the borrower) applies and must be strictly monitored by the bank.

EC5. Generally, the same limit applies as for exposures to a single counterparty or group of connected counterparties, i.e., 25 percent of the capital funds. However, Article 182 PRD exempts some related parties from the limit (See CP 10, AC1). Neither the BA, nor the CUA entitles the CNB to require the collateralization of exposures to related parties. Capital investments exceeding 10 percent of the registered capital of the individual entities must be deducted from the acquirer's own funds. Article 15 BA and Article 11 CUA prohibits certain transactions between a bank or credit union and legal persons with a qualifying holding or persons who act in concert or have control over it. Credit unions are prohibited from acquiring holdings in the registered capital of a legal entity, or becoming a member, partner, shareholder of a legal entity or acquiring influence in the management of a legal entity in a different way. Related parties are not automatically regarded as a connected group (in the terms of concentration risk), but if there are proven relationships between certain related parties exposures such as a common main source of income for the related parties concerned (for instance in their positions as managers of the bank) to those will be aggregated as representing a single risk.

EC6. Pursuant to the PRD, a bank or credit union must have an approved risk management strategy which, i.a., contains rules and methods for credit risk management and systems for credit risk measurement and monitoring. Banks and credit unions are obliged to establish and maintain a set of limits for credit risk, and procedures for credit risk measurement and monitoring. This must be approved and monitored by the board of directors. Violations of limits shall be accompanied by adequate procedures, including information flows. Deals in payments on related party exposures will be monitored and reported according to the same procedures as other exposures. In its supervision, the CNB reviews internal rules for limits and restrictions for approving loans. Moreover, the CNB checks whether a bank or credit union has procedures in place with respect to providing loans to employees, members of their group, related parties and so on. For instance, the CNB will check that the credit

	<p>institution's internal audit will cover adequate reporting of problem exposures, whether to related parties or to other parties.</p> <p>EC7. Should the exposure to a related party or connected group of related parties exceed 10 percent of the bank's own funds, it will be recorded in the monthly report to the CNB on a solo basis and quarterly report on a group consolidated basis. There is no separate reporting on related exposures—even on aggregate basis. The reporting is merged with the reporting on large exposures to any counterparty.</p>
Assessment	Materially noncompliant
Comments	<p>The BCP assessors acknowledge that the CNB already addresses related party lending through general provisions for banks and credit unions, e.g., requiring them to establish policies for avoiding "conflicts-of-interests" and for mitigating risks to the institution. There exist also strict rules that transactions with related parties must be conducted on purely market-based terms. That said, CP 11 sets the bar higher: It requires supervisors to have a dedicated set of rules for related party transactions. The rules should contain, among other things, clear prohibition for a person who is close to the beneficiary of being part of the process to take part in the preparations or in the decision itself. Decisions on all significant transactions should be escalated to the Supervisory Board level, which should also be immediately informed of any significant delays in the fulfillment of obligations of related parties. There should also be dedicated processes for the audit and the reporting of transactions with related parties. Finally, the aggregate limit for all exposures to related parties should not exceed 25per cent of the bank's capital. The BCP assessors find that the Czech rules fall short of the BCP bar, mainly since they do not treat related party lending as a specific issue but as an issue of risk management in general.</p> <p>There should be an explicit prohibition for bank managers and staff to take part in loan processes (or other transactions) in which there might be a conflict of interest, in particular to closely related parties.</p> <p>The CNB should be provided with the power to require that all or some exposures to related parties are collateralized, in particular when the exposures are large or risky.</p> <p>Aggregated exposures to all related parties, excluding exposures to group credit institutions and investment firms under consolidated supervision, should have a limit which should not be higher than 25 percent of capital.</p> <p>Reporting of exposures to related parties should be separate from reporting on large exposures in general and should be on an individual basis, except for insignificant transactions.</p> <p>Banks should have internal rules for immediate reporting to the board level of delays in payments of related party exposures.</p>
Principle 12.	Country and transfer risks. Supervisors must be satisfied that banks have adequate policies and processes for identifying, measuring, monitoring, and controlling country risk and transfer risk in their international lending and investment activities, and for maintaining adequate provisions and reserves against such risks.
Description	EC 1. The requirements for country risk and transfer risk are included in the requirements for credit risk management. Pursuant to the PRD (Article 26), a bank and a credit union should have a risk management strategy appropriate to the nature,

	<p>scope and complexity of its activities. Banks and credit unions should apply specific policies to implement this strategy. The PRD stipulates that banks must assess whether countries with which they have transactions are eligible. Such assessments include transfer and other country risks. Annex 1 PRD sets out requirements for credit risk measurement and monitoring, including to establish and maintain a set of limits, such as for individual counterparties, states, geographical areas, or for individual activities. All these requirements apply to country risk and transfer risk to the full extent.</p> <p>EC2. During their on-site inspections, the supervisors review the information systems, the risk management systems, and the internal control systems for country and transfer risks.</p> <p>EC3. Although this is not explicitly mandated by law, the CNB expects, in particular, large banks to assess the receivables from financial activities also on a country-by-country basis as well as maintains provisions and reserves (See also CP 9). Detailed rules for this are set in PRD Articles 194 to 205. On the on-site examinations, the supervisor examines the system for provisioning and makes random checks of the amounts for provisions set with respect to receivables. The sufficiency of provisioning is also included in the normal audits of the annual financial statements for the bank.</p> <p>EC4. Banks must report quarterly to the CNB (credit unions' foreign exposures are insignificant and fall below the de minimis limit for reporting country and transfer risk) on their exposures to individual countries and the structure of the exposure as to selected types of on-balance sheet and off-balance sheet assets and liabilities. These reports are assessed by the CNB in its off-site monitoring activities. During its on-site inspections, the CNB will check that the measurement system and procedures are reliable and that the reported data are correct.</p>
Assessment	Compliant
Comments	
Principle 13.	Market risk. Supervisors must be satisfied that banks have in place policies and processes that accurately identify, measure, monitor, and control market risks; supervisors should have powers to impose specific limits and/or a specific capital charge on market risk exposures, if warranted.
Description	<p>EC1. The CNB rules require that credit institutions have market risk management strategies, which include defining, evaluating, monitoring, stress testing, and limiting market risk. Management boards must approve the strategies and must receive current, reliable, and comprehensive information. The CNB examiners evaluate suitability of strategies and implementation.</p> <p>EC2. Market risk limits must be approved and regularly reviewed by the management board or board committee, and senior management must regularly, and upon material changes in market conditions, evaluate limits. The CNB examiners evaluate adherence to limits during on-site reviews, but they have not seen instances where limits have been breached. Large Czech banks have limited market risk exposure, except indirectly through parents. The estimate provided was under 3 percent of capital, with the largest positions in Czech bonds (only very small positions in corporate bonds). Banks must calculate market risk exposure when it exceeds 3 percent of capital, and large banks set limits based on Value at Risk.</p> <p>EC3. Information systems must be able to capture all transactions and market risks in a</p>

	<p>timely and accurate fashion with independent valuations. If models are used, they must comply with the CNB guidelines. The CNB examiners evaluate adequacy of information systems, valuation methods, and provision system. Provisions are created if there is a danger of default or downgrade. There are no prohibitions against purchases of unusual investments; however, banks must demonstrate an ability to perform appropriate valuations. There are no foreign exchange position limits; however, those that exceed 15 percent for an open net position in a single currency and 20 percent for the aggregate net position in all currencies must be reported to the CNB.</p> <p>EC4. The CNB requires credit institutions to perform regular stress tests to include extraordinary adverse market movements. Results are used by firms to evaluate their procedures and limits. During on-site inspections, specialists from the CNB market risk team evaluate the bank stress tests, how the tests are utilized, and how results are considered in risk management and strategic planning.</p> <p>AC1. Valuations and models must be performed independently of business lines. Also, models must be tested by parties independent of their development.</p>
Assessment	Compliant
Comments	The CNB requires that banks have appropriate market risk management processes. Banks must set limits, monitor activity, independently value positions, and perform stress testing. The CNB has the authority to limit activity, if necessary.
Principle 14.	Liquidity risk. Supervisors must be satisfied that banks have a liquidity management strategy that takes into account the risk profile of the institution, with prudent policies and processes to identify, measure, monitor and control liquidity risk, and to manage liquidity on a day-to-day basis. Supervisors require banks to have contingency plans for handling liquidity problems.
Description	<p>EC1. Although the CNB is authorized to establish liquidity minimums, it uses qualitative standards that follow Basel guidelines. Credit institutions are required to have liquidity strategies for daily liquidity management as well as contingency plans. Such strategies and plans must include off-balance sheet activities.</p> <p>EC2. Management boards are required to approve and regularly update risk management strategies and limits, including liquidity risk. The CNB examiners evaluate liquidity strategies and policies, verify board approvals, and assess implementation by management. Weekly liquidity reports from large banks are monitored by the CNB. Czech banks have been carrying very large liquidity surpluses (with deposit-to-loan ratios of 130–140 percent) and, according to the CNB, the volume of reverse repos between the large banks and the CNB is sufficient to cover all liquidity needs, without need to consider the banks' Czech bond portfolios. A severe stress event will not result in needs above the reverse repo amounts. Also, large exposure limits of 25 percent of capital, and foreign exchange risks for parents associated with Czech crown funding, provide limits on the outflow of liquidity to parent banks.</p> <p>EC3. During onsite reviews, the CNB evaluates the effectiveness of liquidity strategies and daily processes, implementation, and reporting. It also evaluates management capability and effectiveness.</p> <p>EC4. The CNB requires monitoring of funds flows, daily net cash flows (five days in advance), maturity calendars, and liquidity position calculations. Credit institutions must sufficiently stabilize and diversify funds, develop contingency plans, perform stress</p>

