



**The SELF-ASSESSMENT OF COMPLIANCE WITH THE
BASEL CORE PRINCIPLES FOR EFFECTIVE BANKING
SUPERVISION
(to 31 December, 2010)**

Prague, 26 August 2011

To assess BCP compliance, the following four-grade scale is used:

1. “**Compliant**” means that there are no shortcomings in the legislation, the exercise of supervision or in internal rules.
2. “**Largely compliant**” means that
 - a) there exist minor shortcomings in the legislation, the exercise of supervision or in internal rules, or
 - b) supervision is performed, although supervisory practice is not based on standardised internal rules.
3. “**Materially non-compliant**” means that
 - a) there exist essential shortcomings in the legislation, the exercise of supervision or in internal rules, or
 - b) there is no legislation or regulation in place, but supervision is performed, or
 - c) there exists a legislative and regulatory framework, but the exercise of supervision is not functional.
4. “**Non-compliant**” means that there is no legislation or regulatory basis and the exercise of supervision is insufficient.

ASSESSMENT OF THE INDIVIDUAL PRINCIPLES AND CRITERIA

Principle 1: Objectives, independence, powers, transparency and cooperation

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 authorisation of banking establishments and their ongoing supervision; powers to address compliance with laws as well as safety and soundness concerns; and legal protection for supervisors. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.

Note: CP 1 is divided into six component parts. Three of the component parts are not repeated elsewhere in the CPs. However, two parts (3 and 4) are developed in greater detail in one or more of the subsequent CPs. For these two, since the criteria will be developed further elsewhere, this section identifies only the most fundamental and crucial ones. Part 6 is enhanced in CPs 18, 24 and 25.

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

Overall assessment of part 1(1):
COMPLIANT

Essential criteria

Pursuant to [Act No. 6/1993 Coll., on the Czech National Bank, as amended](#) (hereinafter referred to as the “Act on the CNB”), the CNB is the central bank of the Czech Republic and the supervisor of the Czech financial market. It means that the CNB is the integrated supervisory authority which is responsible for banking supervision as well as for supervision of regulated non-bank financial institutions. Subject to banking supervision are regulated credit institutions, i.e. banks, foreign bank branches not having their registered office within the territory of a Member State of the EU or a state of the European Economic Area, and credit unions. The objectives and responsibilities of the CNB in the banking supervision area are laid down in the Act on the CNB. Acts and other legal rules (decrees) stipulate minimum prudential and safety requirements which the regulated credit institutions are obliged to meet. The frequency of changes to the relevant laws is acceptable from the point of view of the needs of banking regulation and supervision. The legislative framework for banking and banking supervision is harmonised with the law of the European Union law (hereinafter referred to as “EU law”) and covers also the directly applicable EU regulations. The CNB publishes on its website the lists of all regulated entities, detailed quarterly aggregated information about the banking sector and the credit unions sector and much more information about the banking sector and banking supervision.

Additional criterion

In the past, the CNB had in place a medium-term strategy for regulation and banking supervision (2005–2010) approved by the Bank Board. Based on this strategy, annual plans were drawn up, emphasising that funds for banking supervision should be allocated depending on the risk profile of supervised credit institutions and banking groups as well as in view of

banking sector stability. The medium-term strategy was replaced by “*The Mission of the Czech National Bank for the Supervision of the Czech Financial Market*”, which is available on the CNB website.

Analysis of the individual criteria

Essential criteria

1. Laws are in place for banking, and for the authority (each of the authorities) involved in banking supervision. The responsibilities and objectives of each of the authorities are clearly defined and publicly disclosed.

COMPLIANT

The CNB is currently the only authority dealing with banking supervision. Under the Act on the CNB, the CNB is the central bank of the Czech Republic and, in addition, the supervisor of the Czech financial market. It means that the CNB is the integrated supervisory authority which is responsible for banking supervision as well as for supervision of regulated non-bank financial institutions, in particular electronic money institutions, small-scale electronic money issuers, payment institutions, small-scale payment service providers, investment firms, securities issuers, the central depository, investment companies, investment funds, settlement system operators, organisers of investment instrument markets and other persons specified in special legal rules governing capital market undertakings, as well as insurance and reinsurance companies, pension funds and other entities active in the insurance and private pension industries and entities operating under the Foreign Exchange Act (bureaux de change) – Article 44(1) of the Act on the CNB. Subject to banking supervision are credit institutions defined in Article 4 of Directive 2006/48/EC of the European Parliament and of the Council relating to the taking up and pursuit of the business of credit institutions (recast of Directive 2000/12/EC). In the Czech Republic these include banks, foreign bank branches not having their registered office within the territory of a Member State of the EU or a state of the European Economic Area, and credit unions. The activities and supervision of banks are governed by the Act on the CNB and [Act No. 21/1992 Coll., on Banks, as amended](#) (hereinafter referred to as the “Act on Banks”). The activities and supervision of credit unions are subject to [Act No. 87/1995 Coll., on Credit Unions and Certain Related Measures and on the Amendment of Czech National Council Act No. 586/1992 Coll., on Income Tax, as amended](#) (hereinafter referred to as the “Act on Credit Unions”).

Banking supervision is one of the key components of integrated supervision of the Czech financial market and as such it shall:

- a) facilitate the sound operation and development of the financial market in the Czech Republic and contribute to the stability of its financial system as a whole; The objectives are in line with the CNB’s primary objective, namely to maintain price stability (Article 1 of the Act on the CNB);
- b) be performed both on a solo and consolidated basis;
- c) comprise:
 - decisions on licence, permit and registration applications and prior approvals pursuant to special legal rules;
 - inspection of adherence to the conditions stipulated in licences and permits;
 - inspection of adherence to laws and directly applicable legal rules of EU, insofar as the CNB has the power to conduct such inspections under this Act or special legal rules, and inspection of adherence to the decrees and provisions issued by the CNB;

- collection of the information needed to perform supervision pursuant to special legal rules and its enforcement, and verification of whether it is true, complete and up-to-date;
- the imposition of remedial measures and penalties pursuant to the Act on the CNB or special legal rules;
- proceedings regarding administrative offences, see Article 44(2) of the Act on the CNB.

2. The laws and supporting regulations provide a framework of minimum prudential standards that banks must meet.¹

COMPLIANT

Prudential standards and rules for banks which do not enjoy the advantages of the single licence in accordance with EU law (hereinafter referred to as a “third country bank branch”) and credit unions are included in:

- a) laws, mainly the Act on Banks, Act on Credit Unions and Act No. 284/2009 Coll., the Payment System Act, as amended (Part IV concerning rights and obligations in the provision of payment services and the issuance of electronic money);
- b) implementing legal regulations issued on the basis of law and within legally defined framework, i.e. in CNB decrees and provisions; The CNB as a supervisory authority issues implementing legal regulations in accordance with Article 79 of the Czech Constitution, under the Act on Banks and other laws. CNB decrees are promulgated in the Collection of Laws. CNB provisions are promulgated in the CNB Bulletin;
- c) directly applicable EU regulations.

Prudential rules stipulated for banks directly by the Act on Banks include in particular:

- setting the minimum capital of a bank that must be at least CZK 500 million (Article 4);
- the obligation of a bank and foreign bank branch to have in place a system of governance (Article 8b);
- the obligation of a bank to carry on its activities with prudence (Article 12);
- the obligation of a bank to maintain capital adequacy both on a solo and consolidated basis pursuant to Article 12a with the CNB being authorised to lay down detailed capital adequacy rules (Article 15);
- the obligation to adopt and apply sound, effective and complete strategies and processes to determine, assess and maintain on an ongoing basis the amounts, structure and distribution of internal capital to adequately cover the risks to which it is or might be exposed (Article 12c);
- the obligation of a bank to comply with the exposure limits both on a solo and consolidated basis (Article 13) with the CNB being authorised to lay down detailed exposure rules (Article 15);
- the obligation of a bank to maintain their solvency both in the Czech currency and in foreign currencies on a solo and consolidated basis at all times (Article 14) with the CNB being authorised to lay down liquidity management rules (Article 15);
- the prohibition to conclude any agreements under conspicuously disadvantageous conditions for the bank (Article 12);
- the prohibition for a bank to acquire a holding in another legal entity, establish another legal entity or participate in the establishment thereof, provided that it does not become a partner with unlimited liability, the entity does not have a qualifying holding in the

¹ See CP 1(1), EC 1.

bank, unless the entity's equity securities are held for trading and for a short period of time and the bank complies with the rules for the acquisition, financing and assessment of assets, laid down by the CNB, there are no legal or other obstacles relating to the provision of information to the bank by this entity or relating to the provision of information by the bank for the purposes of supervision of the bank's activities, the transparency of the consolidated group of which the bank is a member is maintained, and close links within the consolidated group do not prevent the performance of supervision of the bank's activities, or the investment is in line with the bank's overall strategy and the bank manages risks associated with this investment above all from the point of view of potential liabilities arising therefrom (Article 17(1));

- the limitation of a bank's qualifying holding in an entity that is neither a bank pursuant to the Act on Banks, nor a foreign bank, nor a financial institution nor an ancillary banking services undertaking with the exception pursuant to Article 17(5) – qualifying holding arising from a claim of the bank on that entity);
- the obligation to comply with the limits for a bank's qualifying holding (Article 17(2));
- the restriction on transactions with persons having a special relation to the bank (Article 18);
- the obligation to apply for the prior consent of the CNB regarding *inter alia*:
 - the conclusion of an agreement based on which the business or part thereof is disposed of in any way (Article 16(1)(a) and a decision by the General Meeting to wind up the bank (Article 16(1)(b));
 - a merger of banks (Article 16(1)(c));
 - a reduction of the capital of the bank, unless the capital is being reduced to cover a loss (Article 16(1)(d));
 - a resolution of the General Meeting on the decision that the bank will cease to carry on any activity for which a licence is required (Article 16(1)(e));
- the obligation to disclose information (Article 11a);
- the obligation of a bank to ensure that the auditor performs
 - an audit of the bank's financial statements;
 - an audit of the bank's system of governance ; the bank shall provide the auditor with an overview of the internal inspections conducted which relate to this audit (Article 22 of the Act on Banks and Article 8b of the Act on Credit Unions);
 - preparation of reports on the audit of its financial statements and system of governance; the bank shall submit those reports to the Czech National Bank on the stipulated dates;
 - an audit of the disclosed data stipulated by the Act on Banks (Article 11a), within the scope set forth in a CNB decree;
- the obligation of a parent bank, a responsible bank in a financial holding entity group, a responsible bank in a foreign parent bank group and a bank in a mixed-activity holding entity group to comply on a consolidated basis with;
 - the requirements for the system of governance (Article 8b);
 - the rules for information disclosure (Article 11a);
 - the rules for setting capital, the rules for setting capital requirements and capital adequacy (Article 12a);
 - strategies and processes to assess and change the internal capital (Article 12c);
 - exposure rules (Article 13);
 - restrictions on qualifying holdings (Article 17);
 - the requirements for operations within a consolidated group (Article 26g(4));

- the obligation of entities belonging to a consolidated group to create adequate control mechanisms ensuring the correctness of information supplied for the purposes of banking supervision on a consolidated basis (Article 26g).

The Act on Credit Unions also stipulates some basic prudential rules for credit unions, namely:

- the obligation of a credit union to carry on its activities with prudence and due care (Article 1(5)(b));
- the prohibition to conclude any agreements under conspicuously disadvantageous conditions for the credit union (Article 1(5)(c));
- the prohibition to be an issuer of a subordinated bond (Article 1(5)(d));
- the prohibition to acquire a receivable bound by a subordination condition (Article 1(5)(e));
- the prohibition to acquire direct or indirect share of the capital of a legal entity, to become a member, partner or shareholder of a legal entity, or acquire influence over the management of a legal entity in some other manner (Article 1(8));
- the definition of capital of a credit union and setting its minimal amount to CZK 35 million (Article 8);
- the obligation to comply with prudential rules (Article 11);
- setting of conditions for providing loans to members of credit unions' elected bodies and persons close to such members, as well as to those credit unions' members who are employed in a credit union and persons close to such members (Article 7);
- the obligation of a credit union to have in place an system of governance (Article 7a);
- the obligation to disclose information (Article 7b);
- the obligation of a credit union to adopt and apply sound, effective and complete strategies and processes to determine, assess and maintain on an ongoing basis the amounts, structure and distribution of internal capital to adequately cover the risks to which it is or might be exposed (Article 8a);
- regulation of the conditions for profit distribution among members of the credit union and at the same time the settlement duty if the credit union ends the year in a loss (Article 9);
- the obligation of a credit union to deliver to the CNB within ten working days of the day a member of a credit union body was elected or a senior officer appointed the application for the assessment of the conditions for discharging the office, including the documents attesting compliance with such conditions (Article 7(7));
- the obligation of a credit union to ensure that the external auditor performs
 - an audit of its financial statements;
 - an audit of a credit union's l system of governance every three calendar years; the credit union shall provide the external auditor with an overview of the internal inspections conducted which relate to this audit;
 - preparation of reports on the audit of its financial statements and the system of governance ; the credit union shall submit those reports to the Czech National Bank on the stipulated dates;
 - an audit of the disclosed data stipulated by the Act on Credit Unions and within the scope set forth in a CNB decree (Article 8b).

However, most specific prudential rules and standards are not contained directly in laws, but in CNB decrees and provisions.

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

COMPLIANT

The Act on the CNB had been amended many times between 1993 and June 2011. The fundamental law governing banking regulation is the Act on Banks. From 1992 to 1 May 2004, when the Czech Republic joined the EU, 11 amendments were of major significance for strengthening banking supervisory competencies, harmonisation of Czech law with EU law or for enhancing client protection. Then, until June 2011, other amendments came into effect, only some of which were just technical. An amendment adopted in 2006 in connection with the integration of financial market supervision into the CNB and an amendment of 2007, which created a legal basis for the implementation of Basel II under relevant EU directives, deserve special mention.

The Act on Credit Unions took effect in 1995 and was amended 19 times by June 2011. All amendments – except two, which were technical – helped to improve the legal framework for supervision of credit unions. For example, the 2000 amendment specified prudential requirements for credit unions, the 2005 amendment regulated consolidated supervision of credit unions, and the amendments adopted in 2006 harmonised the conditions for credit unions’ activities with European rules applicable to the credit institutions having the right to use the single licence. These amendments also made it possible for the CNB to take over supervision of credit unions.

4. The supervisor confirms that information on the financial strength and performance of the industry under its jurisdiction is publicly available.

COMPLIANT

The CNB published on its website detailed information on the banking sector, namely an up-to-date list of banks and foreign bank branches and credit unions, including basic information about these entities, their development over time and in various breakdowns by size or ownership structure. The CNB also publishes on its website an up-to-date list of foreign banks providing banking services in the Czech Republic without establishing a branch based on cross-border service provision notifications, and a list of representations of foreign banks. The CNB publishes quarterly data on assets and liabilities, off-balance sheet activities, profit and effectiveness of the banking sector and the credit unions sector, as well as selected prudential indicators. These include in particular liquidity indicators, capital adequacy indicators, data on default claims, provisions, etc. The CNB publishes also the information on the shares of bank groups in assets, loans and deposits, and selected basic indicators for the individual bank groups. Also published are the *Financial Soundness Indicators* calculated according to the IMF methodology. In addition, the individual banks and credit unions are obliged to publish information about their activities within the scope laid down in Decree No. [123/2007 Coll., stipulating the prudential rules for banks, credit unions and investment firms](#) (hereinafter referred to as the “decree on prudential rules”). The CNB maintains and updates on its website the list of links to the respective websites of the individual banks and credit unions, where such information is available. Until 2005, annual banking supervision reports had been prepared, containing further detailed information. Starting from 2006, following the integration of financial market supervision, the CNB issues the Financial Market Supervision Report containing information not only about the banking sector, but also about credit unions, the capital market, insurance and private pension industries.

Additional criterion

1. In determining supervisory programmes and allocating resources, supervisors take into account the risks posed by individual banks and banking groups and the different approaches available to mitigate those risks.

COMPLIANT

The CNB had in place a medium-term strategy for banking regulation and supervision (for 2005–2010) approved by the Bank Board. This strategy was replaced by “*The Mission of the Czech National Bank for the Supervision of the Czech Financial Market*”. The CNB applies the principle of fund allocation depending on risks in the exercise of banking supervision (and has applied this principle also after it became the integrated financial market supervisor in April 2006). In line with Czech law, European law and internationally acknowledged standards in the area of financial market supervision, the CNB performs its role of integrated supervisory authority also by means of **supervisory work**, including **off-site supervision** of financial institutions, market conduct and capital market infrastructure, and analyses of the financial market and its sectors, and **on-site examinations** in financial institutions and other institutions making up the infrastructure of the capital market. On-site examinations in banks and credit unions are carried out at intervals set according to the risk profile of individual credit institutions and from the point of view of their significance for the stability of the banking or credit unions sector. Annual plans of on-site examinations are prepared in line with this principle. The Risk Profile Assessment System (RAS) provides support to supervision planning and exercising. This system was created in line with the European Banking Authority’s (EBA - former CEBS) recommendations.