	<p>tests, and regularly verify assumptions. Stress tests must include three scenarios: idiosyncratic, market-driven, and a combination of the two. The banks credit and market stress tests are incorporated in the liquidity stress tests.</p> <p>EC5. Monthly, credit institutions provide the CNB with liquidity reports by maturity and currency for assets, liabilities, and off-balance sheet activities. During on-site reviews, the CNB evaluates strategies and processes employed by credit institutions for all significant currencies. Czech banks do not engage in any material foreign exchange trading, or in providing loans in foreign currencies.</p> <p>EC6. During on-site reviews, the CNB confirms that credit institutions have appropriate and regularly updated plans for liquidity crises. These plans must include timely information flows, clearly defined responsibilities, and communication protocols with funds providers, clients, others and the public, and sources for emergency funds.</p> <p>AC1. While stress testing by currency is not required, the CNB requires that credit institutions have processes for measuring and monitoring liquidity in the main currencies in which it operates. The CNB examiners evaluate credit institution liquidity risk management for main currencies, including limits, whether institutions analyze market risks that can influence foreign currency access, and consideration of currency exposures in stress tests.</p> <p>AC2. The CNB requires banks to periodically review their risk management system, including communicating with important creditors and correspondent banks, establishing information flows, and maintaining a presence on the interbank market. The CNB inspectors review such activity.</p>
Assessment	Compliant
Comments	Banks are required to have liquidity strategies, policies, and procedures, including contingency plans, and perform stress tests. The authorities expect to introduce quantitative liquidity rules when the relevant EU Directive (to be passed), reflecting the Basel III rules, comes into effect.
Principle 15.	Operational risk. Supervisors must be satisfied that banks have in place risk management policies and processes to identify, assess, monitor, and control/mitigate operational risk. These policies and processes should be commensurate with the size and complexity of the bank.
Description	<p>EC1. Credit institutions are required to have risk management strategies that designate the principles, methods, and acceptable levels of operational risk, evaluated and amended on a regular basis. Onsite examiners evaluate such strategies and their proper implementation.</p> <p>EC2. Management boards are required to approve strategies, oversee implementation, discuss matters of concern with management, and annually evaluate functionality, and timely address findings of auditors and others. Supervisory boards monitor the activities of the institution, including serious exceptions to policies and limits.</p> <p>EC3. During on-site inspections, the CNB evaluates the adequacy and implementation of strategies to address operational risk, including information systems and security, and assesses board approvals, oversight, and periodic re-assessment of strategies.</p> <p>EC4. Credit institutions are required to maintain contingency and business resumption</p>

	<p>plans that are regularly tested and updated, and with which employees are familiar. While there are no requirements for the frequency of tests, the CNB expects frequent testing of IT systems. The CNB expends considerable resources and employs specialists to inspect adequacy of institutions' plans. There is a staff of 15 on the credit and operational risk on-site team. Inspectors evaluate internal controls, IT infrastructure, and contingency planning, among other things. As the team inspects all of the CNB-supervised financial institutions, it is well suited to horizontal analysis of financial institution programs and industry trends.</p> <p>EC5. The CNB rules impose detailed requirements for information systems and technology, and the CNB employs specialists to assess adequacy of strategies, implementation, and day-to-day management. Banks usually use in-house, or shared (intra-company), services.</p> <p>EC6. Quarterly, credit institutions are required to publish information about operational risk management, measurement and assessment processes, organization, and risk reduction techniques. Information is provided on responsible parties, how the institution defines operational risk and the calculation methods used important findings of the measurement process, risk mitigants used, and comparison of size of operational risk compared to other risks. Also quarterly, banks provide commentaries on the three greatest operational risk losses in three categories: electronic banking, information systems, and other.</p> <p>EC7. Legal and compliance risks must be included in operational risk management processes, and the CNB examiners evaluate the processes along with methodologies used to resolve legal disputes and assign reserves.</p> <p>EC8. Credit institutions must notify the CNB of any outsourcing activities. Overall responsibility, including compliance obligations and reporting requirements, is retained by credit institutions regardless of where activities are sourced, and CNB retains supervisory authority over such activities. The CNB evaluates outsourcing management, including processes to ensure service providers meet compliance and reporting obligations. The CNB coordinates with foreign supervisor in the case of cross-border outsourcing.</p> <p>AC1. Operational risk obligations apply on a solo and consolidated basis and incorporate all risk areas, including custody and correspondent banking. The CNB examiners perform evaluations on a group-wide basis.</p>
Assessment	Compliant
Comments	The CNB provides clear expectations and guidelines regarding operational risk. Onsite inspections focus on evaluating risk strategies, feasibility, and proper implementation.
Principle 16.	Interest rate risk in the banking book. Supervisors must be satisfied that banks have effective systems in place to identify, measure, monitor, and control interest rate risk in the banking book, including a well defined strategy that has been approved by the Board and implemented by senior management; these should be appropriate to the size and complexity of such risk..
Description	EC1. Credit institution management boards are required to approve, and regularly evaluate, interest rate risk management strategies, including establishing limits. Limits are set for both the banking and trading books. Senior managers are required to apply the strategies. The CNB evaluates such strategies and their implementation during onsite reviews.

	<p>EC2. Credit institutions are required to maintain a system for the management of interest rate risk that includes measuring risk separately for each currency and for assessing limits. Onsite examiners evaluate whether limits reflect strategy, exceptions are monitored by management, and staff are familiar with limits.</p> <p>EC3. The CNB rules outline requirements for quarterly stress tests using one of two methods: assuming a parallel shift in the yield curve of 200 bp for one year, and determining the change in the yield curve at a 99 percent confidence level. A stress test result that shows a 20 percent drop in economic value of capital requires notice to the CNB and remedial action. Such stress tests are evaluated during on-site inspections.</p> <p>AC1. Quarterly, banks submit to the CNB a report showing assets and liabilities by revaluation bands, type of interest rate, and results of stress tests using standardized shocks, overall and by currency. The CNB has a sectoral view of customer behavior and of the tenor and extent of IRR in the Czech Republic, and believe, for example that a European sovereign debt default would cause minimal change in the Czech yield curve.</p> <p>AC2. During onsite reviews, the CNB evaluates stress tests and the impact of interest rate risk on Pillar 1 and 2, including its effect on economic capital.</p> <p>AC3. The CNB rules specify the two permissible stress testing methods. The CNB examiners evaluate assumptions and inclusion of all sources of risk, and verify that results are incorporated in planning and policy-making.</p> <p>AC4. The CNB requires that approval of limits, valuation systems, and models are independent of business activities.</p>
Assessment	Compliant
Comments	Banks are required to have appropriate interest rate risk strategies that include establishing limits, measurement and monitoring systems, and stress tests.
Principle 17.	Internal control and audit. Supervisors must be satisfied that banks have in place internal controls that are adequate for the size and complexity of their business. These should include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding the bank's assets; and appropriate independent internal audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.
Description	<p>EC1. The CNB rules establish management board responsibility for the creation and assessment of a governance system and for its maintenance and effectiveness. Rules specify the requirement for internal control mechanisms, including separation of incompatible functions and internal audit. Senior management is responsible for the execution of board policies and maintenance of an effective organization.</p> <p>EC2. Rules explicitly address, for example: recordkeeping obligations for decisions, design of processes to prevent conflicts, early identification and independent monitoring of possible areas of conflict, independent verification of books and data by internal audit, four-yes principle (e.g., for compliance with rules, approval of limit exceptions, transaction details, reconciliations, model verification), and security of material assets. In addition to review during on-site examinations of individual risk</p>

	<p>areas, the CNB assesses corporate governance and internal control systems overall, including internal audit, compliance, governance, organizational structures, and information flows.</p> <p>EC3. The management board approves and regularly assesses the risk management strategy and internal control system. It designates principles for human resource management, including requirements for qualified staff. Senior management is responsible for implementing board policies. The CNB verifies governance programs and knowledge levels of management. As described in BCP 7, the supervisory board is not required to approve strategies, policies, or the control environment although the CNB expects it to provide proper oversight of bank activities.</p> <p>EC4. The CNB has the power to require credit institutions replace management and board members in the event that shortcomings in the institution's activities are identified.</p> <p>EC5. The CNB evaluates the skills and resources of control functions during on-site reviews. This involves evaluating staffing levels, organizational structure, and testing of transactions to evaluate competence of staff and auditors.</p> <p>EC6. Credit institutions must have independent compliance functions to ensure compliance with legal and internal policies that inform senior management and the board of significant deviations and inform senior management of new and other requirements. The management board must approve, and annually evaluate, the compliance system. During on-site reviews, the CNB evaluates the compliance program and that it is kept up-to-date and includes training and communication processes. Inspectors test transactions, evaluate planning processes of the compliance function, and the quality of reports submitted to management and supervisory boards.</p> <p>EC7. The CNB requires that credit institutions have an internal audit function that operates on a permanent and consistent basis covering all bank functions and headed by at least one officer or by a third party contract (or combination).</p> <p>EC8. Internal auditors must have the necessary capacity, access to information, and organizational independence to perform their functions. Auditors must be qualified for the task and be of good repute. The head auditor is required to inform the management board if he or she believes that staffing levels are insufficient. The head auditor must be permitted to attend board and audit committee meetings at his or her discretion; however, he or she does not participate in decision-making. Auditors must produce reports in a timely fashion and report findings to the board, supervisory body and the audit committee. For significant issues, an extraordinary meeting of the supervisory body is required.</p> <p>One-year plans, and three to five-year strategic plans, are submitted and approved by the management board that outline audit work after taking into account senior management and board suggestions and regulatory requirements. Also, a risk analysis is performed that considers probability and extent of failure in each risk area. All credit institution activities are subject to internal audit, including those that are outsourced. While there are no requirements regarding the scope of annual audits (i.e., all areas in a year), the CNB considers the high priority areas to be: compliance with prudential rules and internal policies, risk management and internal controls, reliability of</p>
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	<p>information, and physical security.</p> <p>The CNB examiners conduct a full range verification of the internal audit function, and where there are shortcomings they determine the likely cause, which might be the level and competence of staff. Inspectors also consider the management responsiveness, whether timely and effective, to audit findings.</p> <p>AC1. The Czech Republic uses a bicameral board structure. Management boards are comprised of bank senior management representing the major risk areas. Supervisory boards must have at least three members and they are elected by the shareholders.</p> <p>AC2. Credit institutions must establish audit committees, unless exempted by law (e.g., small banks). Most banks in the Czech Republic use audit committees. The head auditor reports to the audit committee or management board and is required to inform the management board of findings and the supervisory board and audit committee of serious deficiencies.</p> <p>AC3. Audit committees must have at least three members, of which one must be independent of bank management. Typically, for large banks, the members are executives of the parent bank. Audit committees oversee the internal audit, risk management, and internal control systems as well as reporting systems, and provide advice on selecting external auditors.</p> <p>AC4. While credit unions are required to notify the CNB of the loss of professional fitness or propriety of senior managers and board members, there is no such requirement of banks. However, banks in practice notify the CNB of such circumstances.</p>
Assessment	Compliant
Comments	<p>Banks are required to develop and maintain appropriate internal audit and control systems that provide for accountability, separation of the functions, safeguarding of assets, and proper reconciliation processes; and appropriate independent internal audit and compliance functions. The CNB assesses the adequacy of these functions during on-site inspections and using transaction testing. The CNB reads the internal audit reports and, for instance, uses them as an input for focusing future on-site visits or other monitoring of the bank.</p> <p>Laws, regulations, or the CNB should encourage an increased use of independent members of banks' supervisory boards, in particular in subsidiaries to large bank or financial groups. The existence of such members will strengthen banks' corporate governance.</p>
Principle 18.	Abuse of financial services. Supervisors must be satisfied that banks have adequate policies and processes in place, including strict "know-your-customer" rules, that promote high ethical and professional standards in the financial sector and prevent the bank from being used, intentionally or unintentionally, for criminal activities.
Description	<p>EC1. The CNB and the MOF are responsible for AML/CFT and financial crime oversight in CNB-supervised entities. Credit institutions are required to notify the FIU (the Czech Financial Analytical Unit which is part of the MOF) of suspicious activities related to AML/CFT; other financial crimes are reported to police. The FIU can impose fines for violations and can recommend revocation of licenses. In cases of banks, such recommendations are considered by the CNB for consideration and action. The CNB</p>

must also report suspicions uncovered during inspections to the FIU, and it provides the FIU with conclusions on AML/CFT inspections. The CNB can also penalize banks for weaknesses or noncompliance. The CNB and the FIU coordinate responses in such cases. The FIU provides the CNB with information collected on credit institutions. The police conduct criminal investigations and prosecutions are handled by independent state prosecutors.

EC2. Credit institutions must have written ethics policies, policies to control the risks arising from financial crime, as well as AML/CFT policies, procedures, and controls in conformance with legal specifications and designed for the particular institution, and the program must be provided to the FIU and the CNB. An officer must be designated with responsibility for communicating with the FIU on AML/CFT matters, and staff must be trained and familiar with requirements. The legal requirement for reporting of suspicious activity is limited to reporting of suspected money laundering or terrorist financing (not other suspected crimes).

EC3. Credit institutions notify the FIU of suspicious activity related to AML/CFT. The FIU provides the CNB with the number of reports filed by the institution, the FIU's assessment of the institution's AML/CFT program, and the name of the reporting officer. Quarterly, credit institutions notify the CNB of the three largest loss events, including from fraud. However, there is not a requirement to inform the CNB of all material incidents of fraud and possible threats to reputation.

EC4. Credit institution AML/CFT program must include, among other things, examples of suspicious activity, customer identification and verification procedures (including PEPs), risk assessment processes, recordkeeping requirements, and suspicious activity reporting requirements. Concerns identified during the assessment or in the April 2011 Moneyval (Council of Europe's Committee of Experts on the Evaluation of Anti-Money Laundering Measures and the Financing of Terrorism) report are as follows:

- Customer due diligence should include practices outlined in international guidance (e.g., General Guide to Account Opening and Customer Identification (BCBS)); identification processes for low-risk customers are needed; and measures and guidelines are needed to ensure beneficial owners are verified, including those that may be low risk and including natural persons acting on behalf of beneficial owners.
- Bearer shares are permitted in the Czech Republic; however, the CNB does not provide guidelines to institutions on how to control these high risk accounts.
- Beneficial owners need not be verified when the source of funds has been verified.
- Procedures on PEPs and private banking accounts require escalation to the supervisor but not to senior management.
- The definition of PEPs is limited and does not include certain politicians.

EC5. Management board approval is required for the establishment of a correspondent banking relationship, and credit institutions must perform due diligence on the counterparty (understand its business, quality of supervisory oversight, and AML/CFT measures). Direct or indirect relationships with shell banks or with banks not adequately supervised, or under adequate regimes, are not permitted.

EC6. During on-site inspections, the CNB AML specialists evaluate the adequacy of AML/CFT programs. There are no specifications for the frequency of such exams, and they can lapse as long as five years which is considered inadequate by the assessors. Inspectors test transactions to evaluate customer due diligence and account opening procedures, risk profiles, and correspondent bank accounts. Analytical tools to identify unusual customer behavior and cash activity are evaluated as are internal investigation procedures and suspicious activity reports. Training programs are also assessed. Operational risk inspections evaluate bank procedures to prevent and identify other financial crimes. Large banks typically have special security departments to deal with fraud and other financial crimes.

EC7. As with other shortcomings, when the CNB identifies noncompliance with AML rules, it can take remedial action or sanctions against the institution. It must inform the FIU of deficiencies without delay. If the FIU identifies gross or repeated breaches by a financial institution, it submits a suggestion to the CNB for the revocation or cancellation of the financial institution's license. The CNB has 30 days to present its course of action to the MOF. While there are a number of offenses for which penalties are provided for under the money laundering act, fines of up to CZK 1 million (roughly \$50,000) can be assessed for failure to prepare or deliver an AML program. While other laws (e.g., the Act on Banks, Act on Criminal Liability of Legal Entities) may be available to provide higher fines, the law most specific to the particular deficiency may be the most relevant, and Moneyval concluded that the fine for deficient AML programs provided in the money laundering act was insufficiently dissuasive.

EC8. The CNB rules require banks to have appropriate audit and compliance function, designated staff to report AML/CFT findings to the FIU and to provide an annual assessment of the AML program to the board of directors, designated staff to provide AML/CFT training, and the training program be updated to reflect emerging issues. There is not a requirement that the compliance function, designated staff, or the training program address other financial crimes. There is no requirement that dedicated compliance officers be at the management level, that they are the person to whom suspicions or crimes are reported, or that their responsibility includes financial crimes other than AML/CFT. The CNB inspectors evaluate such programs as well as hiring programs and practices during onsite reviews.

EC9. Credit institutions are required to have current, reliable, and effective AML policies that must be provided to the FIU upon development and amendment. Operational risk policies address other significant areas of risk, such as other financial crimes. Inspectors evaluate the program and management information systems during onsite inspections.

EC10. Secrecy laws can be breached allowing for the reporting of client information, and credit institutions are obligated to report suspicious AML/CFT activity. There are no specific legal provisions that protect bank employees that report suspicious activity, in good faith, to the authorities. The CNB does not believe it is necessary to provide such protections as employees are not identified in the suspicious activity reports and banks, not employees, would be liable in lawsuits. Also, the bank cannot terminate an employee without legitimate reason (the Labour Code defines the acceptable reasons). Even when an employee acts negligently, there is a limit on penalties of 4½ times his or her monthly salary.

	<p>EC11. The CNB must report suspicions regarding AML/CFT uncovered during inspections to the FIU, but not other financial crimes. Professional confidentiality laws do not apply in connection with AML and maintaining international peace and security, and for criminal proceedings.</p> <p>EC 12. Supervisory and client information may be provided to international organizations and foreign states responsible for fighting crime or responsible for criminal proceedings.</p> <p>AC1. The CNB employs AML/CFT specialists to conduct on-site supervision and has liaisons to interact with the FIU and law enforcement.</p>
Assessment	Materially noncompliant
Comments	<p>Credit institutions are required to have specific AML/CFT programs. Operational risk management systems cover other financial crime. There are a number of matters identified herein and/or by Moneyval that do not meet the minimum Basel standards. The following changes are recommended:</p> <ul style="list-style-type: none"> • Require credit institutions have compliance programs, with components for audit, training, and a designated compliance officer(s) at the management level, that address AML/CFT and financial crime. • Require credit institutions to report suspected criminal activity, in addition to suspected AML/CFT activity, to the FIU or CNB. • Increase the frequency of AML/CFT inspections. • Increase the maximum level of fines under the money laundering act for inadequate AML programs to improve their dissuasive nature. • Require escalation procedures above the supervisor level for high risk accounts, such as private banking customers and PEPs. • Improve KYC requirements or guidelines, including those for low-risk customers and beneficial owners, and particularly for bearer share companies, along with proper controls over them. • Define PEPs to include all relevant politicians (according to FATF definitions).
Principle 19.	Supervisory approach. An effective banking supervisory system requires that supervisors develop and maintain a thorough understanding of the operations of individual banks and banking groups, and also of the banking system as a whole, focusing on safety and soundness, and the stability of the banking system.
Description	<p>EC1. Using qualitative and quantitative factors, the CNB analyses each financial institution quarterly, on a solo and consolidated basis, and produces a rating for each institution which are used in on-site planning. Annual analyses are performed on building societies with a quarterly assessment of the sector. The CNB uses the CEBS guidelines on RASs which uses quantitative measures to rate each risk category (credit, market, liquidity, operational, reputational, and strategic risks, mitigated by capital and profitability). Quantitative ratings are adjusted for qualitative conclusions from on-site exams about internal controls. Institutions are divided into five groupings based on ratings. Ratings are not provided to banks; however, they are used to monitor changes in the bank condition and for scoping of onsite work. Bank ratings are provided to the CNB board semiannually.</p> <p>EC2. Quarterly, a report on the banking sector, and its major participants, is provided to the CNB board. In developing the report, the CNB's financial stability unit provides input such as its parallel testing of the resilience of the banking and insurance sectors. Also,</p>