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.

Overall assessment of part 1(2):

LARGELY COMPLIANT

Under the Czech Constitution and the Act on the CNB, the CNB – as a central bank which is also a supervisory authority – has an independent status, which is in line with the law of EU law. According to the Act on the CNB, the CNB possesses operational independence, personal independence and financial independence which it uses in fulfilling all its statutory objectives, i.e. also in banking supervision, which is a substantial part of supervision of the Czech financial market. The supreme governing body of the CNB is the Bank Board, whose members are appointed by the President of the Republic for a fixed term (six years) and they are not allowed to hold the mandate more than twice. The President of the Republic may relieve the Governor or another Board member in the cases specified in the Act on the CNB. However, the Act does not stipulate explicitly the obligation to disclose the reasons for dismissal should the President of the Republic decide to relieve the Governor or some of the other Board members. The framework within which the CNB is accountable for the fulfilment of its statutory objectives in financial market supervision, including banking supervision, covers open communication policies vis-à-vis the public and the system of the CNB’s relations vis-à-vis the Czech Parliament, the Czech Government and the Financial Market Committee (an advisory body to the CNB Bank Board for financial market supervision) governed by the Constitution of the Czech Republic and the Act on the CNB.

The grading is decreased as no specific term of office is set for lower management (executive directors of departments), who can in principle be immediately removed from office by the Bank Board.

Analysis of the individual criteria

Essential criteria

- 1. The operational independence, accountability and governance structures of each supervisory authority are prescribed by law and publicly disclosed. There is, in practice, no evidence of government or industry interference which compromises the operational independence of each authority, or in each authority's ability to obtain and deploy the resources needed to carry out its mandate. The head(s) of the supervisory authority can be removed from office during his (their) term only for reasons specified in law. The reason(s) for removal should be publicly disclosed.**

LARGELY COMPLIANT

The operational independence in banking supervision is guaranteed by the Czech Constitution stipulating in Article 98 that interventions in CNB activities are only permissible on the basis of a law, and secured by the Act on the CNB stipulating in Article 9(1) that when providing for the primary objective of the CNB and when carrying out other activities, neither the CNB nor the Bank Board shall seek or take instructions from the President of the Republic, from Parliament, from the Government, from administrative authorities or from any other body. Articles 4 to 8 of the Act on the CNB stipulate the CNB's organisational structure. The supreme governing body of the CNB is the Bank Board. It has seven members: the Governor, two Vice-Governors and four other members. The Governor represents the CNB externally. In his absence, a Vice-Governor nominated by him shall act on his behalf. In line with its policy of open communication with the public, the CNB publishes on its website a detailed organisational structure of its headquarters and branches. The CNB has necessary resources to fulfil its function of an integrated financial market supervisor and is financially independent of the state budget. The CNB manages its finances in compliance with the budget approved by the Bank Board (Article 5(2)(b) of the Act on the CNB). The CNB budget must be broken down so as to show clearly the operating and investment expenditure of the CNB. The CNB defrays the necessary costs of its operations from its income. The profit it generates is used to replenish its reserve fund and other funds created from profits and for other purposes in the budgeted amount. It shall transfer the remaining profit to the state budget (Article 47(1) and (2) of the Act on the CNB). Financial independence is provided for in Article 1(4) of the Act on the CNB stipulating that the CNB shall manage the assets entrusted to it by the state independently and with due diligence, as well as in Article 30(2) of this Act prohibiting the CNB to provide returnable funds or any other financial support to the Czech Republic or its bodies, or to regional authorities, bodies governed by public law or legal entities under the control of the state, a regional authority or a body governed by public law, with the exception of banks. Article 6 of the Act on the CNB stipulates that the term of office of Bank Board members is six years and at the same time lists the reasons for which the Governor or another Board member may be relieved from office. The President of the Republic may relieve the Governor or another Board member in the cases specified in the Act on the CNB. The Governor shall be relieved from office by the President of the Republic if he no longer fulfils the conditions required for the performance of his duties or if he has been guilty of serious misconduct. The President may also relieve the Governor from office if he fails to perform his duties for a period exceeding six months. As the CNB is a member of the European System of

Central Banks, the decision on the Governor's dismissal is reviewable by the European Court of Justice. The President shall relieve a member of the Bank Board from office if he no longer fulfils the conditions required for the performance of his duties. The President may also relieve a Bank Board member from office if he fails to perform his duties for a period exceeding six months. Unlike the decision on removal of the Governor, the decision on removal of a Bank Board member is not reviewable by the European Court of Justice, but can be reviewed by courts at the national level. However, the Act does not stipulate explicitly the obligation to publish the reasons for removal if the President of the Republic decides to relieve the Governor or some of the other Board members. It can be assumed, however, that the President would justify such a serious decision in public. No efforts to affect the CNB's independence or pressures affecting the CNB's ability to supervise the financial market have been observed so far. As regards lower management (executive directors of departments in the case of the CNB), no specific term of office is set and they can in principle be immediately removed from office by the Bank Board.

2. The supervisor publishes objectives and is accountable through a transparent framework for the discharge of its duties in relation to those objectives¹⁾

COMPLIANT

Banking supervision is one of the key components of integrated supervision of the Czech financial market and Article 2 of the Act on the CNB stipulates that financial market supervision shall see to the sound operation and development of the financial market in the Czech Republic, and contribute to the stability of its financial system as a whole. These objectives are in line with the CNB's primary objective, namely to maintain price stability. The framework within which the CNB is accountable for the fulfilment of these objectives in financial market supervision covers open communication policies vis-à-vis the public and the system of the CNB's relations vis-à-vis the Czech Parliament, the Czech Government and the Financial Market Committee governed by the Act on the CNB.

The CNB pursues the policy of transparency and openness to the public. To inform the public, the CNB has published on its *website* "*The Mission of the Czech National Bank for the Supervision of the Czech Financial Market*" containing the CNB's visions and missions, and the values and principles governing its activities in fulfilling the visions and missions. In line with the objectives that the CNB fulfils as a financial market supervisor (see also Principle 1(1)), the CNB issues every year:

- Financial Market Supervision Report (since 2006), providing information about the banking sector, the capital market, insurance and private pension industries and the credit unions sector and about their supervision (Act on the CNB, Article 45d); previously, i.e. before the integration of supervision, the CNB had issued Banking Supervision Reports. This report is submitted for information to the Chamber of Deputies, the Senate and the Government by 30 June of the following year; the section on the banking sector and banking supervision is a substantial part of the report. The report is also intended to inform the public about supervisory activities and financial market developments in the previous year.
- Financial Stability Report; substantial part of this report deals with the stability of the banking sector, which is the basis of the Czech financial system.

¹⁾ See CP 1 (1), EC 1.

As regards the CNB's relationships with the state authorities (legislative and executive), CNB management - in addition to submitting the Financial Market Supervision Report - meets, if necessary, with the representatives of the Czech Parliament more frequently. Regular communication between the CNB and the Government on important issues, including financial market - and thus also banking - supervision, is laid down also in Article 11 of the Act on Banks, which empowers the Minister of Finance or another nominated member of the Government to attend the meetings of the Bank Board in an advisory capacity and may submit motions for discussion and at the same time stipulates that the CNB Governor or a Vice-Governor nominated by him may attend the meetings of the Government in an advisory capacity.

Before the Financial Market Supervision Report is submitted to the Chamber of Deputies, the Senate and the Government for information, it is discussed by the Financial Market Committee (hereinafter referred to as the "Committee"), which is entitled to append its opinion to the report. The Committee is an advisory body to the CNB Bank Board which was established in 2006 in connection with the integration of the supervision of the Czech financial market pursuant to the Act on the CNB (Article 45 to 45c). The Committee has seven members: a Chairman, a Vice-Chairman and another member of the Committee, elected by the Budget Committee of the Chamber of Deputies at the proposal of professional organisations or interest groups of financial market participants and after the CNB and the Ministry of Finance have issued their opinions on the proposed persons, a Bank Board member appointed and dismissed by the Bank Board, two senior officers of the Ministry of Finance appointed and dismissed by the Minister of Finance, and the Financial Arbitrator. *The term of office of the Committee's members is three years. The members of the Committee perform their duties impartially and without compensation (see Article 45a of the Act on the CNB).* In addition to the Financial Market Supervision Report the Committee monitors and discusses general frameworks, strategies and approaches to financial market supervision, significant new trends in the financial market and the supervision or regulation thereof, and systemic national and international issues regarding the financial market and the supervision thereof. The CNB informs the Committee at least twice a year about its main financial market supervisory activities in the past period, including decisions made, e.g. the decisions on granting a licence to a new credit institution or the decisions to impose sanctions on a credit or other financial institution for breaching prudential rules. The Committee is entitled to request information about the activities relating to financial market supervision from the CNB and information about the activities relating to the financial market from the Ministry of Finance and from the Financial Arbitrator. As the banking sector is the basis of the Czech financial system and banking supervision is a substantial part of financial market supervision, the banking supervision issues account for a substantial part of the matters dealt with by the Committee.

The CNB is responsible for the specific decisions which it adopted vis-à-vis financial market entities subject to its supervision. The decisions within licensing proceedings (granting a licence, changing a licence, consent to acquire or increase a qualifying holding in a bank or a credit union, etc.), as well as the decisions on imposing remedial measures on a bank and the decisions on imposing remedial measures on a credit union have the form of administrative proceedings. Each decision adopted by the CNB in administrative proceedings in connection with the exercise of banking supervision can be appealed. The Bank Board decides about the appeals after they are discussed in the Appeals Committee, an advisory body consisting solely of external experts (lawyers in particular). These Bank

Board's decisions are reviewable by courts and each entity concerned may refer the matter to the court to review the decision.

3. The supervisory authority and its staff have credibility based on their professionalism and integrity.

COMPLIANT

The confidence of both the public and market participants in the CNB as a supervisory authority has been increasing according to available information, particularly after it took over the responsibility for supervision of the whole Czech financial market in 2006. The CNB is aware that it must systematically work on enhancing its credibility as a supervisory authority. Under Article 50(4) of the Act on the CNB, the staff of the CNB shall be obliged to follow the principles of professional ethics set forth in the Code of Ethics of the CNB, which shall be approved by the Bank Board. In 2003, the CNB issued the *Code of Ethics of the Czech National Bank*, which was amended in 2006 and 2007 so that it was in line with its role of the integrated financial market supervisor. At the same time, the CNB established the Ethics Committee which shall ensure that the above Code is complied with. This Code, among other things, stipulates the conditions under which the CNB staff may invest on the financial markets so as to increase the protection of the credibility of the CNB as a financial market supervisor beyond the framework provided for by law. The text of the Code of Ethics is available on the CNB website

http://www.cnb.cz/cs/verejnost/pro_media/tiskove_zpravy_cnb/2007/070820_eticky_kodex.html.

As regards the CNB's efforts in the human resources area, including training of the supervisory staff, see below – criterion 4.

4. The supervisor is financed in a manner that does not undermine its autonomy or independence and permits it to conduct effective supervision and oversight. This includes:

- **a budget that provides for staff in sufficient numbers and with skills commensurate with the size and complexity of the institutions supervised;**
- **salary scales that allow it to attract and retain qualified staff;**
- **the ability to commission outside experts with the necessary professional skills and independence, and subject to necessary confidentiality restrictions to conduct supervisory tasks;**
- **a training budget and programme that provide regular training opportunities for staff;**
- **a budget for computers and other equipment sufficient to equip its staff with the tools needed to review the banking industry and assess individual banks and banking groups; and**
- **a travel budget that allows appropriate on-site work.**

COMPLIANT

The CNB manages its finances in compliance with the budget approved by the Bank Board (Article 5(2)(b) of the Act on the CNB). The CNB budget must be broken down so as to show clearly the operating and investment expenditure of the CNB. The CNB defrays the necessary costs of its operations from its income.

- **a budget that provides for staff in sufficient numbers and with skills commensurate with the size and complexity of the institutions supervised;**

The selection procedures for jobs in the CNB's regulation and supervision departments show that working at the CNB - associated with good salary and other bonuses - becomes ever more attractive and prestigious. This is confirmed by the fact that interest in jobs offered by the CNB greatly exceeds the supply of vacancies. Although the CNB applies demanding criteria in the selection procedures, it succeeds to fill the vacancies in several months.

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

The supervisory staff has long been sufficiently stable, as the average annual labour turnover rate has been around 8% in recent years. This applies also to key experts.

- **the ability to commission outside experts with the necessary professional skills and independence, and subject to necessary confidentiality restrictions to conduct supervisory tasks;**

The CNB has sufficient human resources for inspection, methodological and analytical activities as well as for the fulfilment of its other tasks in the area of banking supervision (cooperation with domestic and foreign regulators, the operation of the Credit Register, etc.). In addition, the units engaged in methodological and analytical activities, as well as those exercising banking supervision, can rely on the extensive professional background represented by the other CNB units. The need to commission external staff is thus small. The use of outsourcing of core activities in the exercise of banking supervision is inhibited by legislative barriers. Banks could refuse to provide external staff with internal documents and other information needed for banking supervision as such staff would not be the CNB staff authorised by law. When needed, the CNB had used and is using the services of legal experts in connection with some complex legal matters arising during the exercise of banking supervision. In banking supervision, outside experts are also used in the area of transposition and implementation of EU law into Czech law, supervisory staff training and the development of modern methods of banking supervision.

- **a training budget and programme that provide regular training opportunities for staff;**

The CNB's training system is in place and meets the needs of lifelong learning as regards innovation in banking and banking supervision (the relevant Basel Accords, risk management systems, amendments to legal regulations, accounting amendments, assessment of risk management models, coping with innovated software, language teaching, etc.).

- **a budget for computers and other equipment sufficient to equip its staff with the tools needed to review the banking industry and assess individual banks and banking groups;**

The hardware and software of banking supervisors has the level corresponding to the needs of banking supervision, analytical and methodological activities and all other related activities.

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

The CNB budget allocates to banking supervision departments sufficient funds to cover the costs of planned on-site examinations; necessary funds had always been allocated also for extraordinary examinations.

Additional criterion

1. The head(s) of the supervisory authority is (are) appointed for a minimum term.

LARGELY COMPLIANT

Article 6 of the Act on the CNB stipulates that the term of office of Bank Board members is six years (and they are not allowed to hold the mandate more than twice) and at the same time lists the reasons for which the Governor or another Board member may be relieved from office. This does not apply to lower management. See essential criterion 1 above.

Principle 1(3): Legal framework

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

Overall assessment of part 1(3):

COMPLIANT

The Act on the CNB and a number of other laws are governing the powers of the CNB as the financial market supervisor of the Czech Republic, including supervision of credit institutions. The laws empower the CNB to assess the applications for licences and applications for authorisation to establish a credit union. The laws grant the CNB the necessary powers to exercise supervision in the form of off-site surveillance and on-site examinations, and to impose remedial measures and sanctions (including licence or authorisation withdrawals). The laws also empower the CNB to issue specific implementing regulations which shall - under the relevant laws - lay down detailed regulatory rules. The Act on the CNB and some other laws also empower the CNB to obtain information in the necessary form and frequency from credit institutions and banking and other financial groups of which credit institutions are part.

Analysis of the individual criteria

Essential criteria

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

COMPLIANT

The Czech financial market is part of the single market of financial services of the EU, and credit institutions (and other financial institutions) from EU member countries enjoy here the advantages of the single licence. The CNB acts towards the entities that do not intend or cannot enjoy the advantages of the single licence in the Czech Republic as an authority responsible for granting and withdrawing licences of credit institutions (and other financial institutions).

Decisions concerning the granting of a licence are made by the CNB in accordance with the Act on Banks, Article 4(2) (a banking licence) and Article 5(3) (a licence for a foreign bank wishing to establish a branch within the territory of the Czech Republic). The conditions for the granting of a licence are stipulated by law. The essential elements of an application for a licence are specified in detail in [Decree No. 233/2009 Coll., on applications, approval of persons and the manner of proving professional qualifications, trustworthiness and experience of persons, and on the minimum amount of funds to be provided by a foreign bank to its branch](#) (hereinafter referred to as “Decree No. 233/2009 Coll.”). The CNB also makes decisions on licence revocation (Article 34 and 35 of the Act on Banks).