	<p>quarterly discussions are held by the CNB macroprudential stability panel, and the CNB considers input from rating agencies and European entities (the ECB, EBA) concerning development trends. Currently, the CNB is performing extraordinary monitoring of the liquidity position of its larger banks. As an integrated supervisor of the financial industry, the CNB is aware of developments in the nonbanking sector. It uses specialist teams of on-site examiners that inspect financial institutions across the sectors (i.e., banking, credit union, insurance, securities, and pension funds).</p> <p>EC3. Off-site and on-site procedures are used to assess the condition of, and risks facing, financial institutions. Based on bank-provided reports, off-site inspectors evaluate 18–20 indicators, early warning notices, and limit compliance on a monthly basis. Media reports are also considered. Informal comparisons are made between the large banks. Annually, an examination plan is devised, based on off-site findings and knowledge of the institutions from on-site work. There is no minimum frequency for onsite inspections, and full-scope inspections generally occur every three to four years. Targeted inspections, in the large banks, generally occur every two years. Annually, the CNB evaluates audit findings.</p> <p>The CNB has established supervisory manuals covering: off-site supervision, licensing and remedial actions, and on-site manuals for credit risk, market risk, internal controls and audit, operational risk, capital, and the RAS. There is guidance for stress testing, compliance, and money laundering.</p> <p>There are three on-site teams, divided by specialties: credit and operational risk (which include special teams for AML and IT), market risk, and advanced approaches. These specialized teams are used across the Czech financial system (e.g., bank, insurance, security sectors). On-site reviews include transaction testing (e.g., 100 commercial loan files and 100 retail loan files selecting large and high risk accounts) and interviews with bank staff (front and back office and risk management staff) to evaluate management's compliance with policy and legal requirements, form an opinion on the quality of risk management and usefulness of policies, identify systemic issues, and evaluate policy exception processes, etc. Exams can last two months in a large bank and have 30 inspectors; a small bank exam could be three weeks long. The on-site exam department has 32 staff divided into three teams: market & liquidity risk (9), credit and operational risk (15), and model validation (4).</p> <p>EC4. The CNB evaluates compliance with laws and decrees, e.g., accounting, AML, fraud, and privacy rules, during on-site and off-site inspections. This includes obtaining information needed to conduct supervision and verifying truthfulness, completeness and validity. Poor compliance can affect conclusions regarding bank risk management and internal controls. The CNB compliance manual assists examiners in this regard.</p> <p>EC5. Banks are required to provide the CNB with advance notice for: changes in board members and senior managers, when establishing offices, or providing services abroad, use of outsourcing contracts, and breaches to regulatory limits. Although not required, banks will notify the CNB of other significant events and changes in activities. Credit institutions must notify the CNB, without delay, of insolvency, potential insolvency, and losses that would cause a drop in capital below certain levels (two thirds of minimums, in the case of banks). The CNB conducts a dialogue with management two to three times a year to discuss financials, risks, bank strategy and any negative trends, and immediately initiates discussions when issues of concern arise.</p>
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	<p>EC6. Monthly on a solo basis, and quarterly on a consolidated basis, credit institutions provide the CNB with information on: profits, provision reconciliation, capital, loans, mortgages, investments, derivatives, repos, commitments, maturity schedules, concentrations (countries and products), electronic banking, and organizational structure. Standardized and ad hoc reports are compiled by sector. Outputs include uniform tables for the quarterly assessments as well as signaling (early warning) reports showing areas of possible concern.</p> <p>AC1. From reports submitted by credit institutions, the CNB stress tests individual banks (top down) and the banking sector as a whole on a quarterly basis. In 2009, the CNB introduced bottom-up stress tests of major banks semiannually. The CNB (financial stability and monetary departments) provide scenarios to the banks for the bottom up tests. These tests are compared with the top-down results and are used in the assessment of capital adequacy and in Pillar 2 discussions.</p>
Assessment	Compliant
Comments	The CNB takes a number of approaches to understand the risks facing individual banks and the banking sector. It assesses financial reports and returns on a frequent basis, performs stress tests of the banking and insurance sectors, utilizes a macroprudential stability panel, and incorporates the findings of cross-sectoral onsite specialists.
Principle 20.	Supervisory techniques. An effective banking supervisory system should consist of on-site and off-site supervision and regular contacts with bank management.
Description	<p>EC1. The CNB's supervisory approach includes a combination of off-site and on-site reviews, consideration of external audit work, and periodic discussions with senior management regarding financial results, risks, strategies, and trading plans (at least annually and more frequently for large institutions). The RAS is the culmination of these supervisory activities. The manual for creating a supervisory plan provides guidance to examiners.</p> <p>Off-site portfolio managers, of which there are eight, are responsible for the supervision of two to three financial institutions (points of contact and accountable for supervision). These inspectors perform regular analyses of institution-provided data, conduct periodic discussions with bank management, consider results of on-site inspections, and devise supervisory plans. Currently, there is no rotation policy for off-site inspectors to address regulatory capture, however, while desirable, the CNB does not think it is feasible with the current staffing levels.</p> <p>Based on bank-provided reports, off-site inspectors evaluate 18–20 indicators, early warning notices, and limit compliance on a monthly basis. Media reports are also considered. Informal comparisons are made between the large banks. Annually, an examination plan is devised, based on off-site findings and knowledge of the institutions from on-site work.</p> <p>There is no minimum frequency for on-site inspections, and full-scope inspections generally occur every three to four years. Targeted inspections, in the large banks, generally occur every two years. For branches of EU banks and based on EU law, supervision is limited to liquidity and AML compliance. Off-site monitoring is the same for such branches as for other banks, however, onsite supervision tends to be less frequent, for example, it could extend to five years where AML controls are considered good. There is no requirement to perform an on-site inspection shortly after a new bank begins operation (say within a few months to a year). Finally, problem banks, while monitored more intensively offsite, may not receive more frequent on-site supervision. Inspections are carried out by three on-site teams who are guided by CNB-established supervisory manuals (see BCP 19).</p>

EC2. The CNB's manual for creating a supervisory plan provides guidance on exam processes and the main objectives and basic tasks of off-site supervision. Supervisory plans are devised each December 1 for the subsequent year. Changes can occur, e.g., with adverse developments. Off-site procedures are conducted monthly (solo basis) and quarterly (consolidated), and can be increased in frequency, if needed. Generally, off-site staff participates in onsite exams to improve coordination and quality of supervision.

EC3. Every three to four years, on-site examiners evaluate governance systems for each risk area and overall, e.g., organizational structure, controls, board functions and oversight, compliance, and audit coverage. Targeted exams of identified risk areas are generally performed every two years in the large banks. Examiners verify that reported information is materially correct, but not primary accounting data (part of external auditors' remit). If errors are found, institutions must resubmit reports (up to the prior years' reports). Also, examiners evaluate actions taken, and compliance with action plans, to correct prior supervisory concerns.

EC4. Off-site staff evaluates reported information, annual reports, audit reports, bank presentations, and public reports, and they hold discussions with management. Staff identifies negative trends and issues, propose corrective measures, and monitor, and evaluate quarterly reports submitted by institutions on corrective measures to address supervisory concerns. Off-site findings and conclusions are incorporated in supervisory planning processes.

EC5. Off-site supervision includes regular (at least annual) discussions with senior management (the CRO and CFO in large banks and the chief executive officer and board members in small banks) to discuss trading results, business strategy, governance issues, capital and to clarify specific problems. Information visits with senior management are also used to gain knowledge on bank activities and are conducted two to three times each year for the large banks. Finally, on-site inspections include discussions at all levels of the management structure, including the management board (banks) and control body (credit unions). Meetings are not generally held with audit committees or supervisory boards.

EC6. In addition to evaluating management upon licensing and later changes, the CNB examiners evaluate the quality of management during onsite reviews. The quality of management is reflected in the internal control rating for each risk category. When there are shortcomings identified, the CNB has the authority to require changes.

EC7. The CNB examiners verify the performance of internal audit, its functionality, and reliability. They also consider the findings of external auditors regarding bank governance systems in the instances where such work is requested. Audit reports are an important input into supervisory planning processes, and the work of auditors, if recent and reliable, may be used to reduce the scope of on-site work.

EC8. After on-site exams, the CNB provides institutions with two written reports; one reflecting shortcomings by risk area, and the other reflecting the ratings (1–4) by risk area and subcategory. Institutions can appeal the findings of the first report but not the second. Institutions must submit to the CNB an action plan to correct shortcomings, and thereafter provide quarterly status reports until corrective measures are achieved.

	<p>At the beginning and at the completion of inspections, the CNB meets with management board members. The CNB on-site team leader and division head present the findings at completion.</p> <p>AC1. The CNB meets regularly and at least annually with management and management boards, and to discuss on-site findings. In the Czech Republic, management boards are made up of bank executive officers, and supervisory boards are made up of shareholder representatives. In the case of the large banks these are the executives of the parent bank.</p>
Assessment	Materially noncompliant
Comments	<p>While the CNB performs frequent off-site analyses, full-scope and targeted on-site inspections are infrequent, even in the large banks. Also, the CNB does not meet with audit committees and supervisory boards, unless there are exigent circumstances. Increased staffing levels are recommended to allow for more frequent on-site inspections, including for AML and for new and problem banks, and to allow for the rotation of off-site inspectors. At least annual on-site inspections are recommended for the largest institutions to conform with best practice, and de novo banks should be inspected within a few months or up to a year after commencement. Also, it is strongly recommended that the CNB increase its interaction with audit committees and supervisory boards, particularly in large banks, as their external members provided crucial control functions. Such interaction, for example, would include annual meetings/visits by the head of the CNB supervision department along with his or her participation on presentations after on-site visits.</p>
Principle 21.	<p>Supervisory reporting. Supervisors must have a means of collecting, reviewing, and analyzing prudential reports and statistical returns from banks on both a solo and a consolidated basis, and a means of independent verification of these reports, through either on-site examinations or use of external experts.</p>
Description	<p>EC1. Monthly on a solo basis, and quarterly on a consolidated basis, credit institutions are required to provide the CNB with information on profits, provision reconciliation, capital, loans and asset quality, mortgage loans and bonds, investments, derivatives, repos, commitments and off-balance sheet items, maturity schedules, interest rates on new loans and deposits, interest rate risk, large exposures and concentrations (countries and products), electronic banking and bank accounts, qualified participations, and organizational structure. Related party transactions are reported to the extent that they are large exposures and intra-group. Weekly liquidity reports are obtained from large banks.</p> <p>EC2. Regulatory reports are prepared using financial reporting standards (FINREP) which are based on IFRS. Listed banks keep their accounts according to IFRS. Other financial institutions use ministry of finance-issued accounting methods and instructions (FINREP) which are comparable to IFRS, and may use IFRS. The main difference is in the presentation of the financial statements.</p> <p>EC3. Using the CNB guidelines, credit institutions use a solo or portfolio approach to assess whether there is a loss in book value of individual assets or a portfolio of assets with like characteristics. Using IFRS rules, trading assets are held at market value or fair value; available for sale are recorded at fair value, and banking book assets are held at amortized cost. Impairment is recognized quarterly on the basis of discounted cash flows, models, or the coefficient approach, as specified in CNB rules.</p>

	<p>EC4. Banks provide reports monthly, quarterly, and annually and credit unions provide information quarterly and annually. More frequent submissions may be required on an ad hoc basis, such as the weekly liquidity reports currently submitted by large banks. The CNB monthly assesses signaling information, performs a quarterly credit analysis of each bank, prepares a report for the CNB board of each bank by rating category which highlights risks and supervisory plans for each, and annually performs a comprehensive analysis of individual banks.</p> <p>EC5. Reports are required of all banks, branches of foreign banks and credit unions, and consolidated units in a standardized form and as of fixed dates. These reports are used by the CNB to evaluate credit institution and industry performance. Quarterly peer group analyses of building societies are performed. For other banks, comparisons are drawn from other reports produced by the Financial Market Supervision Department, e.g. the quarterly report on the development of the banking sector (presented to the CNB Board) which contains a standardized analysis of the position of the six largest banks (i.e., looking at the same areas and using comparable ratios). The semiannual Bank Rating report divides banks into five groups based on the assessment of the banks' exposures to individual risks, their risk bearing capacity (i.e., mainly profitability and capitalisation), and the quality of internal control systems. The first two areas are assessed using a standardised set of indicators.</p> <p>EC6. Businesses that are part of groups are required to provide the CNB with information necessary for supervision, directly or through the bank or credit union. Reports on organizational structure are provided to the CNB.</p> <p>EC7. The CNB staff is authorized to obtain any and all information from credit institutions, including access to management and board members. There is no information that is off limits.</p> <p>EC8. The CNB can impose a fine or other remedial action should a financial institution fail to submit information in a timely or accurate manner. There have been no such fines in recent history. Penalties are assessed against institutions, not persons, and there are no attestation requirements for reports submitted to the CNB.</p> <p>EC9. The CNB uses automated systems that perform tests on data and generate exception reports/notices (e.g., missing items, late submissions). Off-site examiners perform logical checks on submissions, and on-site examiners verify material correctness and evaluate internal audit (which verifies the reliability of regulatory reporting). External auditors also audit bank accounts. Customer verifications can be used by the CNB, if necessary.</p> <p>EC10-11. Typically, the CNB does not use external experts to conduct supervisory tasks. However, it might request external auditors conduct a risk management audit as provided by CNB rules. In such cases, the CNB will notify the bank to commission the work and it will specify the scope and rationale. The CNB has the authority to reject external auditor appointments. Also, external auditors are required to immediately report to the CNB material adverse findings (see BCP 22).</p>
Assessment	Compliant
Comments	Credit institutions provide frequent, detailed financial information to the CNB using a common format and accounting guidelines. To improve supervisory systems, it is recommended that the CNB establish monthly or quarterly peer reports to facilitate

	more frequent comparative and trend analyses. Also, the CNB should establish guidelines or rules for signatories on financial statement and other submissions and the capacity to impose penalties on them on an individual basis.
Principle 22.	Accounting and disclosure. Supervisors must be satisfied that each bank maintains adequate records drawn up in accordance with accounting policies and practices that are widely accepted internationally, and publishes, on a regular basis, information that fairly reflects its financial condition and profitability.
Description	<p>EC1. Binding general legal regulations stipulate the liability of the management of the institution for the reliability of accounting data. If the CNB finds flaws, such as information not being provided on time or in the correct form, the entity may be prosecuted as a legal entity. The CNB may also require the replacement of an individual manager or member of the supervisory board of the institution. Sanctions are permitted in Article 27a CUA, according to which a member of an elected body or a manager commits a misdemeanor by not informing (or falsely informing) the CNB. A penalty of up to CZK 1 million may be imposed on the credit union.</p> <p>Banks, foreign bank branches, and credit unions are obliged to keep accounts according to Act No. 563/1991 Coll. The PRD sets out the specific requirements for information designated for the performance of banking supervision.</p> <p>EC2. Article 22 BA and Article 8b CUA obliges a bank or credit union to ensure that the auditor verifies the financial statements, and if requested by the CNB, the system of governance and provides further information in a report on this audit. Auditors also perform some testing of Pillar 3 disclosures. The audit report is part of the published annual report, the requirements of which are governed by the Act on Accounting.</p> <p>EC3. Banks which issue quoted securities are obliged to present their accounts according to IFRS; other banks and credit unions keep accounts according to national regulations (but may choose the IFRS on a voluntary basis), the valuation methods of which are comparable to the IFRS. The PRD stipulates that in the event of a loss-of-value of an asset, the institution must adjust its appraisal valuation. If the credit institution does not write off the corresponding amount, it must create an adjustment item within the profit and loss account. Such adjustments must be reviewed at least quarterly. Articles 201 to 204 PRD regulate the methods for calculating the discounting of future cash flows.</p> <p>EC4. The statutory audit is governed by the Act on Auditors No. 93/2009 Coll. and the guidelines of the Chamber of Auditors of the Czech Republic. According to Article 22 BA and Article 8b CUA, the institution is obliged to ensure that the auditor verifies (i) the financial statements; (ii) the system of governance including the risk management system (these are performed upon request of the CNB); and (iii) information disclosure as defined by the relevant Decree. The CNB Bulletin publishes selected acknowledged standards and benchmarks, which constitute the CNB's expectations on the audit.</p> <p>In practice, there are at least four forms of audits on credit institutions. The CNB may influence the scope of Nos. 2 and 3.</p> <ol style="list-style-type: none"> 1. The statutory audit of the financial statements. 2. Targeted audits if required by the CNB (when there are shortcomings). In practice, these are rarely requested.

	<p>3. Audits of institutions' internal governance and control systems,— to be requested by the CNB.</p> <p>4. A yearly note by an auditor based on testing of some items, that a bank fulfills the Pillar 3 disclosure requirements.</p> <p>EC5. The local audit standards are close to international standards and require auditors to cover, inter alia, the following areas: the loan portfolio, loan loss reserves, nonperforming assets, asset valuation, trading and other securities activities, derivatives, asset securitizations, and the adequacy of internal controls over financial reporting.</p> <p>EC6. According to Articles 22 BA and 8b CUA, the bank or credit union is obliged to report yearly the name of the chosen audit firm and the head of the intended audit team to the CNB, which may reject the appointment within 30 days from notification. The CNB has used this right in practice. The law states that auditors cannot be entities with a special relation to the audited institution. The CNB compares the audit with its own findings in off-site and on-site examinations. The comparison covers not only the reporting but also the statutory audit, in particular the quality of assets and the volume of provisions. The CNB's own findings are also compared with the auditor's findings with respect to verifying the risk management system. If significant discrepancies are found, the CNB discuss those with the auditors. However, the CNB does not have the power to terminate the ongoing appointment of an auditor. In practice, the CNB would use other methods, such as informing the Chamber of Auditors. (This has happened several times, and the auditors have subsequently been relieved from their duties).</p> <p>EC7. Commercial companies and issuers of securities registered in EU member states must apply the IFRS for accounting and compiling their financial statements on a solo and consolidated basis. Other financial organizations are governed by the accounting decrees and standards issues by the MOF; however, the stipulated accounting methods are comparable to IFRS methods (the two deviations refer to financial leasing and to the Czech requirement that good-will positions must be amortized.) According to Article 22 BA and Article 8b CUA, these financial statements must be verified by a certified auditor. The auditor should verify the financial statements according to internationally acknowledged auditing standards and procedures.</p> <p>EC8. Article 11a BA and Article 7b CUA stipulate that institutions must publish information on themselves, the structure of shareholders or members, the structure of the consolidated whole of which they are a part, and about their activities and financial standing. They also publish information about fulfillment of the prudential rules of business and risk management on an individual entity basis, unless this information is published on a consolidated basis. Articles 206 to 213 PRD stipulate the content of the information designed for publication, the periodicity, deadlines and manner of its publication and the structure and content of the data which must be verified by an auditor. The PRD requires information to be on time, in accessible form, and presented in an adequate and balanced manner. Annual, audited financial statements are published within four months of year-end. Also, banks publish quarterly financial information.</p> <p>EC9. Information published by financial institutions, at latest by April 30, must reflect the size, management method, number of employees, nature, scope, and complexity of activities performed by the institution. A detailed list of all the quantitative as well as</p>
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	<p>qualitative information is defined in the PRD (annexes 24 to 28).</p> <p>EC10. The violation or evasion of the laws and regulations governing information disclosures is regarded as a “deficiency in activity.” In such case, the CNB may undertake corrective measures and sanctions according to the BA and the CUA. During the year, the CNB compares the information published by the bank with the data obtained from periodical reporting to the CNB—and may act if significant discrepancies are found.</p> <p>EC11. Every quarter, the CNB publishes aggregate information about the banking and credit union sector, which essentially corresponds to the structure of information which the individual institutions are obliged to publish. Additional information is published by the CNB in its annual report on supervision. Also, on its website the CNB publishes links to websites of individual institutions which publish information according to the PRD.</p> <p>AC1. The CNB meets periodically with auditors, e.g., through the Chamber of Auditors. CNB supervisors sometimes call meetings with auditors to inform about trends in auditing, in particular when bad practices are detected.</p> <p>AC2. Article 21 Act on Auditors states that the auditor is obliged to inform the CNB in writing of any serious facts, which indicate that there has been a violation of regulations governing the activity of the institution or other serious facts which have a fundamental negative impact on its management, may threaten its sustainability, or may lead to the rejection of an auditor’s statement, a negative statement or a statement with objections.</p> <p>AC3. There is no explicit legal requirement for an institution to change its auditor. However, the CNB may, in theory although this has never been tested, use its right to reject a bank’s appointment of an auditor due to the loss of impartiality and the building of overly close personal ties after several years. Moreover, banks and credit unions are expected to present established policies for appointing auditors, according to which a rotation period of five to seven years is recommended. The firms themselves typically have policies to rotate partners responsible for bank audits every five years.</p> <p>AC4. Article 11a BA and Article 7b CUA requires an institution to implement internal procedures and principles for fulfillment of the information disclosure requirements stipulated by these laws or by the PRD, and for the evaluation of the adequacy of disclosed information, including its verification and disclosure frequency. Through its supervision, the CNB ascertains whether procedures for disclosure have been created at the bank or credit union, including controlling that these procedures are applied in practice.</p> <p>AC5. As noted above, the CNB has the right to be informed immediately about facts/events of a fundamental character. The auditor is also obliged to provide information and explanations concerning the course of the mandatory audit and the findings based on this on the request of the CNB for the purpose of carrying out its supervision. The CNB may request to read the auditor’s working papers, and has done so on several occasions.</p>
Assessment	Compliant
Comments	Although the CNB cannot influence the scope of the statutory annual audit, it may and