Pursuant to Article 2a of the Act on Credit Unions, the CNB is empowered to issue an authorisation to establish a credit union. To be granted the authorisation, it is necessary to

meet the terms and conditions set out in Article 2a(4) of the Act. When submitting the application for authorisation to establish a credit union, the applicants shall follow Decree No. 233/2009 Coll. The conditions and procedures for licence revocation are set out in Article 28g and 28h of the Act on Credit Unions.

2. The law empowers the supervisor to set prudential rules (without changing laws). The supervisor consults publicly and in a timely way on proposed changes, as appropriate.
COMPLIANT

The Act on the CNB empowers the CNB as the supervisor of the Czech financial market to issue, on the basis of the relevant laws and within their limits, implementing regulations stipulating prudential rules for credit institutions as well as other financial market entities subject to its supervision or affected by financial market regulation. To this end, it is not necessary to change the laws on the basis of which the implementing regulations are issued (cf. Principle 1(1), essential criterion 2). Specifically, the CNB is authorised to stipulate in an implementing regulation prudential rules:

- for banks and foreign bank branches from third countries on the basis of Article 8b(5), Article 11a(9), Article 12a(8), Article 12a(15), Article 22(2), Article 24(1) and Article 26d(3) of the Act on Banks; this authorisation pertains to stipulating prudential rules both on a solo basis and on a consolidated basis,
- for credit unions on the basis of Article 1a(3), Article 7a(5), Article 7b(9), Article 8(9), Article 8b(1), Article 11(3), Article 27(1) and Article 28i of the Act on Credit Unions; this authorisation pertains to stipulating prudential rules both on a solo basis and on a consolidated basis.

The CNB consults all major changes to prudential rules with the interest groups of credit institutions, i.e. with the Czech Banking Association and the Association of Credit Unions, and where appropriate also with professional organisations such as the Union of Accountants or the Chamber of Auditors of the Czech Republic.

3. The law or regulations empower the supervisor to obtain information from the banks and banking groups in the form and frequency it deems necessary.
COMPLIANT

The CNB is empowered to obtain information in the necessary form and frequency from credit institutions and banking and other financial groups of which credit institutions are part above all in Article 41(2) of the Act on the CNB, which stipulates that in order to undertake its tasks, the CNB shall demand the necessary information and documents from banks, foreign bank branches, credit unions and other entities subject to its supervision (see also Principle 1(1)). The subsequent paragraphs of the same Article authorise the CNB to issue implementing regulations setting forth the content, form, dates and manner of compilation and submission of the information and documents required from the aforementioned entities, and the organisational and communicational terms and conditions for submitting them to the CNB. In addition, Article 41(5) of the Act on the CNB stipulates that if the submitted information and documents do not comply with the requirements set by the CNB or if reasonable doubts arise about the correctness or completeness of the information and documents submitted, the CNB shall be entitled to request relevant details or an explanation. In this context, the Act on the CNB also notes that the CNB is entitled to request other information also pursuant to the relevant provisions of other special legal rules. This includes above all:

- a) information specified in individual decrees or provisions issued by the CNB, regarding in particular prudential rules beyond the basic reporting system pursuant to Article 41(2) of the Act on the CNB, which is submitted by banks and foreign bank branches in accordance with Articles 24(1) and 24(2) and by credit unions in accordance with Article 27(1),
- b) other documents necessary for the performance of supervision of credit institutions on a solo and consolidated basis (Article 24(1) of the Act on Banks and Article 27(3) of the Act on Credit Unions).

The CNB is also empowered to request any information from supervised entities even within on-site examinations, and the laws of the Czech Republic also govern the exchange of information between the CNB and foreign banking supervisory authorities. The latter regulation implements the relevant EU directives.

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.²⁾⁾

Overall assessment of part 1(4):

COMPLIANT

Essential criteria

Pursuant to the Act on the CNB, the CNB acts as an administrative authority in performing financial market supervision and therefore also banking supervision. It is therefore empowered to determine whether banks comply with laws where the Act authorises it to do so. A similar authorisation is in place for implementing legal regulations, i.e. decrees and provision, issued by the CNB on the basis and within the limits of the relevant Acts. Where the CNB detects violation of such an Act or implementing legal regulation, the law empowers it to impose remedial measures or sanctions. The CNB is also empowered to use qualitative judgment in performing banking supervision, and it exercises this power. In the assessment of Principle 1(1), essential criterion 3, it was stated that the CNB is empowered to request from credit institutions subject to its supervision any information and documents necessary to perform supervision both on a solo and consolidated basis. Final responsibility for the activities of these institutions rests with their Board, which also means that the CNB may demand explanations or additional information from the Board of a supervised entity. Thus, the relevant laws make it significantly easier for the CNB to access the Board of the supervised banks, both in off-site supervision and on-site examinations. The CNB uses, but not abuses, these powers in performing supervision.

Analysis of the individual criteria

Essential criteria

1. The law and regulations enable the supervisor to address compliance with laws and the safety and soundness of the banks under its supervision. The law and regulations permit the supervisor to apply qualitative judgement in safeguarding the safety and soundness of the banks within its jurisdiction.

COMPLIANT

²⁾ This component of Principle 1 is amplified in the Principle which addresses „Corrective and remedial powers of supervisors“ (23).

Under the Act on the CNB, the CNB is the central bank of the Czech Republic and the supervisor of the Czech financial market. Banking supervision is exercised over credit institutions and is one of the key components of integrated supervision of the Czech financial market. Banking supervision involves, among other things, checking compliance with laws to the extent stipulated in the Czech law, as well as checking compliance with decrees and provisions issued by the CNB – see Principle 1(1). All the laws and regulations the observance of which by credit institutions the CNB checks contain many provisions focusing on the safety and soundness of credit institutions and thus of the entire financial system of the Czech Republic. The Act on Banks deserves a special mention, stipulating in Article 12 that a bank shall carry on its activities with prudence and, in particular, pursue its business in a manner which is not detrimental to the interests of its depositors in respect of the recoverability of their deposits and which does not endanger the bank's safety and soundness. Similarly, Article 1(5)(b) of the Act on Credit Unions requires credit unions to carry on their business with prudence and due care, above all in a manner which is not detrimental to the interests of their members and their safety and soundness.

The CNB is empowered to use qualitative judgment in performing banking supervision, and it exercises this power. Pursuant to Article 25(3) of the Act on Banks and Article 28(1)(g) of the Act on Credit Unions, the CNB is entitled to review and evaluate whether the arrangements, strategies, processes and mechanisms implemented by the bank or credit union and the capital of the bank or credit union ensure the safe and sound operation of the bank or credit union and coverage of the risks to which it is or might be exposed. Such review and evaluation is carried out at a frequency and intensity proportionate to the size, significance and position of the bank or credit union on the financial market and the nature, scale and complexity of its activities, but at least once a year. It is apparent that qualitative judgement plays a considerable role in such review and evaluation of banks and credit unions.

Qualitative judgement is also used to detect and evaluate shortcomings in the activities of entities subject to CNB supervision, as well as in imposing remedial measures pursuant to Article 46(1) of the Act on the CNB, pursuant to Article 26 of the Act on Banks in respect of banks and pursuant to Article 28 of the Act on Credit Unions in respect of credit unions. The range of remedial measures available to the CNB as the Czech financial market supervisor is broad (see Principle 23). To give one example for the purposes of this Principle, the review and evaluation of a bank or credit union as described above may result in a decision to impose remedial measures under Article 26(1)(h) of the Act on Banks or Article 28(1)(g) of the Act on Credit Unions. This means that the CNB may, after evaluating specific circumstances, require that the bank or credit union increase capital so that capital adequacy higher than the required minimum of 8% is ensured (see also Principle 6). The CNB may require this in particular where the bank or credit union has ineffective arrangements, strategies, processes or mechanisms and other remedial measures appear to be insufficient to rectify the shortcomings in good time.

Qualitative judgement is also the basis for evaluating whether bans have been breached or circumvented. Breaching or circumventing the rules for acquiring interests under Article 17 of the Act on Bank or violating the defined object of business as stipulated in Articles 1(2) to 1(4) of the Act on Banks for banks and Article 3 of the Act on Credit Unions for credit unions are typical examples.

It follows from the nature of the matter that qualitative judgements are also frequently used in licensing and authorisation proceedings. Checking compliance with the Anti-Money Laundering Act and the implementing regulations the CNB has issued for credit institutions is also a specific area where qualitative judgement is applied.

2. The supervisor has full access to banks' Board, management, staff and records in order to review compliance with internal rules and limits as well as external laws and regulations.

COMPLIANT

In the assessment of Principle 1(3), essential criterion 3, it was stated that the CNB is empowered to request from credit institutions subject to its supervision any information and documents necessary to perform supervision both on a solo and consolidated basis. Final responsibility for the activities of these institutions rests with their Board, which also means that the CNB may demand explanations or additional information from the Board of a supervised entity. Thus, the relevant laws make it significantly easier for the CNB to access the Board and senior management of the supervised banks, both in off-site supervision and on-site examinations. The CNB uses, but not abuses, these powers in performing banking supervision.

3. When, in a supervisor's judgment, a bank is not complying with laws or regulations, or it is or is likely to be engaged in unsafe or unsound practices, the supervisor has the power to:

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

COMPLIANT

The laws empower the CNB to require remedial action (see essential criterion 1 above) or impose a sanction when it detects shortcomings in the activities of credit institutions. The scale of remedial measures and sanctions is broad, ranging from fines, prohibition or restriction of some types of licensed or authorised activities to imposition of conservatorship and licence withdrawal.

Principle 1(5): Legal protection

A suitable legal framework for banking supervision is also necessary, including legal protection for supervisors.

Overall assessment of part 1(5):

LARGELY COMPLIANT

The legal order of the Czech Republic creates an appropriate legal framework for banking supervision and supervision of the Czech financial market. The legislative framework for banking and banking supervision is harmonised with the law of the EU law;(cf. Principle 1(1) and part of 1(3)). In principle, the protection of the CNB as the banking supervisor, or rather the financial market supervisor, of the Czech Republic and the protection of CNB staff authorised to perform banking supervision is guaranteed by law and by the independence of the judicial system embodied in the Constitution. Responsibility for potential loss caused in performing banking supervision is defined by the Act No. 82/1998 Coll., on Responsibility for Damages Caused in Exercising State Authority by a Decision or Incorrect Official Procedure and on the Amendment of Czech National Council Act No. 358/1992 Coll., on

Notaries and their Activities (Notarial Code), as amended (hereinafter “Act on Responsibility for Damages Caused in Exercising State Authority”) and borne primarily by the state, which is represented by the CNB before a court of law. The actions of CNB staff authorised to perform banking supervision and the decisions they adopt in performing banking supervision are deemed to have been made by the CNB. If a court of law decided that the state should pay compensation for damages caused by banking supervision, such compensation would be required from the CNB. In that case, the CNB would be entitled to impose sanctions (by recourse) against persons culpable for a breach of their legal duties (culpability must be proved by the party requiring recourse). However, the amount of such compensation by recourse vis-à-vis CNB staff is limited by Act No. 262/2006, the Labour Code, as amended (hereinafter the “Labour Code”). An appropriate degree of protection of CNB staff authorised to perform banking supervision is also ensured by the Criminal Code, as is the case for other staff of public administration control authorities. The CNB is reasonably protected against expenses for legal defence of its decisions adopted in administrative proceedings, as a court of law decides on compensation of such expenses. Together with the decision on the matter, the court also decides who is to pay the expenses for legal representation; however, even in successful cases the CNB does not request compensation of expenses for legal representation, as it represents itself before courts. CNB staff do not bear the expenses of court proceedings in matters relating to responsibility for damages caused in performing banking supervision, as these are borne by the CNB. Enhanced protection of supervisory staff including criminal law protection in the event of misuse of powers by a supervisory staff would be in contradiction of the Czech Republic’s constitutional order. Full compliance with this principle would require a fundamental overhaul of legislation. Such a change is currently not under preparation. Therefore this Principle is assessed as “Largely compliant”.

Analysis of the individual criteria

Essential criteria

1. The law provides protection to the supervisory authority and its staff against lawsuits for actions taken and/or omissions made while discharging their duties in good faith.

LARGELY COMPLIANT

Responsibility for any damages caused in performing banking supervision (i.e. in exercising state authority) by an unlawful decision or incorrect official procedure is governed by Act on Responsibility for Damages Caused in Exercising State Authority. Such responsibility is borne primarily by the state, not an individual institution (e.g. the CNB) or natural person (employee). The Act on Responsibility for Damages Caused in Exercising State Authority lays down the conditions under which the state is responsible for damages caused in exercising state authority; Article 6(4) thereof stipulates that the CNB represents the state in matters concerning its decisions in administrative proceedings or its incorrect official procedure. If the state provides compensation for damages, it will require its full extent from the CNB. This means that the actions of CNB staff authorised to perform banking supervision and the decisions they adopt in performing banking supervision are deemed to have been made by the CNB. If the CNB has to pay damages, however, it is entitled to impose sanctions (by recourse) against the authorised persons who participated in the issuance of the unlawful decision or the incorrect official procedure and who are culpable for a breach of their legal duties (culpability must be proved by the party requiring recourse). The Labour Code limits recourse compensation vis-à-vis CNB staff as well as Bank Board members to 4.5 times the average monthly salary, unless the damage has been caused by an intentional breach of duty (see Articles 250 to 264 of the Labour Code, which govern employees’ responsibility for

damages). A court of law may decrease this limit. However, this option is not possible if the damage has been caused intentionally. Full compliance with this criterion, which requires protection of supervisory staff by law from prosecution for actions taken in fulfilling their duties in good faith, would require a fundamental overhaul of legislation. Such a change is currently not under preparation. Note: the legal framework for responsibility for damages under Czech law does not use the concept of “acting in good faith”.

In the Czech Republic, any citizen may be prosecuted for his actions, with some exceptions specified by law. Criminal law protection is ensured as follows. An inspector or other staff of the CNB is, in the performance of his duties, in the position of a public official when using the powers entrusted in him in connection with his responsibility for the performance of these tasks (e.g. he may issue administrative decisions or perform administrative supervision as part of banking supervision). On the other hand, this may result in potential criminal law liability (e.g. for misuse of powers of a public official). If criminal proceedings are being conducted against a CNB staff for a criminal offence allegedly committed in connection with performing banking supervision, his position in the criminal proceedings is the same as that of any other citizen accused of a criminal offence. In such cases, enhanced protection would be inappropriate from a moral point of view. From the legal perspective, it would be in contradiction of the constitutional order of the Czech Republic: leaving aside diplomatic immunity, which is governed by the Czech Republic’s obligations under international law, only selected persons or groups thereof (the President of the Republic, Deputies and Senators of the Parliament of the Czech Republic, judges and to a certain extent the Ombudsman) are entitled to enhanced protection (immunity). Full compliance with this criterion would require a fundamental overhaul of legislation. Such a change is currently not under preparation.

2. The supervisory authority and its staff are adequately protected against the costs of defending their actions and/or omissions made while discharging their duties in good faith.

LARGELY COMPLIANT

The CNB is reasonably protected against expenses for legal defence of its decisions adopted in administrative proceedings, as in potential lawsuits against the CNB for compensation of damages connected with an unlawful decision or incorrect official procedure a court of law decides whether any damage has occurred and what its extent has been. Together with the decision on the matter, the court also decides who is to pay the expenses for legal representation. Usually, the unsuccessful party to the dispute is obliged to pay the expenses of the successful party, but there are justified exceptional situations in which the court may decide otherwise. However, even in successful cases the CNB does not request compensation for legal representation, as it represents itself before courts.

CNB staff do not bear the expenses of court proceedings in matters relating to responsibility for damages caused in performing banking supervision, i.e. in executing state authority, by an unlawful decision or incorrect official procedure. However, if the CNB is obliged on the basis of a court verdict to pay damages, subsequently requires compensation by recourse from an employee and the employee unsuccessfully challenges the recourse in court, he may bear the expenses for the court proceedings on compensation by recourse. In addition, CNB staff are not protected *ex ante* from expenses on criminal law proceedings if criminal law proceedings are conducted against them for misuse of powers of a public official in connection with the performance of banking supervision. In this case it depends on the result of the proceedings.

Full compliance with this criterion would require a fundamental overhaul of legislation. Such a change is currently not under preparation.

Principle 1(6): Cooperation

Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.³⁾⁾

Overall assessment of part 1(6):

COMPLIANT

The CNB is an integrated supervisor of the Czech financial market (see Principle 1(1) and therefore the exchange of information on the various sectors of this market (credit institutions, the capital market, insurance and private pension schemes), as well as on supervision of these sectors, takes place within the CNB and is governed by the CNB's internal rules.

The law stipulates that the Ministry of Finance as a government administration authority and the CNB as the central bank and financial market supervisor of the Czech Republic 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 Act on the CNB, which stipulates that the CNB acts in an advisory capacity vis-à-vis the Government in matters of monetary policy and the financial market. It also stipulates that the CNB cooperates with the Ministry of Finance in preparing draft legislation on the financial market, that the Minister of Finance or another nominated member of the Government may attend the meetings of the Bank Board in an advisory capacity, and vice versa, that the CNB Governor or a Vice-Governor nominated by him may attend the meetings of the Government in an advisory capacity. Accordingly, the CNB and the Ministry of Finance have concluded three agreements on cooperation in financial market supervision. The "Agreement on cooperation in the preparation of national legislation concerning the financial market and other regulations concerning the fields of competence of the parties to the Agreement" and the "Agreement on cooperation in the area of financial stability and resolving financial market crises" were signed in 2006, and the "Agreement on cooperation in the exchange of information relating to the financial market" was signed in 2007.

As a supervisory authority, the CNB cooperates with its partner supervisory authorities from EU Member States on a multilateral basis, focusing on the CNB's participation in the newly created European Supervisory Authorities including the European Banking Authority (former CEBS) and its expert groups. The CNB develops bilateral and multilateral cooperation with foreign supervisory authorities from EU Member States, the United States and other countries, usually through memoranda of understanding. The Act on Banks specified confidentiality rules protecting information obtained in performing banking supervision as well as requirements for cooperation with state authorities of the Czech Republic and international cooperation. This legal framework is harmonised with EU law.

³⁾ This component of Principle 1 is developed further in the Principles dealing with "Abuse of financial services" (18), "Consolidated supervision" (24) and "Home-host relationships" (25).

Analysis of the individual criteria

Essential criteria

- 1. Arrangements, formal or informal, are in place for cooperation and information sharing between all domestic authorities with responsibility for the soundness of the financial system, and there is evidence that these arrangements work in practice, where necessary.**

COMPLIANT

The Ministry of Finance as a central government authority pursuant to Article 4 of Act No. 2/1969 Coll., on the Establishment of Ministries and other Central Government Authorities of the Czech Republic, as amended (hereinafter “Competence Act”) and the CNB as the central bank and financial market supervisor of the Czech Republic pursuant to Article 2(2) of the Act on 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 Act on the CNB, which stipulates in Article 10(2) that the CNB acts in an advisory capacity vis-à-vis the Government in matters of monetary policy and the financial market. According to Article 37(1) of the Act on the CNB, the CNB prepares and submits, together with the Ministry of Finance, to the Government draft legislation concerning the currency and the circulation of money, and the status, competence, organisation and activities of the CNB, except for financial market supervision, the payment system and electronic money issuance. Pursuant to Article 37(2) of the Act on the CNB, the CNB also cooperates with the Ministry of Finance in preparing draft legislation on the financial market, the payment system, the regulation of electronic money issuance, foreign exchange management and on the introduction of the single currency in the Czech Republic. In addition, pursuant to Article 11 of the CNB, the Minister of Finance or another nominated member of the government may attend the meetings of the Bank Board and may submit motions for discussion. The Act on the CNB also empowers the CNB Governor or a Vice-Governor nominated by him to attend the meetings of the Government in an advisory capacity.

In accordance with the aforementioned Acts, the CNB and the Ministry of Finance have concluded three agreements on cooperation in financial market supervision. The “Agreement on cooperation in the preparation of national legislation concerning the financial market and other regulations concerning the fields of competence of the parties to the Agreement” and the “Agreement on cooperation in the area of financial stability and resolving financial market crises” were signed in 2006, and the “Agreement on cooperation in the exchange of information relating to the financial market” was signed in 2007.

- 2. Arrangements, formal or informal, are in place, where relevant, for cooperation and information sharing with foreign financial sector supervisors of banks and banking groups of material interest to the home or host supervisor, and there is evidence that these arrangements work in practice, where necessary.**

COMPLIANT

The legal basis of cooperation with foreign supervisors is defined in Articles 25 and 38c to 38j of the Act on Banks, which entitle the CNB to exchange information on all facts necessary for banking supervision and governs the possibility to conduct on-site examinations via the

home supervisory authority in the host country. Cooperation with foreign supervisors in supervision of credit unions is governed by virtually identical rules as stipulated in Articles 22 and 22a of the Act on Credit Unions. In both cases, the legal basis is harmonised with EU law.

As a supervisory authority, the CNB cooperates with its partner supervisory authorities from EU Member States on a multilateral basis, focusing on the CNB's participation in the newly created European Supervisory Authorities - for banking supervision this means participation in the work of the European Banking Authority (former CEBS) and its expert groups.

The CNB also develops bilateral cooperation with foreign supervisory authorities from EU Member States, the United States and other countries. The CNB has signed memoranda of understanding on banking supervision with supervisory authorities from Belgium, France, Italy, Germany, the Netherlands, Austria, Slovakia, the United States (New York state) and China. The memoranda of understanding significantly strengthened mutual contacts of the parties' staff and extended the possibilities of information exchange, which are also used to a large extent. The legal basis described above enabled the memoranda of understanding to have contents typical in relationships between banking supervisors in EU Member States. This reinforced the trust of foreign supervisory authorities in the CNB and the CNB's cooperation with foreign supervisory authorities was lifted to a level common in EU Member States. Cooperation with partner supervisors intensified in connection with the implementation of Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006, relating to the taking up and pursuit of the business of credit institutions (recast Directive 2000/12/EC) and Directive 2006/49/EC of the European Parliament and of the Council of 14 June 2006, on the capital adequacy of investment firms and credit institutions (recast Directive 93/6/EEC), especially in the area of joint assessment of specific approaches to measurement and monitoring of credit, market and operational risks and overall assessment of banks risk profiles (joint risk assessment). The CNB cooperates with the consolidating supervisory authority on the basis of pre-defined rules.

In 2009, authorities responsible for supervising cross-border groups within the EU started to establish colleges of supervisors in order to enhance cooperation and coordination and the exchange of information. In the area of banking supervision, the CNB has so far signed seven multilateral memoranda of understanding on supervision of cross-border bank groups. These pertain to the following bank groups: Societe Generale, KBC, ING, UniCredit, Erste, Volksbank and Raiffeisenbank. The home supervisors of these banks are Commission bancaire (Societe Generale), the Banking, Finance and Insurance Commission (KBC), De Nederlandsche Bank (ING), Banca d'Italia (UniCredit) and the Financial Market Authority (Erste, Volksbank, Raiffeisenbank). In addition to these groups, a similar form of multilateral cooperation (albeit not formalised by an MoU) is in place for the LBBW, Wüstenrot and GE Capital groups.

3. The supervisor may provide confidential information to another domestic or foreign financial sector supervisor. The supervisor is required to take reasonable steps to ensure that any confidential information released to another supervisor will be used only for supervisory purposes and will be treated as confidential by the receiving party. The supervisor receiving confidential information from other supervisors is also required to take reasonable steps to ensure that the confidential information will be used only for supervisory purposes and will be treated as confidential.

COMPLIANT

Provision of confidential information to other supervisory authorities, especially foreign ones, is subject to the confidentiality principle by which the CNB is bound in performing banking supervision on both a solo and consolidated basis. Confidentiality is stipulated in:

- Article 25a of the Act on Banks for banking supervision;
- Article 25a of the Act on Credit Unions for supervision of credit unions.

Both Acts stipulate the same confidentiality rules, which are harmonised with EU law and include above all:

- 1) a provision stipulating that all persons exercising supervision or conservatorship with regard to credit institutions are obliged to maintain confidentiality regarding all information acquired in the context of the performance of their occupation, employment or duties. They may divulge to third parties information in aggregate form only such that the specific bank or person in question cannot be identified. The obligation of confidentiality persists even after their occupation, employment or duties have ceased,
- 2) an exhaustive list of authorities and persons to whom such information may be provided under conditions stipulated in the Act,
- 3) a provision stipulating that information acquired in performing supervision may be used solely for executing the tasks of supervision of credit institutions, conservatorship or in judicial proceedings concerning the decisions or the exercise of supervision of credit institutions or in like proceedings before an international authority,
- 4) provisions enabling cooperation with other domestic and foreign supervisory authorities, under which disclosure of information acquired in the context of exercising supervision of credit institutions to an authority responsible for supervising financial institutions or financial markets in the Czech Republic or to an authority responsible for supervising banks, financial institutions or financial markets in another state is not deemed a breach of the confidentiality obligation subject to compliance with the statutory conditions. Given the integration of financial market supervision into the CNB, these provisions are important mainly with regard to cooperation with foreign supervisors,
- 5) conditions under which confidential information, i.e. information subject to the confidentiality obligation, may be disclosed, which are as follows:
 - a counterparty, or the institution concerned, has in place an information protection regime at least within the scope of EU law;
 - exemption from the confidentiality obligation by the CNB Governor. Article 50(1) is applied together with the provisions of the two aforementioned Acts, stipulating that the CNB staff are obliged to maintain confidentiality in the performance of their duties even after the termination of their employment or any similar relation. Pursuant to Article 50(2) of the Act on the CNB, CNB staff may be exempted from this obligation by the CNB Governor;
 - public interest exists. This cumulative condition is also included in Article 50(2) of the Act on the CNB,
- 6) the regime of treatment of confidential information obtained from other supervisory authorities: information acquired from the authorities of foreign states 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.

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

COMPLIANT

The confidentiality obligation requires the CNB to deny disclosure of any confidential information in its possession, with the exception of:

- 1) its partner authorities responsible for banking supervision or financial market supervision (see above), and
- 2) some other authorities and persons resident in the Czech Republic and EU Member States, to whom analogous provisions to those pertaining to supervisory authorities apply.

In addition, Article 25a of the Act on Banks and Article 25a of the Act on Credit Unions stipulate that subject to compliance with other provisions of these Acts, information acquired in the context of exercising banking supervision may be disclosed to:

- EU bodies where necessary to meet the obligations of international treaties;
- international organisations operating in the area of combating criminal activities and also to law enforcement authorities of foreign countries to allow them to fulfil their functions;
- public authorities and other entities in the Czech Republic and in other EU Member States, provided that the information is disclosed for the performance of their duties:
 - a) as authorities involved in the liquidation or bankruptcy of a bank or financial institution,
 - b) of supervision of the authority referred to in subparagraph a),
 - c) as auditor of the statutory financial statements of a credit union,
 - d) of supervision of the auditor of the statutory financial statements of a bank or financial institution,
 - e) of supervision of compliance with company law,
 - f) in combating money laundering and terrorist financing, or imposing international sanctions for the purposes of maintaining international peace and security, protecting fundamental human rights and combating terrorism,
 - g) of supervision of payment or settlement systems,
 - h) as operator of a payment or settlement system,
 - i) as a law enforcement authority,
 - j) as a central bank responsible for monetary policy,
 - k) as systems of insurance of deposit claims and insurance of investors.

Principle 2 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.

Overall assessment of the principle:

COMPLIANT

Essential criteria

The terms “bank” and “permitted activities” are defined in [Act No. 21/1992 Coll., on Banks, as amended](#) (hereinafter the “Act on Banks”). The Act on Banks also stipulates that the term “bank” or “savings bank” may only be used in the commercial name of a legal entity that has been granted a licence.

[Act No. 87/1995 Coll., on Credit Unions and Certain Related Measures and on the Amendment of Czech National Council Act No. 586/1992 Coll., on Income Tax, as amended, as amended](#) (hereinafter the “Act on Credit Unions”) defines the terms “credit union” and “permitted activities”. This Act also stipulates that the term “credit union” may only be used by an entity with the relevant authorisation.

Analysis of the individual criteria

Essential criteria

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

COMPLIANT

Regulation:

Pursuant to Article 1(1) of the Act on Banks, 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 licence 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 financial activities to support the economic activities of its members, consisting above all in accepting deposits and providing loans, providing guarantees and various forms of money services.

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

COMPLIANT

Regulation:

The activities a bank may carry on (permitted activities) are defined in the Act on Banks. 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 Act on Banks, if they are specified in its licence. They are as follows:

- a) investing in securities for own account,
- b) financial leasing,
- c) money transmission services,
- d) issuing and administering means of payment, e.g. credit cards and travellers cheques,

- e) providing guarantees,
- f) opening letters of credit,
- g) collecting payments,
- h) providing investment services pursuant to a special legal rule, where the licence specifies the principal investment services and activities and ancillary investment services the bank is authorised to carry on and the investment instruments in relation to which they may be carried on pursuant to a special legal rule,
- i) money broking,
- j) acting as a depository,
- k) bureau-de-change activities,
- l) providing banking information,
- m) trading for own account or for account of clients in foreign exchange and gold,
- n) renting safe deposit boxes,
- o) activities directly associated with the activities listed in a) to n) and in Article 1(1) of the Act on Banks.

Pursuant to Article 1(4), a bank may not carry on business activities other than those permitted in its licence; however, this does not apply to activities carried on 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.

The principal activities that may be carried on by a credit union are listed in Article 3(1) of the Act on Credit Unions. A credit union may carry on the following activities:

- a) accepting deposits from members,
- b) providing loans to members,
- c) financial leasing for members,
- d) money transmission services and issuing and administering means of payment for members,
- e) providing guarantees in the form of security or bank guarantees on behalf of members,
- f) opening letters of credit for members,
- g) collecting payments for members,
- h) purchase and sale of foreign currency for members,
- i) renting safe deposit boxes for members.

A credit union may carry on these activities only for its members.

The Act on Credit Unions also permits other activities, provided that they are carried on solely for the purpose of ensuring the credit union's principal activities. They are as follows:

- a) placing deposits with credit unions, banks and foreign bank branches,
- b) accepting loans from credit unions and banks,
- c) acquiring and disposing of assets,
- d) trading for own account in foreign exchange and exchange rate and interest rate instruments for the purpose of hedging against risks stemming from principal activities (see Article 3(1) of the Act on Credit Unions),
- e) trading for own account in registered securities, unless stipulated otherwise in the Act.

These activities are not subject to authorisation proceedings.

The Act on Credit Unions also allows credit unions to carry on activities for entities other than their members. Such entities include, for example, the state and its organisational units, regional authorities and municipalities, legal entities established by them or legal entities in

which the state, regional authorities or municipalities are sole shareholders, and other public institutions administering public funds.

The scope of permitted activities of banks and credit unions is included in the information published on the CNB website under the lists of these institutions.

Supervision:

If a bank carries on activities other than those permitted in its licence, it violates the law. Such conduct is deemed to be a shortcoming in the bank's activity. The bank must cease the non-permitted activity within a specified period. Depending on the nature and extent of this activity, the CNB may impose further sanctions on the bank in administrative proceedings as defined in Article 26 et seq. of the Act on Banks, e.g. impose a fine of up to CZK 50 million.

If a credit union carries on activities in conflict with the licence, it commits an administrative offence for which a fine of up to CZK 20 million may be imposed.

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

COMPLIANT

Regulation:

Article 3 of the Act on Banks stipulates that the term “bank” or “savings bank”, translations thereof or terms derived therefrom may only be used in the commercial name of a legal entity that has been granted a licence, unless it is clear from the context in which the term “bank” or “savings bank” is used that such person is not engaged in the activities listed in Article 1(1) of the Act on Banks. Article 3(1) does not apply to legal entities whose commercial name or designation is well established or recognised by law or pursuant to an international treaty.

Article 1(3) of the Act on Credit Unions stipulates that the commercial name of a credit union must contain the designation “credit union”. Only a legal entity established pursuant to the Act on Credit Unions that has been granted authorisation by the CNB may use this designation.

Supervision:

Article 26(9) of the Act on Banks directly defines actions to be taken against entities which use the term “bank” or “savings bank” in their commercial name in an unauthorised way (if Article 3 of the Act on Banks is violated, the CNB may impose a fine of up to CZK 50 million on the entity violating this provision). In such a case the entity would be called upon to change its commercial name. If the entity fails to rectify the shortcoming, further possibilities exist, as stipulated in Act No. 513 Coll., the commercial Code, as amended (hereinafter the “Commercial Code”). Pursuant to Article 29(6) of the Commercial Code, if an entry in the Companies Register is in contradiction with an enforcing provision of the law and remedy cannot be obtained otherwise, the Commercial Court shall call upon the entity to which the entry relates to take remedial action; if the entity is a legal entity and this entity fails to take remedial action within the specified period, the court may decide on its winding up and liquidation, even without a proposal if this is in the interest of protecting third parties.