	<p>does in practice ask for different targeted or special audits for which the CNB sets the content. Hence, the BCP assessors deem that EC 4 is fulfilled.</p> <p>The rule that the appointment of a bank's auditor must be submitted to a CNB decision before becoming valid is commendable. The CNB has in practice used this to refuse the appointment of unsuitable auditors. However, the CNB has no legal powers to dismiss an auditor during the working year, should he prove unsuitable. In practice, the CNB would contact the Chamber of Auditors and action has, in the actual cases, been taken by them.</p> <p>The BCP assessors recommend that the CNB is provided the powers to dismiss unsuitable auditors during the working year, so as not having to rely on external parties such as the Chamber of Auditors.</p> <p>The BCP assessors recommend that the supervisory team of a specific bank meets with the bank's external auditors more frequently in order to increase its understanding of the bank and of the audit work. Depending on the character of the meeting, it would be appropriate to include or not to include bank management.</p>
Principle 23.	<p>Corrective and remedial powers of supervisors. Supervisors must have at their disposal an adequate range of supervisory tools to bring about timely corrective actions. This includes the ability, where appropriate, to revoke the banking license or to recommend its revocation.</p>
Description	<p>EC 1. According to its guidelines, during supervision, the CNB is expected to identify and react to negative tendencies, which may not yet mean an explicit violation of obligations, but may lead to their violation if developed further. If during supervision, the CNB has doubts as to the fulfillment of the stipulated obligations or that the development of certain facts may lead to the worsening of the financial situation or stability of the regulated entity, the CNB uses its lawful right to adopt the adequate actions. The specific chosen instrument corresponds to the gravity and character of the situation. Generally, the CNB first warns the institution of the deficiencies while also demanding an explanation. Depending on the deficiency, the CNB may require the institution to set a deadline by which it is obliged to inform the CNB of the measures taken to solve the problem. The CNB may discuss the deficiency directly with the top management of the institution and stipulate steps to address it. The CNB may also prescribe that the institution reports within a set time frame on the progress to implement the necessary measures. Subsequently on its on-site inspections, the CNB evaluates whether the measures for elimination of the deficiencies were truly adopted by the institution. Written communications between the CNB and the credit institution will always be used for enforcement actions, but not necessarily for informal recommendations for (less severe) remedial action as set out in the written report from on-site inspections.</p> <p>EC2. The CNB may adopt measures such as the imposition of conservatorship or the revocation of the license or permit. The CNB may also assist in finding merger partners. The CNB and the MOF also cooperate in other crisis situations, including providing advice and assessments to the MOF in situations which may require government solvency support. For instance, the CNB will assess the systemic impact of the situation and through its agreements with the MOF (Refer CP 1(6)), the CNB and the MOF cooperate on resolution matters.</p> <p>EC3 and 4. The BA (Article 26) defines a wide range of deficiencies in a bank's activities. If any of those deficiencies are identified, the CNB is authorized to require</p>

that the bank implement a remedy within a stipulated deadline, in particular to restrict or prohibit certain activities; limit the distribution network; replace the managers; replace board members; require the bank's organization, strategy, procedures and mechanisms be brought in line with the BA; adopt stricter rules for liquidity, provisioning, and capital; increase provisions and reserves; maintain capital above the regulatory minimum level; reduce the registered capital; use nondistributed profits to supplement reserve funds or to increase the registered capital; or limit the risks to the bank arising from its shares in another entity.

If urgent and necessary, the CNB may apply one or more of the following sanctions: changing the license by eliminating certain activities; order an extraordinary audit; impose receivership; impose a penalty of up to CZK 50 million; reduce the bank's capital to pay losses; restrict transactions with entities that are closely related to the bank; require an increase of capital above the regulatory minimum; and require an increase in liquid resources.

If a bank's capital falls below two-thirds of its capital requirements, the CNB is obliged to apply one or more of the following remedial actions: require higher capital; prohibit acquisitions of assets with a risk weight of 100 percent or more; prohibit acquisition of shares in other institutions; prohibit loans to entities with a close relation; and prohibit interest rates on deposits above the current standard interest rate.

The CNB may revoke the license (BA Article 34) if serious deficiencies persist. The CNB is obliged to revoke the license if the bank's capital on a solo basis falls below one third of its capital requirements.

Corresponding rules for identifying deficiencies and taking remedial action in credit unions are laid down in the CUA (Article 28, Paragraph 4).

To date, enforcement actions against banks have focused on penalties for consumer issues (e.g., misleading advertising). While the law provides the CNB with an adequate range of powers that can be used quickly and to the extent necessary, the assessors note that in practice there have been some delays and restrictions due to legal uncertainty. See comment section.

EC 5. If the bank's registered capital falls below CZK 500 million, or a credit union's capital falls below CZK 35 million, or below the regulatory minimum for the capital ratio, this constitutes a deficiency, and the CNB is authorized to take remedial action, as specified in Article 26a BA. Similarly, a decline below two-thirds of the calculated capital requirement for a bank must lead to remedial action. A decline below one-third of the capital requirement implies the revocation of the license. There are no explicit rules for proactive actions, but if capital adequacy falls towards the stipulated level for a bank, including Pillar 2 requirements, the CNB supervisors will contact the bank to discuss measures such as infusing new capital or limiting the payment of dividends. The CNB Act (Art 2(2)(d) and Art 44(2)) makes it compulsory for the CNB to act whenever necessary for achieving of its prudential objectives. The failure of an institution to address risk, e.g., by not maintaining an adequate capital adequacy ratio is a breach of law (e.g. Art. 12 (1) of the Act on Banks) and allows for even formal (administrative) preventive action, should the need arise.

EC6. The CNB may apply monetary penalties against a bank, but only in narrowly

	<p>defined situations against individuals in the bank. For instance, the CNB can impose fines (up to CZK 1 million, which can be imposed repeatedly) on a bank's manager (and on its former manager who held the managerial function anytime within 2 years prior to introduction of the conservatorship) if he/she fails to cooperate with the bank's conservator (Art 28(3) of the Act on Banks). However, as a nonmonetary sanction, the CNB may require the removal of a bank's manager or board (managerial or supervisory) member. The CNB has the same power vis-à-vis credit unions (see Art. 28 par 1(a) of the CUA. The option of personal penalties is possible only insofar as a clear link (causal nexus) can be proven between the deficiency and the personal responsibility; functional liability cannot be applied in these cases.</p> <p>AC1. Corrective actions are imposed in accordance with the law and within the shortest possible term after the CNB determines the deficiency. The law also stipulates cases when the CNB is obliged immediately to adopt remedial actions (when the capital ratio declines below two-thirds or one-third of the minimum capital requirements). As regards fines that may be imposed on banks and all remedial measures that may be imposed on credit unions, there is a statute of limitation periods that sets out the maximum time after the violation that administrative proceedings must be initiated (within 1 year of the discovery of the violation but no later than 10 years after its occurrence). Except for those cases, there are no time limits set for the CNB to start remedial actions.</p> <p>AC2. According to Article 26 BA, the CNB may prohibit or restrict the controlling or controlled bank's operations with entities that are a part of the same consolidated whole, or are linked to or have special relations with the bank. Similar rules are stated in Article 27f CUA for credit unions.</p> <p>AC3. Since the CNB is an integrated supervisory authority, coordination is internal. This internal coordination works well—in particular as evidenced during the financial crisis.</p>
Assessment	Largely compliant
Comments	<p>In the rating of CP 23, the BCP assessors took into consideration that the main weaknesses lie in the low frequency of on-site visits. Since on-site visits are the main means to verify that the bank has implemented the recommended remedial action correctly there is a risk that inadequate implementation is discovered only after considerable delay. The weakness of infrequent on-site visits is already criticized in CP 20 and contributed to the MNC grade for this CP. Although “double jeopardy”, i.e., downgrading of two or more CPs for the same reason, is allowed in the BCP Methodology it should be used with caution. Hence, CP 23 is rated as Largely Compliant. This rating is also in line with what other BCP assessors have awarded other countries having similar weaknesses.</p> <p>The BCP assessors acknowledge that the CNB has a clear prudential objective. This makes it compulsory for the CNB to act whenever necessary for achieving those objectives.</p> <p>The only mandatory and explicit thresholds for immediate, remedial action from the CNB are when a bank's (or credit union's) capital declines below two-thirds or one-third of the minimum regulatory capital requirement (although any decline below the regulatory threshold would constitute a legal shortcoming which will imply some action from the CNB). The authorities need to stand ready to demand progressively stronger remedial action as the situation of a particular institution becomes more precarious, to which end it would be useful to have a more formalized “ladder” of actions, ensuring</p>

that timely and appropriate supervisory actions are taken, commensurate with the nature and seriousness of the identified issues. Such a ladder, even if it does not rely on simple quantitative criteria, would help resist pressure from special interest groups, promote appropriate consistency in the treatment of different banks, and contribute to public confidence in the ability of the authorities to preempt emerging strains in the financial system.

The assessors note that sanctions, with few exceptions, cannot be applied to individuals in banks. The BCP recommends that it should be possible also to sanction individuals at least in defined situations, since it may improve discipline. (A typical example is to sanction managers who repeatedly do not send complete or timely reports to the supervisor).

The BCP assessors noted that there was at least one significant case in which CNB assessors had repeatedly requested a financial institution to take measures to address shortcomings, but the institution had not reacted adequately. Such CNB requests are typically provided after an on-site inspection and are formally agreed with the bank management. As a next step, the CNB (Enforcement Division) may issue an administrative order to the bank. On several occasions, the administrative order was issued only after a major delay after the first request from the CNB, sometimes due to the infrequent rate of onsite visits to this institution. There is also a significant time delay when transforming requests for remedial action into an administrative order since the matter and the grounds for acting have to be reviewed. At this stage, the institution's problems may have become exacerbated. While the BCP assessors support the division between non legally binding requests for less severe shortcomings and legally binding enforcement actions for other cases, the CNB should adopt policies to ensure that an institution's failure to adequately and timely address requests will lead to enforcement actions with less delay. In addition, CNB indicated that there is some legal uncertainty as to whether it can impose an enforcement action when the bank asserts that corrections have been made (and supports this by showing a set of formally correct new internal rules) and the CNB is not in a position to prove otherwise until it has undertaken a new on-site inspection. In another case, an enforcement action was mistakenly dropped against a bank with repeated and significant shortcomings on the basis of assertions made by a new management team that new internal rules had been adopted, although the CNB had not yet verified the adequate implementation of the rules through an on-site visit. In the view of the BCP assessors, the main weaknesses lie in the low frequency of onsite visits to banks and procedures to incorporate management assertions. The effective implementation of remedial measures will not be verified until the next on-site visit and if the implementation is found inadequate, stricter enforcement actions cannot be undertaken after the visit and, in fact, only several months after the visit due to the need to review the issue before the onset of a formal administrative order. The assessors therefore recommend the conduct of quick, narrowly targeted on-site visits just to verify the implementation of supervisory measures in those cases where the measure is significant and where it cannot be adequately verified on an off-site basis. Also, the CNB should obtain the ability or legal certainty to take formal action based on current facts and circumstances irrespective of management assertions. The enforcement action should not be abrogated until the CNB has verified that the intended actions have been effectively implemented. The BCP assessors do not question the assertions by the CNB that the process leading to formal enforcement will be faster in urgent and severe situations, but we prefer that a more streamlined framework encompassing all cases is adopted.