According to Article 27a(1)(b) and Article 27c(1)(b) of the Act on Credit Unions, a natural person or legal entity commits an offence or administrative offence by using the designation “credit union” in contradiction with Article 1(3), for which the CNB will impose a fine of up

to CZK 1 million in the case of a natural person and up to CZK 10 million in the case of a legal entity. The aforementioned provision of Article 29(6) of the Commercial Code applies at the same time.

4. The taking of deposits from the public is generally reserved for institutions that are licensed and subject to supervision as banks.

COMPLIANT

Regulation:

Only banks (Article 2(1) of the Act on Banks) and credit unions (Articles 1(2) and 3(1) of the Act on Credit Unions) may accept deposits, but subject to restrictions specified in these Acts. A deposit is defined in Article 1(2)(a) of the Act on Banks as any entrusted funds that constitute an obligation to the depositor to repayment thereof. Pursuant to Article 2(2) of the Act on Banks, the continuing issuance of bonds and other comparable securities is also deemed acceptance of deposits where:

- a) it constitutes the sole, or one of the main, activities of the issuer,
- b) the issuer's line of business is providing loans, or
- c) the issuer's line of business is one or more of the activities listed in Article 1(3) of the Act on Banks (see their list under criterion 2).

Supervision:

The CNB is not obliged by law to investigate actively whether an entity accepts deposits from the public in an unauthorised way. However, if it detects such a fact as part of its supervisory activities or economic analyses or if it is notified of such a fact, it files with law enforcement authorities a notification of a suspicion of unauthorised business carried on by the entity pursuant to Article 251 of the Criminal Code (Act No. 40/2009 Coll. the Criminal Code, as amended) or files other notifications with the relevant state authorities.

5. The supervisory or licensing authority publishes, and keeps current, a list of licensed banks and branches of foreign banks operating within its jurisdiction.

COMPLIANT

Regulation:

The Act on Banks (Article 7) requires that the CNB maintain a complete list of the banks and branches of foreign banks active within the territory of the Czech Republic. The CNB maintains up-to-date lists of regulated and registered financial market entities in the Czech Republic through an automated application available to the public on the CNB website. This application also presents basic information about banks, credit unions, foreign banks providing services in the Czech Republic under the single licence regime either by establishing a branch (exercise of the right of establishment) or without establishing a branch (exercise of the right of free movement of services) on the basis of notification on cross-border provision of services, as well as a list of representations of foreign banks and financial institutions carrying on banking activities. This information is updated daily and enables tracking of changes over time. The application also enables direct search of individual entities, information on further involvement in the financial sector, the scope of permitted activities, etc.

The Act on Credit Unions does not place an explicit obligation on the regulator to maintain a list of authorised credit unions, but credit unions are also included in the aforementioned application.

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 organisation is a foreign bank, the prior consent of its home country supervisor should be obtained.

Overall assessment of the principle:

COMPLIANT

Essential criteria

The basic conditions that must be met for a licence to be granted are laid down in [Act No. 21/1992 Coll., on Banks, as amended](#) (hereinafter the “Act on Banks”). The Ministry of Finance is responsible for preparing draft primary legislation. However, in line with an agreement between the Ministry of Finance and the CNB, the CNB is actively involved in the preparation of the Acts the practical application of which lies within its field of competence. The CNB is responsible for the preparation of implementing legal rules (e.g. decrees) based on a specific Act.

The current legal framework for licensing criteria is in line with the standard requirements and criteria required from the entities applying for a licence. The criteria focus on the assessment of the bank’s ownership structure and transparency of the ownership and personal links with persons having a qualifying holding in the bank, trustworthiness and competence of persons having a qualifying holding in the bank with respect to the performance of shareholder rights in the bank’s business activity, the origin of registered capital, the proposed strategy and business plan, the quality of senior officers, as well as on the assessment of technical and organisational prerequisites of the bank’s operation including a functional system of governance. Before issuing a decision regarding a licence application, the CNB is obliged by law to ask the relevant supervisory authority of the EU Member State or another state of the European Economic Area (hereinafter the “Member State”) for its opinion if the entity to which the licence is to be granted is controlled by a foreign bank from the Member State, an entity which is authorised by the relevant supervisory authority of the Member State to provide investment services, an insurance company authorised by the relevant supervisory authority of the Member State or an entity controlling such entities. If an entity having a qualifying holding in the entity to which the licence is to be granted is from a non-Member State and this entity is subject to supervision in the country in which it has its registered office, [Decree No. 233/2009 Coll., on Applications, Approval of Persons and the Manner of Proving Professional Qualifications, Trustworthiness and Experience of Persons, and on the Minimum Amount of Funds to be Provided by a Foreign Bank to its Branch](#) (hereinafter the “Decree No. 233/2009 Coll.”) requires the entity applying for the licence to submit the original of the written opinion of the authority exercising supervision of the entity having a qualifying holding in the entity applying for the licence regarding the intention of this entity to participate as owner in the business activities of the regulated legal entity. Failure to meet the required criteria is a reason for refusal of the licence application.

In the case of credit unions, the criteria for granting authorisation are laid down in [Act No. 87/1995 Coll., on Credit Unions and Certain Related Measures and on the Amendment of Czech National Council Act No. 586/1992 Coll., on Income Tax, as amended, as amended](#) (hereinafter the “Act on Credit Unions”). These criteria are comparable to those applied to banks. Any differences relate mainly to the different legal form of these entities.

Additional criteria

In the licensing or authorisation proceedings, the financial situation of the owners also serves as a basis for assessing the owners’ ability to provide the bank or credit union with sufficient funds (i.e. not only in relation to the currently exercised activities, but also the planned activities of the credit institution). Newly licensed banks or credit unions are monitored in the same manner as other banks or credit unions. The CNB does not deem it necessary to have special procedures for monitoring new banks and credit unions. However, in the first month after the launch of activities of the bank, branch of a foreign bank established in a state which does not enjoy the advantages of the single licence or credit union, more frequent communication between this entity and the CNB is assumed.

Analysis of the individual criteria

Essential criteria

1. The licensing authority could be the banking supervisor or another competent authority. If the licensing authority and the supervisory authority are not the same, the supervisor has the right to have its views considered on each specific application. In addition, the licensing authority provides the supervisor with any information that may be material to the supervision of the licensed institution.

COMPLIANT

Regulation:

Pursuant to Article 1 of [Act No. 6/1993 Coll., on the Czech National Bank, as amended](#) (hereinafter the “Act on the CNB”), the CNB is the supervisor of the Czech financial market. Pursuant to Article 44(2) of the Act on the CNB, the CNB decides on licence, permit and registration applications of banks and credit unions.

2. The licensing authority has the power to set criteria for licensing banks. These may be based on criteria set in laws or regulations.

COMPLIANT

Regulation:

The main criteria and conditions for granting a licence are stipulated in the Act on Banks, Article 4 (bank licence) and Article 5 (licence of a branch of a foreign bank established in a state which does not enjoy the advantages of the EU single licence). The prerequisites of the licence application are governed by CNB Decree No. 233/2009 Coll.

The criteria and conditions for granting authorisation to establish a credit union and carry on its business activities are defined in Article 2a(4) of the Act on Credit Unions. The prerequisites of the application for authorisation are governed by Decree No. 233/2009 Coll.

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

COMPLIANT

Supervision:

The criteria and procedures for issuing a licence or authorisation are consistent with those applied in ongoing supervision, i.e. they are in line with the requirements applied in exercising supervision, which must be met by banks and credit unions in their activities on an ongoing basis. This means that basically the same criteria are applied in licensing and authorising and in exercising supervision with regard to the assessment of senior officers of a bank or credit union, the approval of persons having a qualifying holding in a bank or credit union or persons who are intending to take control of a bank or credit union, the assessment of the internal rules of a bank or credit union, the assessment of the business strategy of a bank or credit union, etc. Supervision also comprises monitoring of whether the capital of a bank or credit union has fallen below the (minimum) requirement.

4. The licensing authority has the power to reject an application if the criteria are not fulfilled or if the information provided is inadequate.

COMPLIANT

Regulation:

Articles 4(5) and 5(4) of the Act on Banks stipulate the conditions that must be met for a licence to be granted. In the case of credit unions, the conditions for granting authorisation are specified in Article 2a(4) of the Act on Credit Unions. Decree No. 233/2009 Coll. contains the prerequisites of an application, specimen forms on which applications for a licence or authorisation are submitted, and documents and information confirming fulfilment of the conditions required by law for a licence or authorisation to be granted. The submitted information must be truthful, complete and up-to-date. If the conditions for granting a licence or authorisation are not met, i.e. the applicant fails to provide all documents and information confirming fulfilment of the conditions required by law for a licence or authorisation to be granted, the application cannot be considered complete. If the applicant fails to provide the missing information in the application and submit the required documents, legitimate conditions are created for the application to be refused, or for issuing a decision whereby the application for a licence, or for authorisation in the case of a credit union, is refused.

5. The licensing authority determines that the proposed legal, managerial, operational and ownership structures of the bank and its wider group will not hinder effective supervision on both a solo and a consolidated basis.

COMPLIANT

Regulation:

For banks and credit unions the conditions, information and documents showing compliance with the statutory conditions for the granting of a licence or permit are set so that the licensing authority, i.e. 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 the effective supervision on both a solo and consolidated basis.

A domestic bank can have the form of a joint stock company (Article 1, paragraph 1, of the Act on Banks) or a European Company under EU law. The Act on Banks imposes a duty to submit the draft articles of association of the entity being established that is to operate as a bank. Under Article 9, paragraph 1, of the Act on Banks, the articles of association have to set out the structure and organisation of the bank, the powers and responsibilities of a bank's managerial employees, the powers and responsibilities of other head office and branch employees and, if appropriate, of other bank unit employees authorised to perform banking transactions and organise the system of governance. The statutory conditions for granting a

licence include the technical and organisational conditions for the performance of proposed banking activities, functional system of governance at the bank, including a risk management system. For this purpose the submitter of an application shall, in accordance with Decree No. 233/2009 Coll., produce a description of the technical arrangement of each activity and the expected number of employees who will perform the planned activities for an applicant for a licence, as well as a commentary on the structure and organisation, which will contain the subject of activities of the various sections, their links to other units, and the powers and responsibilities of the various units. 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 system development strategy, principles for an internal control system, including principles for preventing a conflict of interests and principles for compliance, and security principles, including security principles for information systems. The documents submitted shall make it completely clear how the managerial structure of the future bank, including the operating structure, is set up.

A very significant area that is assessed as a part of the licensing process is the bank's ownership structure. In accordance with the Act on Banks, persons with a qualifying holding in an applicant for a licence are assessed. In practice this means that not only leading shareholders with a direct interest, but also entities who can indirectly influence the future bank's operations, as well as other entities with a close link, are also assessed. A close link is defined in the Act on Banks. A close link shall be understood to mean:

- a) The relationship between two or more entities where one entity has a direct or indirect share in the registered capital of another with an aggregate of no less than 20%;
- b) The relationship between two or more entities where one entity has a direct or indirect share in the voting rights of another with an aggregate of no less than 20%;
- c) The relationship between two or more entities where one of the entities controls the other or others; or
- d) The relationship between two or more entities that are controlled by the same entity.

The request for a licence/permit shall include information about persons with a close link that is a list of persons closely linked with the applicant, a description of the group and method of connection, including a graphic of relations between the various closely linked entities, including a statement on whether the legal order of the country on whose territory the group has a close link hinders supervision by the CNB. For persons with a close link to the applicant the information will include the trading company or name, the registered number of the entity or date of incorporation and registered office, if it is a legal entity, and the first name or names, surname, birth index, or date of birth and address of permanent residence or place of business for a private individual. The objectives of entities with a close link are also a subject of information about an entity with a close link. A necessary condition for the granting of a licence is that the close link within the group does not hinder banking supervision and that in the country on whose territory the group has a close link there are no legal or practical barriers to banking supervision.

The procedure for assessing an application for a permit in the case of credit unions is very similar to the procedure applied to banks. The general rules for the operation of credit unions, as well as special forms of co-operatives, are set out in Act No. 513/1991 Coll., the Commercial Code, as amended (hereinafter the "Commercial Code"), and special rules are contained in the Act on Credit Unions. As a part of the licensing proceedings, the same as for banks, there is a requirement for technical and organisational requisites for the performance of the proposed activities of a credit union, resulting in particular from the articles

of association, a proposal for the system of governance, including a risk management system, and other internal regulations, if appropriate. The technical and organisational requisites shall be understood to mean, in particular, the reasoning for the purpose of establishing the credit union and a strategic plan for its development on the market, drafted in particular in accordance with its orientation on members, by economic sector, region, type and kind of services that are to be provided, the arranging of the appropriate computer, information, accounting and statistical records systems, the arrangement of a sufficient number of staff that will ensure planned activities and the arrangement of the appropriate structure and organisation, as well as requirements that the group of entities with a close link to the credit union be transparent. The same as for banks, a close link within the group may not hinder supervision and in the country on whose territory the group has a close link there may be no legal or practical barriers to supervision. An applicant for a permit for credit union activities is governed by Decree No. 233/2009 Coll. when submitting an application.

6. The licensing authority identifies and determines the suitability of major shareholders, including the ultimate beneficial owners, and others that may exert significant influence. It also assesses the transparency of the ownership structure and the sources of initial capital.

COMPLIANT

Regulation:

In accordance with Article 4 of the Act on Banks, a determination of the suitability of persons with a qualifying holding in an applicant to exercise shareholder rights regarding a bank's operations is required. A qualifying holding shall be understood to mean a direct or indirect interest in the registered capital or voting rights of an entity or their aggregate, which represents no less than 10%, or that enables the exercise of a significant influence on its management. A more detailed list of source documents that a person with a qualifying holding produces is contained in Decree No. 233/2009 Coll. According to this decree, an applicant for a licence submits information concerning a person with a qualifying holding. This information includes:

- A list of entities with a qualifying holding in the applicant and entities that, through concerted conduct with another entity, have a qualifying holding in the applicant, include a graphic of relations between such entities and information about such entities specifying the amount of the share or other form of interest in the applicant and for entities acting in concert also the fact based on which the concerted conduct is taking place;
- A questionnaire for each entity specified in the list containing details related to the acquisition of the qualifying holding and basic information about the person that manages the entity with the qualifying holding, including a questionnaire for the purpose of proving that such persons are fit and proper persons to exercise shareholder rights in the bank, including the production of a document showing they are proper persons, if the CNB cannot obtain it itself (the CNB is, under Article 44b, paragraph 2, of the Act on the CNB, entitled to, for the purpose of proving the lack of a criminal record or that a person is a proper person when in administrative proceedings that the CNB is conducting, request an extract from the Criminal Register and in the cases set out by a separate legal act a transcript- see Article 4, paragraph 7, of the Act on Banks).
- A document on a licence to do business for each entity specified in the list;

- Annual reports and financial statements (audited by an auditor) for the last three fiscal years and, if the entity is part of a consolidated unit, also consolidated financial statements for the same period;
- Information about persons with a close link; entities belonging to a group with a close link specify: The trading company or name, registered number or date of incorporation and registered office, if it is a legal entity, or the place of business, if it is a private individual doing business, or the name and surname, date of birth and address of permanent residence, if it is another private individual, as well as a description of the method of connection of the group with a close link and the content of activities of the various entities in the group with a close link;
- The original written opinion of the supervisor that supervises the entity with a qualifying holding in the applicant in the country of its registered office, on the plan to have an asset interest in the Czech Republic in the business, if the entity in question is subject to such supervision.

The proceedings will also include an assessment of the activities of such persons, i.e. whether they were active in companies against which an application for a bankruptcy order was granted or that had financial problems in the past.

For credit unions the procedure is similar to that for banks, although it is necessary to take into account the specifics resulting from their legal form. When assessing entities with a qualifying holding in a credit union the relevant rules are contained in the Act on Credit Unions and Decree No. 233/2009 Coll.

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

COMPLIANT

Regulation:

The minimum amount of a bank's capital is set in the Act on Banks in Article 4, paragraph 1, and is CZK 500 million. The registered capital has to be comprised of monetary contributions up to no less than this amount. The registered capital has to be paid up before a licence is granted. The minimum amount of funds provided by a foreign bank to a branch is set out in Decree No. 233/2009 Coll. and is CZK 500 million.

Under Article 2 of the Act on Credit Unions, the amount of registered capital is no less than CZK 500,000. Before submitting an application for a permit for incorporation and operation of a credit union, an amount no less than CZK 35 million shall be paid up as registered capital, and/or a risk fund and reserve funds, if they are created upon the establishment of a credit union.

8. The licensing authority, at authorisation, evaluates proposed directors and senior management as to expertise and integrity (fit and proper test), and any potential for conflicts of interest. The fit and proper criteria include: (i) skills and experience in relevant financial operations commensurate with the intended activities of the bank; and (ii) no record of criminal activities or adverse regulatory judgments that make a person unfit to uphold important positions in a bank.

COMPLIANT

Regulation:

In Article 8, paragraph 1, the Act on Banks requires that the board of directors have at least three members and be comprised of managerial employees with the bank. Article 4, paragraph

5, subparagraph d), and Article 5, paragraph 4, subparagraph c), of the Act on Banks stipulate for the granting of a licence a condition whereby persons who, based on an employment or other contract, are proposed for senior managerial positions with a bank with which powers and responsibilities defined by the articles of association are linked (bank managers) 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. then 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 (note: a transcript contains all information about each punishment of the person the transcript concerns and all information about the course of punishments and protective measures, as well as the expungement of punishments, a transcript also contains records of the conditional halting of a criminal prosecution, the conditional setting aside of a proposal for punishment and other facts significant for criminal proceedings, if another legal regulation so provides). A person previously sentenced for an intentional criminal offence may not work as a managerial employee (Article 4, paragraph 7, of the Act on Banks). A person proposed for management, for the assessment of experience and fitness to hold a managerial office with a bank, 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 information 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 6., 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.

9. The licensing authority reviews the proposed strategic and operating plans of the bank. This includes determining that an appropriate system of corporate governance, risk management and internal controls, including those related to the detection and prevention of criminal activities, as well as the oversight of proposed outsourced functions, will be in place. The operational structure is required to reflect the scope and degree of sophistication of the proposed activities of the bank.

COMPLIANT

Regulation:

Strategic intentions and business plans are assessed in accordance with Article 4, paragraph 5, f), and Article 5, paragraph 4, subparagraph e), of the Act on Banks. Under Article 4, paragraph 5, subparagraph e), and Article 5, paragraph 4, subparagraph f), of the Act on Banks a bank and a branch of a foreign bank are under a duty to create the technical and

organisational conditions for the performance of the proposed activities and a functional system of governance. Article 9, paragraph 1, of the Act on Banks also sets out a bank's duty to, in the articles of association, set out the structure and organisation of the bank, the powers and responsibilities of managerial employees at the bank, the powers of other employees at head office and branches and the organisation of the system of governance. Under Decree No. 233/2009 Coll., an applicant for a licence submits a strategic intention and business plan for the next three years broken down in detail, including a commentary on the various items in the business plan, the starting points the business plan is built on, the expected impact on the profitability of a bank or branch of a foreign bank, the concept for developing activities of banks in particular in relation to the proposed business plan and the medium-term aims, as well as the structure and organisation of the bank or the branch of a foreign bank, the powers and responsibilities of managerial employees and other employees (part of the bank's articles of association). 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 system development strategy, principles for an internal control system, including principles for preventing a conflict of interests and principles for compliance, and security principles, including security principles for information systems. When assessing whether a bank's corporate governance is appropriate and functional, the CNB assesses how the shareholders' basic rights are ensured in the bank's articles of association, how the system of governance is set out (the system of governance should meet the requirements and criteria set out in the Act on Banks – Article 8b and [in Decree No. 123/2007 Coll., stipulating the prudential rules for banks, credit unions and investment firms, as amended](#) – Articles 7 to 34), and in what way information about serious facts concerning the bank, including its financial situation, the company's performance, the ownership and management of the bank will be provided. A future bank should have, as a part of the proposed system of governance, requirements with the aim of minimising the risk that results for it from the possible abuse of the bank or branch of a foreign bank for money laundering and terrorism financing.

A requisite for permitting the incorporation and operation of a credit union is also the submission of a business plan for the next three years, including a commentary on the requisites and conditions on which the plan is based, and a concept for the development of the activities of the credit union in particular in relation to the proposed business plan and the medium-term aims. The applicant shall submit the material and organisational requisites for the performance of the proposed activities resulting from the articles of association of the credit union, a proposal for the system of governance, including the management of risks and requirements related to the prevention of money laundering. The facts specified for banks apply to the system of governance in the same way.

A future bank or credit union shall also, as a part of its concept, specify whether it expects an activity that it would otherwise perform will be outsourced to another entity. If a future bank or credit union is assuming such option, it shall ensure, when agreeing outsourcing, that such activities will be performed in accordance with the relevant regulations, including the arrangement of a reporting duty to the CNB. A future bank or credit union shall be aware that this does not free it from any of its statutory duties to the CNB and third parties for the activities that are the subject of the outsourcing. The future bank or credit union shall arrange that the CNB will perform supervision and other checks on facts on the outsourcing provider.

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

the principal shareholders of the bank.

COMPLIANT

Regulation:

A condition for the granting of a licence (this concerns a bank and the branch of a foreign bank from a third country) is the submission of a business plan that is based on the proposed strategy of the activities of the bank or branch of the foreign bank based on real economic calculations – Article 4, paragraph 5, subparagraph f), and Article 5, paragraph 4, subparagraph e), of the Act on Banks, and the properness and fitness of an entity with a qualifying holding in a bank to exercise a shareholder's rights [Article 4, paragraph 5, subparagraph c), of the Act on Banks] and of a foreign bank that establishes a branch in the Czech Republic [Article 5, paragraph 4, subparagraph b), of the Act on Banks]. Decree No. 233/2009 Coll. specifies the documents that should be produced in connection with these requirements. When assessing the strategic intention and plan of a bank or branch of a foreign bank, the CNB compares the amount of capital or amount of funds provided to a branch with the expected activities and their scope. A bank's capital and other funds must have a transparent and stain-free origin, and must be sufficient and of appropriate structure, with regard to the planned activities. In the case of a branch of a foreign bank, the act requires a sufficient volume of funds provided by the foreign bank to its branch with regard to the risks of the branch's business. A person with a qualifying holding in a bank submits annual reports and financial statements for the previous three fiscal years. If the same entity is part of a consolidated unit, it also submits the consolidated financial statements for the same period. If the duty to have its financial statements audited by an auditor applies to such entity, it shall submit such financial statements. A foreign bank from a third country establishing a branch in the territory of the Czech Republic submits audited annual reports and financial statements for the last three fiscal years. If the foreign bank is part of a consolidated unit, it also submits consolidated financial statements. The CNB assesses an entity with a qualifying holding in a bank or a foreign bank from the viewpoint of the entities' readiness to contribute further funding to the bank or branch, if necessary.

In the case of credit unions, under the Act on Credit Unions a condition for the granting of a permit to incorporate and operate a credit union is the reality of the business plan and the ability to develop the credit union with regard to the general knowledge and experience [Article 2a, paragraph 4, subparagraph c)] and the fitness of the individuals or legal entities with the qualifying holding in the credit union and the members with a further membership contribution to exercise the rights of a member in relation to the operation of the credit union [Article 2a, paragraph 4, subparagraph d)]. The strategic intention and business plan of a credit union are assessed in the same way as those of banks, i.e. the amount of capital is compared with the expected activities and their extent. Entities with a qualifying holding in a credit union are assessed in the same way. Decree No. 233/2009 Coll. applies to credit unions.

11. In the case of foreign banks establishing a branch or subsidiary, before issuing a licence, the host supervisor establishes that no objection (or a statement of no objection) from the home supervisor has been received. For purposes of the licensing process, as well as ongoing supervision of cross-border banking operations in its country, the host supervisor assesses whether the home supervisor practices global consolidated supervision.

COMPLIANT

Regulation:

Under Article 4, paragraph 3, of the Act on Banks, before issuing a decision on an application for a licence, the CNB asks the supervisor of a member state supervising banks, securities traders or insurance companies for its opinion. This happens in cases where the entity to which the licence is to be granted is controlled:

- By a foreign bank with its registered office in a member state;
- By an entity that has a permit from the relevant member state supervisor to provide investment services;
- By an insurance company that has a permit from the relevant member state supervisor;
- By an entity controlled by an aforementioned entity.

The Act on Banks requires that the opinion of the relevant foreign supervisor contains, in particular, information suitable for an assessment of 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, based on a contract of employment or other contract, are proposed for senior managerial positions in the bank with which powers and responsibilities defined by the articles of association are connected are fit, proper and experienced (a definition of a qualifying holding is contained in Article 17, paragraph 3, of the Act on Banks). Decree No. 233/2009 Coll. [Article 4, paragraph 3, subparagraph h)] sets out a requirement that a person with a qualifying holding in an applicant that has its registered office outside a member state and that is supervised in the country of its registered office, produces, together with the application for a licence, the original opinion of the authority that performs supervision of the legal entity regarding the legal entity's intention to have an interest in a bank's business in the Czech Republic.

In the case of a branch of a foreign bank from a third country, the requirement to produce 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 supervision of the branch will be performed, is expressed in the Act on Banks - Article 5, paragraph 2,.

(Note: At the current time an amendment to the Act on Banks is in the legislative process and its content includes alterations to the requirements for branches of foreign banks with the registered office outside the territory of a member state. One of the new requirements for the granting of a permit is that supervision of the foreign bank is comparable with banking supervision in EU member states.)

In the case of the provision of banking services with the use of an EU single licence, supervision is within the remit of the home supervisor. The framework rules and principles of supervision of activities of branches of foreign banks and cross-border activities of such banks and the rules on the exchange of information are set out in bilateral or multilateral agreements between partner regulatory and supervisory bodies, Memoranda of Understanding (MoU).

The Act on Credit Unions, in addition to the requirements concerning entities with a qualifying holding in a credit union, states in Article 2j that before the granting of a permit to a credit union the CMB shall ask for an opinion from the member state supervisor performing supervision of credit institutions, securities traders or insurance companies if the entity to which the permit is to be granted is controlled:

- a) By a foreign credit institution with its registered office in the member state;
- b) By an entity that has a permit from the relevant member state supervisor to provide

investment services;

- c) By an insurance company that has a permit from the relevant member state supervisor; or
- d) By an entity that controls a person specified in (a) or (c).

The relevant bodies shall keep each other informed in particular when assessing the suitability of members and managerial employees of supervised entities, and shall exchange information in an ongoing way when granting a licence for activities and when checking their activities.

Supervision:

The CNB's banking supervision shall proceed in accordance with these criteria, which means that it will always request a statement from the authority that supervises a foreign bank in the country of its registered office.

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

COMPLIANT

Regulation:

Article 34 of the Act on Banks states when a licence can be withdrawn. One of the reasons is that the license was obtained based on untruthful information specified in a request [Article 34, paragraph 2, subparagraph b)].

The right to withdraw a permit, if it was obtained based on untruthful information specified in an application, is contained in the Act on Credit Unions [Article 28g, paragraph 2, subparagraph b)].

13. The Board, collectively, must have a sound knowledge of each of the types of activities the bank intends to pursue and the associated risks.

COMPLIANT

Supervision:

As a part of an assessment of whether a bank's top management (a bank's managerial employees) is fit, proper and experienced for the purpose of determining their specialist and other abilities, the future responsibility of a proposed candidate for a bank's top management is taken into consideration, from the viewpoint of his expertise and the ability to identify problematic matters concerning an area. The same approach is taken for persons proposed as members of the board of directors, control and credit commissions and other persons who are proposed for managerial positions in a credit union.

Additional criteria

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

COMPLIANT

Supervision:

The CNB, when assessing the fitness of entities with a qualifying holding in a bank to exercise shareholder rights in a bank under the Act on Banks [Article 4, paragraph 5, subparagraph c)] makes an assessment based on annual reports and financial statements submitted and other documents showing the financial situation of an entity with a qualifying holding and its ability to provide additional funding, if the situation so requires in the future. The same applies to a foreign bank that establishes a branch in the Czech Republic under

Article 5, paragraph 4, subparagraph b), of the Act on Banks. The same approach leading to an assessment of financial strength and the ability to provide more capital in the future to a credit union is applied in the case of an assessment of persons with a qualifying holding in a credit union with an additional membership contribution [Article 2a, paragraph 4, subparagraph d) of the Act on Credit Unions].

An assessment of the ability of an entity with a qualifying holding in a bank to provide additional funding is part of the overall assessment of such entity's financial situation as a part of licensing proceedings.

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

COMPLIANT

Supervision:

A new bank and credit union is, in the first stages after the issue of a permit, monitored in particular based on regular mandatory reporting and from the viewpoint of compliance with the business and strategic aims, or how it meets the conditions in a licence or permit, if set.

A licence under the Act on Banks (Article 1, paragraph 7) can contain the setting of conditions that the bank or a branch of a foreign bank is under a duty to meet before the start of any licensed activity, or to maintain when performing any licensed activity. When performing supervision of new banks, standard procedures of remote and on-site examination that are sufficient and appropriate are applied.

The Act on Credit Unions [Article 2a, paragraph 3,] states that a permit can contain a determination of the conditions that a credit union is under a duty to comply with before starting any permitted activity, or to comply with when performing any permitted activity. Generally, the procedure for controls on compliance with the conditions of permits that applies to banks also applies to credit unions.

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.

Overall assessment of the Principle:

COMPLIANT

Essential criteria:

Based on Directive of the European Parliament and of the Council 2007/44/EC of 5 September 2007, amending Council Directive 92/49/EEC and Directives 2002/83/EC, 2004/39/EC, 2005/68/EC and 2006/48/EC as regards procedural rules and evaluation criteria for the prudential assessment of acquisitions and increases of holdings in the financial sector (hereinafter “Directive 2007/44/EC”), the various sector acts governing the acquisition of qualifying holdings were amended with the aim of implementing into such acts the requirements set out in the directive and unifying this throughout the financial sector.

[Act No. 21/1992 Coll., on Banks, as amended](#), (hereinafter the “Act on Banks”) states that an entity or entities acting in concert require the consent of the CNB to acquire a qualifying holding in a bank, to increase a qualifying holding in a bank and to become a bank’s controlling entity. The requisites of an application for the granting of consent, or the documents, data and information that have to be attached to an application for the granting of consent are specified in [Decree No. 233/2009 Coll., on applications, the approval of persons and the manner of proving that persons are fit, proper and experienced and on the minimum amount of funds to be provided by a foreign bank to its branch](#) (hereinafter “Decree No. 233/2009 Coll.”). The CNB has the right not to grant consent, if an applicant does not meet the conditions and requirements set out by the act and the decree. The CNB will suspend the exercise of some shareholder rights if a shareholder acquires itself or through concerted conduct with another entity a qualifying holding in a bank without the CNB’s prior consent after a deadline set by the CNB or without subsequent consent being granted (in cases worthy of special attention).

The requirement for the regular identification of entities with a qualifying holding in a bank is met not only by the approval of acquisition and an increase in qualifying holdings but also by the CNB getting a list of all shareholders and share administrators before a general meeting. The duty to have the CNB’s consent applies only to entities that are beneficial owners of shares in a bank, not to entities that only represent an owner at a general meeting.

The same provisions concerning the problem of a qualifying holding as in the Act on Banks are also contained in [Act No. 87/1995 Coll., on Credit Unions and on the Amendment of Czech National Council Act No. 586/1992 Coll., on income taxes, as amended, as amended](#), (hereinafter the “Act on Credit Unions”). This act also contains a duty for an entity or entities acting in concert to request consent for the acquisition or increase of a qualifying holding in credit unions or to become persons controlling a credit union. If the articles of association of a credit union enable an additional membership contribution and the transfer of membership rights from the contribution would lead to the acquiring member obtaining a qualifying holding in the credit union or increase its qualifying holding in such a way that it reaches the limits set in the Act on Credit Unions, this transfer is conditional on the prior consent of a members’ meeting of the credit union and the granting of prior consent by the

CNB. When submitting an application for the acquisition or increase of a qualifying holding or an application for control an entity proceeds in accordance with Decree No. 233/2009 Coll.

Additional criteria:

The Act on Banks explicitly states for banks a duty to inform the CNB in writing of all changes, if the changes are subject to a procedure in accordance with the act (acquisition or increase of qualifying holding, control of bank or reduction in qualifying holding), promptly after ascertaining the decisive facts. Credit unions are, under the Act on Credit Unions, under a duty to inform the CNB in writing of the acquisition or change to entities' qualifying holdings in a credit union if, due to the changes or actions of other members, the statutory limits are exceeded or reduced, within 5 working days of ascertaining the decisive facts.