Principle 24.	Consolidated supervision. An essential element of banking supervision is that supervisors supervise the banking group on a consolidated basis, adequately monitoring and, as appropriate, applying prudential norms to all aspects of the business conducted by the group worldwide.
Description	<p>EC1. Under Articles 26f BA and 25f CUA and the PRD, the CNB obtains comprehensive information on all members of a consolidated group, i.e., on the controlled entities and affiliates of a controlling bank, financial holding entity or mixed-activity holding entity, and on the relationships within the group, including a graphical representation of the group's structure. That said, while the CNB can obtain any information on the nonfinancial and thus non (financially) regulated entities of a group, it may not supervise such entities.</p> <p>EC2. Under Article 25 BA, the activities of Czech banks, including their branches carrying on activities within the territory of a foreign country, shall be subject to supervision by the CNB. The activities of consolidated groups containing a bank are subject to banking supervision on a consolidated basis by the CNB, unless the law provides otherwise (such as when another country's supervisory authority has the main responsibility for the consolidated group.) Article 26e BA specifies the cases when an entity is not subject to banking supervision on a consolidated basis by the CNB.</p> <p>Under Article 25e CUA, the CNB shall perform consolidated supervision of a controlling credit institution group when it includes a responsible credit union in a controlling credit institution group, or of a financial holding entity group/mixed-activity group, whose members include a responsible credit union.</p> <p>The CNB has compiled an internal manual on the exercise of consolidated supervision which contains, i.a., practical experience and data gained under the information requirements. As part of its regular quarterly analyses, the CNB evaluates data on the financial situation and on the compliance with prudential limits both on a solo and consolidated basis.</p> <p>EC3. The BA and the CUA places certain limitations on risks arising from nonbanking activities. As part of consolidated supervision, the CNB obtains information on the actual activities performed by members of a consolidated group and on transactions within a consolidated group.</p> <p>EC4. Under Article 26f BA, a controlling bank, a responsible bank in a financial holding entity group, or a mixed-activity holding entity group that are members of a consolidated group subject to consolidated supervision by the CNB shall comply on a consolidated basis with the requirements for the governance system, the rules for disclosure of information, and for the determination of capital, capital requirements and capital adequacy as well as for changing capital, the exposure rules, the restrictions on qualifying holdings, and the requirements for operations within a consolidated group. Similar duties are imposed on credit unions in Article 25f CUA. More detailed prudential rules concerning capital adequacy and exposures are set out in the PRD.</p> <p>Holding companies of banks are nonregulated and the CNB cannot place limits on them or on other nonregulated parts of groups (e.g., leasing companies). The CNB obtains and monitors information about the consolidated company, and it limits intra-group exposures in line with EU requirements (see CP 10). The CNB may limit transactions further if warranted in specific cases.</p>

EC5. Domestically, the CNB is an integrated supervisor and can therefore access all necessary information from all regulated entities operating in the financial sector. In addition, the CNB takes active part in the activities of seven colleges of supervisors and has signed multilateral agreements on cooperation and coordination in the supervision on cross-border banking groups. The agreements provide, among other things, for the supervision of banks and branches, including the exchange of information and the conduct of on-site examinations according to agreed terms.

EC6. Article 26c, paragraph 1 BA and Article 25d, paragraph 1 CUA defines how the activities are properly supervised and that the safety and soundness of the institution is not compromised. This includes the monitoring and regulation of the risks of consolidated groups containing a bank in order to limit the risks to which the bank is exposed in respect of its membership of the consolidated group. The PRD further specifies how this may be exercised by the CNB. Thus, the CNB may limit the transactions and exposures within the group which affect the supervised bank.

EC7. Under the Commercial Code, the management board has the ultimate responsibility for running the company. They must formalize procedures and principles, based on the requirements set out in the applicable laws or in the PRD. Under the PRD, the management board is also responsible, e.g., for the ongoing and effective operation of internal controls. The internal controls also cover any foreign activities. The reports and statements submitted to the CNB must always be inclusive of the foreign activities. The reports and statements for a consolidated group must provide data on all subsidiaries, affiliates and jointly managed companies. The CNB will check the management's proper oversight of overseas activities through its normal supervision of the parent bank as well as the subsidiary. (Currently, the only Czech bank with foreign activities has a branch and the CNB has visited it.)

EC8. The effectiveness of a bank's or credit union's internal control system is evaluated during onsite examinations, which also check the quality of internal control over any transactions exercised via the institution's foreign branches.

EC9. In the event that the activities of a domestic bank's foreign branch endanger the activities of the parent bank or if information submitted by the domestic parent bank fails to adequately cover the activities of the foreign branch, the CNB is authorized by law (Article 26 BA, Article 28 CUA) to demand that the situation be remedied and may impose a penalty. The CNB may also require a reduction in the number of sales points or sales representatives, including the restriction of the institution's activities. Should host country supervision be deemed inadequate by the CNB, it may (informally) take over the full supervisory responsibilities. (This has happened in practice).

EC10. When exercising supervision, the CNB checks the compliance of a bank or credit union with all applicable laws and regulations. A bank and credit union must be aware of, monitor, evaluate, and manage all the risks undertaken. This includes situations when higher risks are involved.

AC1. In addition to the regularly submitted and updated information for consolidated groups (Balance Sheet, Income Statement, and Large Exposures are reported quarterly) and besides consolidated reports concerning the compliance with prudential rules, the CNB has the power to carry out an on-site examination at any regulated

	<p>entity belonging to a consolidated group, including parent companies and companies affiliated to parent companies, or to ask the competent supervisor, if abroad, to perform this task.</p> <p>AC2. Not applicable as Czech banks do not have material operations abroad.</p> <p>AC3. The domestic banks have only very few subsidiary banks and branches abroad. The CNB performs on-site examinations abroad although not very often since the entities are very small and there are also regular meetings with foreign supervisors where information on the individual institutions is exchanged.</p>
Assessment	Compliant
Comments	<p>The CNB may ask for any information from nonregulated entities in a group, including from financial and nonfinancial holding companies. The CNB uses such information to ensure that the sub-consolidated banking group and, in particular, the bank entity itself, is not endangered by transactions with or exposures to other group members. While this policy fulfills the main objective for the supervision at consolidated level, surety would be enhanced if the CNB could, when warranted, also physically examine nonfinancial bank holding companies and other non-regulated group entities, e.g., to ensure that reports sent to the bank entity are correct.</p>
Principle 25.	Home-host relationships. Cross-border consolidated supervision requires cooperation and information exchange between home supervisors and the various other supervisors involved, primarily host banking supervisors. Banking supervisors must require the local operations of foreign banks to be conducted to the same standards as those required of domestic institutions.
Description	<p>EC1. Article 38c BA and Article 22 CUA require the CNB to perform consultation and information duties vis-à-vis the supervisory authorities of other states. These Acts also specify the main information to be reported and consulted. During the last decade there have been intensive negotiations and exchange of information with foreign supervisors, especially from countries where parent companies or headquarters of bank and bank branches that operate in the Czech Republic have their registered offices. The CNB has familiarized itself with the manner and scope of supervision conducted by these authorities and they have confirmed to the CNB that they practice supervision on a consolidated basis. The introduction of Basel II deepened cooperation, e.g., with respect to the assessment of applications jointly filed by the parent bank and the Czech subsidiary for the approval of advanced approaches to credit and operational risk management. The CNB will implicitly assess whether the scope and scale of exchanged information is adequate for performing effective supervision and, if this is not the case, apply compensating measures.</p> <p>The exchange of information has been bolstered as a result of signing multilateral cooperation agreements. The CNB has signed seven such agreements on the cooperation of supervision of cross-border banking groups. These agreements formalize the activities of the colleges of supervision. To facilitate the exchange of information, each college has created a secure website which serves as a hub for information exchange between the relevant financial group and the members of the college. CNB officials take active part in the activities of the colleges and participate in their meetings. The CNB notes that the intensity and depth of cooperation through the colleges have increased recently, likely due to the fragile financial situation in Europe. In some cases, there is even weekly information sharing.</p>

EC2. The CNB has signed nine agreements on cooperation with supervisors from Germany, France, Slovakia, Austria, the USA, Belgium, the Netherlands, Italy, and China. The agreements are publicized on the CNB website as soon as the counterparty gives his consent. (Consent for publication has not yet been received from the Netherlands and from China). These agreements have clearly resulted in a strengthened exchange between the relevant authorities. An MOU with Russia has not yet been concluded, although Russian interests are represented in the Czech financial sector (the newly acquired subsidiary of Volksbank and some credit unions). Article 25a BA and Article 22a CUA set out the conditions for providing or receiving confidential information. For instance, information obtained from foreign authorities may be used solely for the purposes for which it was provided and may not be disclosed to any other person without the consent of the provider. This provision is replicated in all of the nine cooperation agreements.

EC3. Under Article 38h BA and Article 22a CUA, the CNB both as home and host supervisor shall, on request, supply other supervisory authorities especially with information on ownership holdings in a bank/credit union, on the management of a bank/credit union, on the capital controlled by a bank, on capital adequacy, on financial holding entities, and on information relevant to the supervision, such as liquidity, solvency, deposit insurance, capital adequacy, consolidated supervision, accounting, internal controls, and risk management of open positions.

Article 38h BA and Article 22a CUA states that the CNB shall, on request or on its own initiative, provide—ex ante—other supervisory authorities with information that materially influences the assessment of the financial situation of a bank. This includes major sanctions and remedial measures imposed on the bank or credit union. The MOUs provide for prior consultation with the foreign authority before taking measures such as requiring capital increases or revoking the bank license. There is an exemption from the consultation requirement only if the situation requires urgent action. In practice, there has never been a case calling for such consultation (or, an exemption.)

EC4. Both the BA and the CUA allow for the disclosure of information to a supervisory authority of the country in which the bank or branch of a credit union have their registered offices. Under Article 5k BA, if a bank under an EU single license violates the provisions in areas within the powers of the host country, and the banks fails to rectify the situation, the CNB has the right to contact the home country supervisor. Should, nevertheless, the violation not be rectified, the CNB may take further measures, including revoking the license of the entity. The CNB provides the home supervisor and supervisory colleges with a summary of the major findings of onsite inspections.

Article 38i BA stipulates that the CNB must make prior consultation with home supervisors in certain significant cases, such as: (i) when concluding an agreement to dispose of the bank or parts thereof; (ii) on a decision by the GM to wind up or merge the bank or to transfer assets to another bank, to reduce the capital of the bank, to acquire or increase a qualifying holding or controlling interest in another bank. Prior consultation must also take place before imposing sanctions or remedial measures of exceptional significance to a bank, in particular when requiring a capital increase. The CNB must also consult the home supervisor if it intends to refuse an application for the consent to use advanced approaches when calculating the capital requirement.

However, prior consultation need not take place in urgent situations when quick action is deemed necessary.

The cooperation agreements provide detailed instructions about which situations that require prior consultation, or information after-the-fact.

Under Article 2h CUA, the CNB must inform without undue delay, the relevant host supervisor of a decision to prohibit the depositors from disposing their deposits. Changes to the license of the credit union shall be discussed with the host supervisors on a prior basis, although exceptions are allowed in urgent situations. The CNB shall promptly inform the host supervisor in the following situations: (i) serious shortcomings persist in the credit union's activities; (ii) it has ceased to accept deposits or to provide loans for a period of six months; or the license was obtained through false information; (iii) the credit union's capital is lower than one-third of its individual capital requirements. The CNB shall also promptly inform host supervisors of an insolvency decision and the adjudication of bankruptcy on the credit union's assets.