Analysis of individual criteria

Essential criteria:

1. Laws or regulations contain clear definitions of “significant” ownership and “controlling interest.”

COMPLIANT

Regulation:

In accordance with the Directive of the European Parliament and of the Council 2006/48/EC of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast), a qualifying holding is regarded as a significant ownership interest. A qualifying holding is defined in the Act on Banks (Article 17a, paragraph 3) as a direct or indirect share in the registered capital or voting rights of a person or their aggregate that represents at least 10% or enables the exercise of a significant influence on its management. An indirect interest shall be understood to be an interest held through an entity or entities that are controlled (Article 17a, paragraph 1).

A qualifying holding is defined in a similar way in the Act on Credit Unions.

The term “controlling person” is defined in Article 66a, paragraph 2 to paragraph 5, and paragraph 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 (hereinafter a “controlled person”). 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.
- A controlling persons is always an entity that:
 - a) Is a majority shareholder; this does not apply if the controlling person is determined in accordance with paragraph b);
 - b) Has a majority of voting rights based on an agreement concluded with another member or members; or
 - c) Can push through the appointment or election or dismissal of most persons who are a statutory body or member thereof, or most persons who are members of the supervisory board of the legal entity of which it is a member.

- Entities acting in concert that together have a majority of voting rights in a certain entity are always controlling persons.

- If it is not proved that another entity has the same or a higher quantity of voting rights, an entity that has no less than 40% of voting rights in a certain entity shall be regarded as the controlling person and entities acting in concert that have no less than 40% of voting rights in a certain entity are controlling persons.

- If one or more entities are subjected to uniform management (hereinafter a “managed person”) by another entity (hereinafter a “managing person”) such entities, together with the managing person, form a group (holding organisation) and their enterprises, including the managing person’s enterprise, are group enterprises. Unless the opposite is proved, a controlling person and entities controlled thereby form a group. Entities can also be subject to uniform management by a contract (hereinafter a “control contract”). A control contract can also be concluded in relations between a controlling person and entities controlled thereby. A person who is a managing person based on a control contract is always a controlling person.

The aforementioned provisions of the Commercial Code apply to banks and credit unions.

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

COMPLIANT

Regulation:

The Act on Banks (Article 20, paragraph 3) sets out for an entity or entities acting in concert a duty to request the CNB’s consent:

- a) For the acquisition of a qualifying holding in a bank;
- b) For the increase of a qualifying holding in a bank in such a manner that it exceeds 20%, 30% or 50%; or
- c) 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. The act also stipulates which interests in registered capital or voting rights are included or not included for the purposes of calculating voting rights.

Changes to a qualifying holding in a bank, or applications for a permit to acquire or increase a qualifying holding or a permit to become a controlling person are assessed the same as in the case of licence proceedings, i.e. in cases of applications for a licence. The CNB, based on a request, issues an administrative decision on consent to the acquisition of a qualifying holding or a decision on consent to an entity that concluded a control contract with a bank. The CNB issues decisions on requests no later than 60 working days after the day written confirmation of the receipt of a request is sent (it is necessary to confirm it within 2 days of the day a request is filed).

An application shall include a statement in which the applicant states whether it is acting on its own behalf and on its own account, whether it is exercising or will exercise voting rights in favour of a third party, whether it intends to authorise another person based on a concluded contract or other agreement to exercise voting rights in the bank, whether a contract has been concluded with a third party based on which the applicant is to become a controlled person,

whether it is acting in concert with another person that owns shares in the bank or to which the exercise of voting rights was transferred or that has the option of exercising an influence on the bank's management, etc.

The reduction or loss of a qualifying holding in the bank or the fact that an entity ceases to control a bank is subject to a reporting duty. Specifically, the Act on Banks imposes a duty on an entity or entities acting in concert to notify the CNB without undue delay that they are reducing their qualifying holding in the bank in such a manner that it falls below, 50%, 30% or 20% or losing it entirely, or are reducing their qualifying holding in such a way that they cease to control it (Article 20, paragraph 14, of the Act on Banks). Such notification shall contain information about the entity or entities reducing or losing their qualifying holding in the bank or the entity or entities ceasing to control it, information about the bank in which the interest was reduced or lost or that ceases to be controlled, information about the total amount of the share in the bank after its reduction and information about the entity or entities that are acquiring or increasing a share in a bank.

In accordance with Directive 2007/44/EC, the issue of the acquisition and increases in a qualifying holding or control or reduction of a qualifying holding for credit unions is dealt with in the same way as for banks (Article 2b of the Act on Credit Unions).

The Act on Banks and the Act on Credit Unions set out the option, in cases worthy of special attention, of granting consent subsequently.

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

COMPLIANT

Regulation:

The CNB grants an application for consent to the acquisition or increase of a qualifying holding in a bank or an application for consent to control provided that the applicant, from the viewpoint of possible influence on the performance of a bank's activities, meets the conditions set out by the Act on Banks. These conditions are:

- a) The entities that apply for the granting of consent are proper persons;
- b) The persons who are proposed as managerial employees of the bank meet, without evident doubts, the conditions of being fit, proper and experienced, if the applicant proposes changes to such managerial employees;
- c) A sufficient volume, transparency of origin and lack of problems with the applicant's funds in relation to the activities performed and planned in the bank;
- d) The bank will continue to comply with the rules of prudent business conduct on a solo and consolidated basis;
- e) The structure of the consolidated unit in which the bank is to be included does not prevent efficient supervision of the bank, effective exchange of information between the CNB and the supervisory authority of the member state that supervises the financial market, or hinder the exercise of powers by each supervisory authority over the consolidated whole and over entities included in the consolidated whole; and
- f) In connection with the proposed acquisition or increase of a qualifying holding in a bank there are no reasonable fears that it could lead to a breach of the act governing money laundering and financing terrorism, or that there has been such a breach.

Documents and other information showing compliance with these conditions and a sample form on which an application for the granting of consent is submitted are contained in Decree No. 233/2009 Coll. This primarily concerns:

- a) An original document on the applicant's authorisation to do business;
- b) Original documents on the origin of the funds from which the acquisition or increase in the qualifying holding was paid;
- c) Financial statements of the applicant i.): Annual reports and financial statements for the last 3 fiscal years, or for the period in which the applicant has been performing business activities, if the period is less than three fiscal years; in the event the applicant is part of a consolidated whole, then the consolidated annual reports and financial statements for the same period; if the financial statements are to be audited by an auditor under another legal regulation, the financial statements shall be audited by an auditor; ii.) Documents similar to the documents in section (i), if they concern a foreign legal entity or foreign individual doing business; iii) documents on revenues for the last three years, assets and liabilities, if this concerns an individual;
- d) Information about entities closely linked to the applicant;
- e) A description of relations between the applicant and the regulated legal entity in which the applicant intends to acquire or increase a qualifying holding, and relations between the applicant and persons with a special relationship to the legal entity, at least regarding persons who are managerial persons, members of the supervisory board or members of the control commission of the regulated legal entity, in the case of credit unions also persons elected to the credit commission;
- f) The original written opinion of the body that performs supervision of the applicant in the country of its registered office on the applicant's plan to acquire or increase its qualifying holding in the regulated legal entity, if this concerns an applicant with its registered office outside the territory of a member state over which such supervision is performed in the country of its registered office;
- g) The strategic plan containing information about:
 1. The period for which the qualifying holding is to be held;
 2. The expected change in the amount of the qualifying holding in the short and long term;
 3. The expected degree of involvement in the strategic management of the regulated legal entity;
 4. Any support for the regulated legal entity using additional own funds, if it is necessary to develop activities or maintain activities;
 5. An agreement with other shareholders or members in the regulated legal entity; and
 6. Also the development of activities of the regulated legal entity in relation to the current plan for business activities, the profit distribution or loss settlement policy, including the dividend policy, the method of financing further development of the regulated legal entity, the system of governance, and possible changes to personnel and the strategic development of the regulated legal entity, if the qualifying holding exceeds a 20% share in the registered capital or voting rights of the regulated legal entity.
- h) A list of entities who, through concerted conduct with the applicant, have, will acquire or will increase their qualifying holding in the regulated legal entity, with data about such entities specifying the amount of the shareholding or other form of interest in the regulated legal entity and the fact based on which concerted conduct is occurring.

Applications also include documents showing the clean criminal report of an individual applicant and also persons who are members of the applicant's board of directors, including a specification of the position of such persons and a questionnaire related to the propriety of

such persons. The applicant also attaches a statement concerning facts related to the acquisition or increase of a qualifying holding or control of a bank.

In the case of credit unions, the statutory requirements (Article 2b of the Act on Credit Unions) for entities that request consent to acquire or increase a qualifying holding or consent to become persons controlling credit unions are the same as for banks. When submitting an application, an applicant follows Decree No. 233/2009 Coll.

In the case of both banks and credit unions, if an applicant for consent does not meet the requirements or conditions set out by the Act on Banks or the Act on Credit Unions, and Decree No. 233/2009 Coll., this is a statutory reason to reject an application for consent to acquire a qualifying holding in a bank or a credit union.

4. The supervisor obtains from banks, through periodic reporting or on-site examinations, the names and holdings of all significant shareholders or those that exert controlling influence, including the identities of beneficial owners of shares being held by nominees, custodians and through vehicles which might be used to disguise ownership.

COMPLIANT

Regulation:

As a part of regular reporting every quarter banks submit a list of all shareholders by name with the amount of their interests in the bank's registered capital, if it is higher than 5%. Information related to significant shareholders and entities that have a controlling interest can also be obtained from the information that banks or branches of foreign banks are under a duty to submit in accordance with the Act on Banks. The Act on Banks (Article 11a) sets out a duty concerning the publication of information by banks and branches of foreign banks that do not enjoy the benefit of an EU single licence. Such entity publishes basic information about itself, the composition of shareholders, the structure of the consolidated unit of which it is part, its activities and financial situation. [CNB Decree No. 123/2007 Coll., stipulating the prudential rules for banks, credit unions and investment firms](#) (hereinafter the "Prudential Rules Decree"), in part seven and the related annexes, deals in detail with the content of information to be published, the periodicity and deadlines for published information, the method of publication, the structure of published information and the content of information audited by an auditor. As can be seen from the name, the decree also applies to credit unions - see the part on credit unions. The CNB is also, under Article 20a, paragraph 8, of the Act on Banks, entitled to, at any time, request (from the central depository) an extract from the register of an issuer that is a bank. According to the Act on Banks (Article 20a, paragraph 3), a bank is under a duty to submit to the CNB a list of all shareholders and administrators of issues of a bank's shares acquired as of a day that is seven days before the general meeting - see criterion 5.

As a part of regular reporting, every quarter a credit union submits to the CNB information about persons with a qualifying holding in the credit union and about members with an interest of more than 5% in the registered capital. Under the Act on Credit Unions (Article 7b, paragraph 1), a credit union publishes basic information about itself, about its members with a qualifying holding in the credit union and about its members with an additional contribution, about the structure of the consolidated unit of which it is part and about its activities and financial situation. The details of the publication of the information by a credit union are specified in Prudential Rules Decree.

5. The supervisor has the power to take appropriate action to modify, reverse or otherwise address a change of control that has taken place without the necessary notification to or approval from the supervisor.

COMPLIANT

Regulation:

The Act on Banks (Article 20a, paragraph 1) entitles the CNB, in cases where a qualifying holding in a bank was acquired without the CNB's prior consent, a qualifying holding was acquired after a deadline set by the CNB in cases where consent was not granted subsequently, or the CNB finds that the actions of an entity or entities with a qualifying holding in a bank are to the detriment of the proper and prudent operation of the bank, or such actions can be expected, to suspend in administrative proceedings the exercise of the following shareholder rights by a shareholder who has itself, or through concerted conduct with another entity, a qualifying interest in the bank:

- a) To attend and vote at the general meeting;
- b) To request the convening of an extraordinary general meeting.

In a similar way, the CNB can also suspend the effect of a control contract. This means that in cases where a bank is taken control of without the CNB's prior consent or after a deadline and subsequent consent is not granted, as well as in cases where the CNB finds that the actions of the controlling person are to the detriment of the proper and prudent operation of the bank, or such actions can reasonably be expected, in administrative proceedings the CNB will suspend the operation of a control contract and the control contract will terminate on the nearest date allowed by the Commercial Code.

According to the Act on Banks (Article 20a, paragraph 3), a bank is under a duty to submit to the CNB an extract of all shareholders and administrators of bank share issues drafted as of a day that is seven days before the general meeting. This extract shall be delivered by the bank to the CNB no later than 6 days before a general meeting. The CNB will approve the list of shareholders specified in the extract from an issue of bank shares or in a written statement on the extract from the issue of bank shares will mark, without undue delay, the shareholders for whom shareholder rights were suspended earlier with which administrative proceedings are being conducted or for which it has newly found a reason to suspend shareholder rights, and return the extract, together with the statement, to the bank no later than the day before the day of the general meeting. A bank cannot admit to a general meeting entities that the CNB has marked in the extract from issue of bank shares, or the attendance of an entity not specified in the extract from issue of bank shares, or persons authorised by such entities (Article 20a, paragraph 4). If the CNB, in its statement on an extract from issue of bank shares marks an entity for which it finds reasons to suspend shareholder rights, this shall start administrative proceedings under Subsection , paragraph 1., unless administrative proceedings have already been commenced with the shareholder on the matter. Without a written statement of the CNB on an extract from issue of bank shares, a bank's general meeting may not be held (Article 20a, paragraph 5).

The Act on Credit Unions also sets out the CNB's right to take steps, if it finds that a person acquired a qualifying holding or increased a qualifying holding in a credit union without prior consent over the limits specified in the act or that the actions of an entity with a qualifying holding in a credit union are in conflict with a permit issued or the Act on Credit Unions, to decide to suspend the right of an entity with a qualifying holding to attend a members' meeting and vote at it and the right to request the convening of a members' meeting. The Act on Credit Unions qualifies the acquisition of a qualifying holding in a credit union or its

increase without prior consent as a misdemeanour (in the case of an individual) or an administrative offence in the case of a legal entity. In the case of credit unions the CNB is entitled to impose a financial penalty, on individuals of up to CZK 1 million and on legal entities of up to CZK 10 million [Article 27a, paragraph 1, subparagraph a), and Article 27c, paragraph 1, subparagraph a), of the Act on Credit Unions].

A credit union cannot allow an entity for which the CNB has suspended the aforementioned rights to attend and vote at a members' meeting (Article 2c, paragraph 2, of the Act on Credit Unions).

Additional criterion

1. Laws or regulations provide, or the supervisor ensures, that banks must notify the supervisor as soon as they become aware of any material information which may negatively affect the suitability of a major shareholder.

COMPLIANT

Regulation:

Under the Act on Banks (Article 20, paragraph 17) banks are under a duty to inform the CNB in writing of all changes, if the changes are subject to a procedure in accordance with the act (acquisition of qualifying holding, acquisition of controlling interest, reduction in qualifying holding), promptly after ascertaining the decisive facts.

Credit unions are, under the Act on Credit Unions (Article 2c, paragraph 3), under a duty to inform the CNB in writing of the acquisition or change to entities' qualifying holdings in a credit union if the statutory limits are exceeded or reduced, within 5 working days of ascertaining the decisive facts.

Principle 5: 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.

Overall assessment of the Principle:

LARGELY COMPLIANT

Essential criteria:

[Act No. 21/1992 Coll., on Banks, as amended](#) (hereinafter the “Act on Banks”), regulates investments and acquisitions in non-financial entities uniformly through quantitative limits and qualitative conditions/limitations, e.g. through a ban on holdings in some forms of commercial companies. A bank, under the Act on Banks, needs the prior consent of the CNB to conclude a contract based on which any disposal of an enterprise or part thereof, or merger or division of a bank is performed. A bank is also under a duty to inform the CNB of a plan to establish a legal entity abroad or to hold an ownership interest therein. Under the Act on Banks, banks are under a duty, when performing their activities, to proceed prudently, in particular to perform transactions in a manner that does not damage the interests of their depositors from the viewpoint of the return on their deposits and does not endanger the safety and stability of the bank as far as concerns making acquisitions and investments. The CNB has the power to review investments and acquisitions realised by a bank and check whether it is exposing itself to unreasonable risks. The transactions are not, however, subject to the “prior consent” of the CNB, so the rating level is reduced. If, however, there has been a breach of the set duties [Article 26, paragraph 3, subparagraph b)], the CNB is, in accordance with the circumstances of the case, entitled to impose a remedial measure as a part of which it can require that a bank reduces the amount of its interest in another entity or transfers its interest in such entity to another entity, or otherwise limits the risks resulting from the bank’s interest in such person [Article 26, paragraph 1, subparagraph a), item 11].