EC5. The requirements placed on domestic and foreign applicants during the licensing process are the same. Banks, including subsidiaries of foreign banks, and foreign bank branches which do not enjoy the benefits of the EU single license are obliged to observe the prudential rules stipulated by an Act or Decree, unless the law provides otherwise. Article 11 BA defines operational requirements applicable to banks and foreign bank branches. Article 41 CNB Act set out the rules for submitting reports or other information for the purposes of banking and monetary statistics, liquidity, and the Central Register of Credits.

Supervision is conducted in a standard fashion for foreign bank subsidiaries and third country banks' branches as well as banks owned by Czech entities. In the case of foreign bank branches operating under the single license the CNB supervision is limited to liquidity and money laundering issues.

EC6. Article 4 BA and Article 2j CUA stipulates that before granting a license the prior consent of the banking supervisory authority of the home country must be obtained. The Acts further require that the home authorities' opinion on the institution states that the following conditions have been met: (i) persons having a qualifying holding in the bank must be eligible to exercise shareholder rights; (ii) persons who are nominated for managerial positions in the bank must be competent, trustworthy, and experienced. The CUA also sets out the requirement for regular exchange of information relevant to the issue of permits and to the inspection of the activities of members and executives of entities being supervised. Article 4 BA states as a condition for licensing that there must be no legal or factual impediments to the exercise of banking supervision in the other state. When a bank from a country outside the EU wishes to establish a branch, the CNB requires an opinion from the home supervisors including, i.a., and a declaration from the supervisors that the branch will be subject to banking supervision on a consolidated basis.

EC7. Article 25 BA allows for carrying out on-site examinations in the Czech Republic by the home supervisors of the bank on the basis of a request and the principle of reciprocity. The agreements signed with foreign regulators set forth the terms and conditions of on-site examinations carried out in the country of the host country. Foreign banks operating in the Czech Republic through a (EU) single license are

	<p>subject to Article 5a BA. Under these provisions, the CNB may carry out on-site examinations if so requested by the home authorities. Alternatively, the home country supervisor may, after having first informed the CNB, carry out on-site inspections within the Czech territory.</p> <p>EC8. Not applicable as there are no shell banks on Czech territory.</p> <p>EC9. Consultations with home supervisory authorities are required in the MOUs in certain cases, including when requiring more capital, license revocation, and AML actions. Major findings on on-site examinations would be discussed with home supervisors, e.g., by bilateral exchange of letters or in the supervisory college.</p> <p>AC1. There is no law providing for the development of a communication strategy with host supervisors, but the signed cooperation agreements include a commitment of the parties to discuss between themselves any significant information pertaining to the relevant bank groups. Further, the agreements contain a commitment that representatives of supervisory authorities will meet at any time when either of the parties deems it necessary to discuss possible solutions to identified problems.</p>
Assessment	Compliant
Comments	<p>Since Russian interests recently acquired a bank in the Czech Republic and have interests in credit unions, bilateral cooperation and information-sharing with the Russian authorities must be ensured in a way that secure that adequate secrecy may be maintained by both countries' authorities.</p>

Table 5. Summary Compliance with the Basel Core Principles—Detailed Assessments

Core Principle	Grading	Comments
1. Objectives, independence, powers, transparency, and cooperation	C	
1.1 Responsibilities and objectives	C	
1.2 Independence, accountability and transparency	LC	<p>The number of supervisory staff is inadequate. This has i.a. resulted in too infrequent onsite inspections. Intensive offsite monitoring and follow-up of requirements for remedial action also require more staff. On the policy side, the substantially increased international activity in rule-making calls for more staff not least to ensure the role of the Czech authorities in the international negotiations. (However, since the number of staff is decided by an internal CNB decision and the CNB is not dependent on outside sources for financing, this is not an issue which has a bearing on the compliance rating of CP 1.2 which deals with independence. Refer instead to CP 20, in which the supervisory weaknesses following from inadequate staff resources are discussed).</p> <p>The minister of finance may take part as an observer in CNB Board meetings, but not in meetings on operational supervisory issues. Close contacts between the MOF and the CNB on regulatory and supervisory issues are recommended by the BCP assessors but should take place through other more transparent channels.</p>
1.3 Legal framework	C	
1.4 Legal powers	C	

1.5 Legal protection	C	Supervisory managers and staff are protected by the collegial decision-making in supervisory matters implying that the complainant primarily must sue the CNB as a legal person rather than the staff member. The BCP assessors deem the CNB as "Compliant" since the present processes protect staff adequately for supervisory actions unless taken with bad intent.
1.6 Cooperation	C	Fora for cooperation between the relevant authorities in financial stability and supervisory matters have been established but have not yet been activated.
2. Permissible activities	C	There is no formal requirement in the CUA that all credit unions should be listed on the CNB website. (It is now done informally)
3. Licensing criteria	C	CRO/CFO/Compliance officers are not formally required to be included in the fit-and-proper test. There is no requirement for the supervisory board to include independent members, except for one member in the Audit Committee. Although start-ups will be monitored offsite there is no rule for the CNB to visit them at an early stage.
4. Transfer of significant ownership	C	The CNB has the power to block the voting rights and other rights of owners of qualified holdings, e.g. if the owner is unsuitable. However, the CNB has no right to require the owner to divest her holdings.
5. Major acquisitions	MNC	Except for certain cases, there are no requirements for banks to request prior consent from the CNB for significant acquisitions or investments. In the case of an investment by a Czech bank in a foreign financial institution the CNB determines that the foreign supervisor practices consolidated supervision, but it does not explicitly assess the quality of such supervision.

6. Capital adequacy	LC	<p>Refer to CP 23 on introducing a trigger for mandatory supervisory action at an earlier stage of a decline in a bank's capital ratio</p> <p>The CNB must be provided the formal power to require banks to abrogate or amend flawed internal models for calculation of risk-weighted capital.</p>
7. Risk management process	LC	<p>The CNB provides clear expectations and guidelines regarding risk management systems. While inspectors evaluate the role and input from the supervisory boards, more emphasis and focus should be placed on supervisory boards. For example, the CNB should more formally evaluate the capability and participation of supervisory board members, through regular meetings with them and evaluation of minutes and board packages. Supervisory boards should formally approve strategies and policies.</p>
8. Credit risk	C	<p>The authorities comply with this CP.</p>
9. Problem assets, provisions, and reserves	C	<p>The past due schedule of 360 days should be shortened as it applies to unsecured as well as secured loans and appears excessive to the assessors.</p>
10. Large exposure limits	LC	<p>The definition of large exposures only encompasses exposures in the banking book. Exposures in the trading book are not subject to the large exposure limitations and may reach 600 percent of a bank's capital.</p> <p>Temporary excesses over the 25 percent limit for large exposures are to be partly, but not wholly, offset by additional bank capital.</p> <p>Exposures to parent banks abroad, to sister banks or to investment firms are exempted from the 25 percent limit and are subject to a limit of 100 percent of bank capital. This is too high and constitutes a risk to the bank.</p>

11. Exposure to related parties	MNC	<p>There is no rule that all banks must have a separate set of policies for related party transactions.</p> <p>CNB guidelines should define in more detail how “conflict of interest-rules” should be applied for related party transactions.</p> <p>Banks should have rules for immediate reporting to their Boards of payment delays in significant related party exposures.</p> <p>Reporting (also to the CNB) of related party exposures should be separate from reporting on large exposures in general and should be on an individual basis, except for insignificant transactions.</p> <p>Aggregated exposures to all related parties, excluding exposures to group credit institutions and investment firms under consolidated supervision, should have a limit which should not exceed 25 percent of the bank’s capital.</p>
12. Country and transfer risks	C	The authorities comply with this CP.
13. Market risks	C	The authorities comply with this CP.
14. Liquidity risk	C	The authorities comply with this CP.
15. Operational risk	C	The authorities comply with this CP.
16. Interest rate risk in the banking book	C	The authorities comply with this CP.
17. Internal control and audit	C	The authorities comply with this CP.

18. Abuse of financial services	MNC	<p>Required compliance programs that address AML/CFT and financial crime should include components for audit, training, and a designated compliance officer at the management level.</p> <p>Credit institutions should regularly report to the CNB or the FIU suspected criminal activity, in addition to suspected AML/CFT activity.</p> <p>The frequency of inspections should increase.</p> <p>The Czech Republic should increase the maximum level of fines for inadequate AML/CFT programs under the money laundering act.</p> <p>Escalation procedures above the supervisor level are needed for high risk accounts.</p> <p>KYC requirements or guidelines should be improved for low-risk customers and beneficial owners, and in particular address bearer share companies.</p> <p>PEPs should be defined to include all relevant politicians (according to FATF definitions).</p>
19. Supervisory approach	C	The authorities comply with this CP.
20. Supervisory techniques	MNC	<p>Full-scope and targeted onsite inspections are infrequent, and the CNB does not meet with audit committees and supervisory boards, unless there are exigent circumstances. Increased staffing levels are recommended to allow for more frequent onsite inspections, including for AML and for new and problem banks, and to allow for the rotation of off-site inspectors. The CNB should increase its interaction with audit committees and supervisory boards, particularly in large banks.</p>
21. Supervisory reporting	C	<p>The CNB should establish monthly or quarterly peer reports to facilitate more frequent comparative and trend analyses. Also, the CNB should establish guidelines or rules for signatories on financial statement and other submissions and the capacity to impose penalties on them on an individual basis.</p>
22. Accounting and disclosure	C	The authorities comply with this CP.

23. Corrective and remedial powers of supervisors	LC	<p>Introduce a structured framework for intervention in banks.</p> <p>The trigger for mandatory supervisory remedial action is released when bank capital declines below two-thirds of the capital requirement. This is too late, since problems may then be ingrained.</p> <p>Introduce a system which in relevant cases would imply narrowly targeted on-site visits to banks, to ensure timely follow-up of remedial requirements.</p> <p>Provide the CNB with the explicit power to displace unsuitable bank managers.</p> <p>Broaden the powers of the CNB to issue monetary sanctions to individual persons.</p>
24. Consolidated supervision	C	The CNB lacks the power to physically inspect entities outside the consolidated banking group.
25. Home-host relationships	C	Although there is now Russian ownership in the Czech banking sector, there is no MOU with Russia, partly due to problems of ensuring the confidentiality of information. The authorities are recommended to seek an alternative arrangement, ensuring such confidentiality.
<p><i>Aggregate:</i> Compliant (C)—#, Largely compliant (LC)—#, Materially noncompliant (MNC)—#, Noncompliant (NC)—#, Not applicable (N/A)—#</p>		