A credit union is not, under [Act No. 87/1995 Coll., on Credit Unions and on the Amendment of Czech National Council Act No. 586/1992 Coll., on income taxes, as amended, as amended](#) (hereinafter the “Act on Credit Unions”) entitled to acquire a direct or indirect interest in the registered capital of a legal entity, become a member or shareholder of a legal entity or otherwise acquire an interest in the management of a legal entity. The Act on Credit Unions, however, enables an exception, as it enables a credit union to acquire other assets, but only in connection with securing its receivables, and for no more than 6 months; this limitation does not apply to assets acquired by security transfer of right in accordance with the Civil Code or by the transfer of financial collateral under the Act on Financial Collateral. A credit union can only merge with another credit union. A credit union can only be split into credit unions. The CNB’s prior consent is necessary for a split or merger.

[Decree No. 123/2007 Coll., stipulating the prudential rules for banks, credit unions and investment firms](#) (hereinafter the “Prudential Rules Decree”) sets out the rules for acquiring, financing and assessing assets. According to these rules, it is not possible to acquire interests or subordinate receivables in persons having a qualifying holding in a bank; an exception is cases where a bank acquires securities as a market maker and their value for one issuer does not exceed 1% of the bank’s capital. Limitations on investments and acquisitions in the Act

on Banks and the aforementioned decree do not distinguish investments in domestic and foreign legal entities, so the aforementioned limitations also apply to legal entities registered abroad. The Decree also sets out the requirements related to the management of risks, which includes a requirement for setting procedures for recognising, assessing, measuring, monitoring and limiting risks, setting a system of limits for risk management, principles for control mechanisms, drafting a strategy for managing various risks containing both principles and methods for risk management and an acceptable degree of risk.

Additional criterion:

The CNB does not issue consents to the acquisition of a major holding in a financial institution, including holdings acquired abroad. When a holding is acquired abroad the requirements set out in the Act on Banks and the Prudential Rules Decree apply and are to prevent activities that could endanger a bank or depositors.

Analysis of individual criteria

Essential criteria:

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

LARGELY COMPLIANT

Regulation:

In addition to implementing limits related to the acquisition of qualifying holdings by banks outside the banking sector, the Act on Banks also enables banks to acquire an interest in another legal entity, to establish another legal entity or contribute to its establishment, under certain conditions. These conditions are that:

- a) The bank does not become a member with unlimited liability;
- b) 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 Article 14, subparagraph c), of the Act on Banks;
- c) There are no legal or other barriers to the provision of information by this person to the bank or to the provision of such information by the bank for the purposes of supervision of the bank's activities and the transparency of the consolidated unit of which the bank is a member is maintained, and the close link within the consolidated unit does not prevent supervision of the bank's activities; or
- d) The investment is in accordance with the bank's overall strategy and the bank manages the risks linked to the investments, in particular from the viewpoint of the bank's possible liabilities resulting from this.

The CNB regards regulation designed in such a way as more effective than approving individual cases. This approach is more acceptable to the CNB from the viewpoint of the CNB's reputation. A major interest in a company brings with it responsibility for its results. The CNB requests that banks have a strategy for acquiring qualifying holdings, so that they can assess in ongoing fashion the effectiveness of such holdings in such a manner that the holdings do not have a negative impact on the bank's financial management. Individual proposals for banks' ownership interests are not assessed by the CNB, so specific criteria for such individual proposals are not set. The CNB's participation in the decision-making process

in individual cases could also be perceived by the public as co-responsibility in the event that the bank's activities make a loss. However, the assessment is reduced for these reasons.

The Act on Banks (Article 17) and the Prudential Rules Decree (Articles 190 and 192) stipulate limitations for banks in the case of asset acquisitions. When realising their plans banks have to comply with statutory limits and restrictions. Under Article 12, paragraph 1, of the Act on Banks, banks are under a duty, when performing their activities, to proceed prudently, in particular to perform transactions in a manner that does not damage the interests of their depositors from the viewpoint of the return on their deposits and does not endanger the safety and stability of the bank. This requirement also concerns acquisitions and investments. Actions in conflict with the duty to behave prudently, under the Act on Banks (Article 12, paragraph 1), include the conclusion of a control contract based on which the bank would be in the position of a managing person.

Credit unions are not, under the Act on Credit Unions (Article 1, paragraph 8), entitled to acquire a direct or indirect interest in the registered capital of a legal entity, become a member or shareholder of a legal entity or otherwise acquire an interest in the management of a legal entity. In connection with the arrangement of its activities, a credit union is entitled to acquire assets and dispose of them under the Act on Credit Unions (Article 3, paragraph 2). A credit union can acquire other assets only in connection with collateral for a receivable, for no more than 6 months.

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

MATERIALLY NON-COMPLIANT

Regulation:

Individual proposals by banks are not assessed ex ante and the criteria for such an assessment are not set, so the rating level is reduced. The Act on Banks and the Prudential Rules Decree, however, set out a number of conditions that should lead to a limitation on the riskiness of a bank's investments and acquisitions. The Act on Banks sets limits for a bank's qualifying holdings in relation to the bank's capital, which is 15% for one legal entity and 60% for the aggregate of all qualifying holdings, on a solo and consolidated basis. The Act on Banks then stipulates that the duty to comply with such limits on a solo basis is only imposed on a bank that:

- a) Is not controlled by a domestic controlling bank or domestic financial holding entity;
- b) Is not the responsible bank in the group of a foreign controlling bank or another bank in such group;
- c) Does not control another bank, financial institution, or ancillary service enterprise; or
- d) Has been taken out of a consolidated unit.

In the case of consolidated supervision, the duty to comply with such limits is only imposed on a bank that is:

- a) A domestic controlling bank;
- b) A controlling bank, but not a domestic controlling bank or responsible bank in the group of a financial holding entity, where one of the members of the consolidated unit is a foreign bank or financial institution that has its registered office in a country that is not a member state;
- c) A responsible bank in the group of a financial holding entity; or
- d) A responsible bank in the group of a foreign controlling person.

The Act on Banks also sets out exceptions for interests arising due to a bank receivable for the term of a rescue operation or financial reconstruction, or due to the issue of securities and time limits for the holding of such interests (Article 17, paragraph 5 and paragraph 6). Under the Act on Banks (Article 17, paragraph 7), a Bank is under a duty to notify the CNB without undue delay of the acquisition of a qualifying holding in a legal entity. The Act on Banks (Article 17, paragraph 1) also sets out limitations for the acquisition of an interest in another legal entity, the establishment of another legal entity or a contribution to the establishment of another legal entity - see Essential Criterion 1.

Other limitations, or rather the criteria relating to the acquisition of qualifying holdings are contained in the Prudential Rules Decree. This Decree (Articles 190 to 193) contains rules for the acquisition, financing and assessment of assets. Specifically, Article 190 of this Decree prevents banks from acquiring an interest or subordinate receivable in a person that has a qualifying holding in a bank independently or through concerted conduct with another person. A bank can acquire participation securities issued by an entity having a qualifying holding in the bank only in accordance with the statutory conditions. A bank can also not acquire units in a unit trust that is managed or created by an investment company that is an entity having a qualifying holding in the bank independently or in concert with another person. The Decree (Article 191) sets out the rules for acquiring some types of assets by credit unions. They also cannot acquire units in a unit trust that is managed or created by an investment company that is an entity having a qualifying holding in the credit union independently or in concert with another person.

The acquisition of a qualifying holding is also covered by risk management, which is set out in general and applies in this general form to banks and credit unions. In this area a bank has to comply with the general requirements related to risk management that are set out by the Prudential Rules Decree (part three, section 2- risk management, Article 24 et seq.). A bank has to have procedures for recognising, assessing, monitoring, reporting and, if appropriate, limiting risks set by the limits system for risk management, as well as control mechanism principles and a risk management strategy containing a definition of risk, the principles for determining the significance of risk, the principles for managing various risks, the risk management methods, an accepted degree of risk, etc.

3. Consistent with the licensing requirements, among the objective criteria that the supervisor uses is that any new acquisitions and investments do not expose the bank to undue risks or hinder effective supervision. The supervisor can prohibit banks from making major acquisitions/investments (including the establishment of foreign branches or subsidiaries) in countries with secrecy laws or other regulations prohibiting information flows deemed necessary for adequate consolidated supervision.

LARGELY COMPLIANT

Regulation:

Under the Act on Banks (Article 12, paragraph 1), banks are under a general duty, when performing their activities, to proceed prudently, in particular to perform transactions in a manner that does not damage the interests of their depositors from the viewpoint of the return on their deposits and does not endanger the safety and stability of the bank. Limits for investments by banks are set in the Act on Banks (Article 17). Under the Act on Banks (Article 16, paragraph 2, subparagraph c), a bank is also under a duty to inform the CNB of a plan to establish a legal entity abroad or to hold an ownership interest therein.

When acquiring new assets, a bank has to comply with the requirements set out by the Act on Banks and the Prudential Rules Decree. With regard to the fact that the CNB does not approve the various proposals for new acquisitions or investments before they are realised, it does not have the opportunity to prohibit them. The rating for this criterion is therefore reduced. Nevertheless, the CNB has the power to review investments and acquisitions realised by a bank and check whether it is exposing itself to unreasonable risks. According to the Act on Banks, the conditions for the granting of a banking licence include the transparency of the group of entities with a close link to the bank. Such close link within a group may not prevent banking supervision in the country on whose territory the group has the close link, there are no legal or practical barriers to banking supervision. These conditions, based on which a licence was issued, have to be complied with for the entire time of the bank's existence. A lack of activity by a bank is a breach of the conditions under which a licence was granted and the bank can, in accordance with the Act on Banks, be invited to effect a remedy or be punished.

This issue does not affect credit unions for the reasons specified in the overall assessment.

4. The supervisor determines that the bank has, from the outset, adequate financial and organisational resources to handle the acquisition/investment.

COMPLIANT

Supervision:

Acquisitions/investments by a bank are a risk that has to be properly handled by it. While performing its supervision, the CNB checks compliance with requirements set by the act and the Prudential Rules Decree concerning the system of governance, including the risk management system - described in detail in essential criterion 2. Supervision includes a check on a bank's strategy for investment in ownership interests, including compliance with prudential criteria. 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 acquisition for a bank.

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

COMPLIANT

Regulation:

A Bank is under a duty under Article 17, paragraph 7, of the Act on Banks to notify the CNB without undue delay of the acquisition of a qualifying holding. In addition to this, banks submit reports on all qualifying holdings every quarter.

This issue does not affect credit unions for the reasons specified in the overall assessment.

6. The supervisor is aware of the risks that non-banking activities can pose to a banking group and has the means to take action to mitigate those risks.

COMPLIANT

Regulation:

The Act on Banks (Article 8b) sets out the basic requirements for a bank's system of governance. Under the law, the CNB is also entitled to issue a decree in which it sets out

more detailed requirements for banks' system of governance on a solo and consolidated basis (Article 8b, paragraph 5). This decree is the Prudential Rules Decree, which, in Articles 24 to 30, specifies other requirements related to risk management. While performing supervision, the CNB checks compliance with the Act on Banks and the Prudential Rules Decree, including whether a bank provides non-banking activities that could expose the banking group to risk. If a bank that does meet the requirements set by the act and the decree, the CNB is entitled, in accordance with the character of the shortcoming ascertained, to take the appropriate remedial and punishment measures. The Act on Banks (Article 26) contains a relatively wide range of possible measures that can be applied to a bank if shortcomings are found in its activities (e.g. the CNB can limit some permitted activities, prohibit the performance of some transactions and operations, order the creation of an appropriate amount of reserves and provisions, adopt stricter rules for the creation of provisions to a bank's assets and reserves or for the setting of capital requirements, impose a fine, require an increase in capital, prohibit or limit the performance of transactions with entities that are closely linked to the bank, require an increase in liquid funds).

This issue does not affect credit unions for the reasons specified in the overall assessment.

Additional criterion

1. When a bank wishes to acquire a significant holding in a financial institution in another country, the supervisor should take into consideration the quality of supervision in that country and its own ability to exercise supervision on a consolidated basis.

LARGELY COMPLIANT

Regulation:

Under the Act on Banks, the CNB performs supervision on a consolidated basis, which is understood to mean the monitoring and regulation of risk for consolidated units of which a bank is part for the purpose of limiting risks to which the bank was exposed from the viewpoint of its participation in the consolidated unit. For the performance of this statutory duty, conditions have to be created, including a requirement that a close link within a group does not hinder the performance of banking supervision, so that in the country in whose territory the group has a close link there are no legal or practical barriers to banking supervision. As was specified in the previous criteria, the CNB does not issue consents to individual asset acquisitions. For this reason there was a reduction in the assessment of the additional criterion. Banks have to comply with requirements, criteria and limits in accordance with the Act on Banks and Prudential Rules Decree (described in detail in essential criteria 1, 3 and 5). The CNB has enough tools to get involved if it was unable to perform supervision on a consolidated basis.

This issue does not affect credit unions for the reasons specified in the overall assessment.

Principle 6: 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.

Overall assessment of the Principle:
COMPLIANT

Essential criteria:

[Act No. 21/1992 Coll., on Banks, as amended](#) (hereinafter the “Act on Banks”) and [Act No. 87/1995 Coll., on Credit Unions and on the Amendment of Czech National Council Act No. 586/1992 Coll., on income taxes, as amended, as amended](#) (hereinafter the “Act on Credit Unions”) impose on banks, branches of foreign banks that do not enjoy the benefits of a single licence under EU Law and credit unions the duty to comply with capital adequacy on a solo and consolidated basis. The aforementioned acts also authorise the CNB to issue a decree stipulating the rules for the definition of capital, the calculation of capital requirements and the calculation of banks’ and credit unions’ capital adequacy. All this is defined in [Decree No. 123/2007 Coll., stipulating the prudential rules for banks, credit unions and investment firms](#) (hereinafter the “Prudential Rules Decree”), which also sets out a duty to allocate capital for credit, market and operational risk, defines basic and special approaches for calculating capital requirements for risks and sets a minimum capital adequacy ratio of 8%. Banks and credit unions can use an internal risk assessment (special approaches) as input for the calculation of capital requirements, either on the basis of the consent of the CNB or the competent supervisory authority in a European Union member state, if the members of the group are European controlling banks or European controlling credit institutions, and have joined a common application of such institution. To obtain consent to the use of special approaches, banks and credit unions have to meet the set qualification standards. Banks and credit unions are under a duty to allocate capital to balance sheet and off-balance sheet items. Laws entitle the CNB to impose on a bank or credit union that does not comply with the set capital adequacy one or more remedial measures from the wide range of such measures.

During the implementation of the Directive of the EU on capital requirements, which includes Directive of the European Parliament and of the Council 2006/48/EC of 14 June 2006 related to the taking up and pursuit of the business of credit institutions (recast Directive 2000/12/EC) and Directive of the European Parliament and of the Council 2006/49/EC dated 14 June 2006 on the capital adequacy of investment firms and credit institutions (recast Directive 93/6/EEC), in both cases the “capital adequacy directives,” the Czech Republic took advantage of the right to decide on the national discretions contained therein in such a manner that it takes into consideration the specific conditions under which banks and credit unions act in the Czech Republic. A stricter variant of national discretion was used, for example, to take into account security in the form of non-residential properties. In other cases, on the contrary, a more liberal alternative was used. The Prudential Rules Decree permits, for example, the use of unsolicited ratings.

Additional criterion

In accordance with the capital adequacy directives, the Basel Accord on Minimum Capital Requirements for Banks, known as Basel II, applies to all banks and credit unions and to

financial groups, or regulated consolidated units, without regard to whether institutions and groups that are internationally active or not are involved. The CNB is entitled to ask a bank, credit union or regulated consolidated unit whose member is a bank or credit union to maintain its capital over the minimum ratio, set at 8%.

Analysis of individual criteria

Essential criteria

- 1. Laws or regulations require all banks to calculate and consistently maintain a minimum capital adequacy ratio. Laws, regulations or the supervisor define the components of capital, ensuring that emphasis is given to those elements of capital available to absorb losses.**

COMPLIANT

Regulation:

The Act on Banks (Article 12a, paragraph 1) instructs a bank or branch of a foreign bank that does not enjoy the benefits of a single licence under EU law to, on an ongoing, solo basis, maintain capital adequacy, and defines the banks (Article 12a, paragraph 2) that are under a duty to maintain capital adequacy also on a consolidated basis.

Analogically, the Act on Credit Unions (Article 8, paragraph 2) instructs credit unions to maintain capital adequacy on a solo basis. In the event that a credit union is the responsible credit union in the group of a financial holding entity or the responsible credit union in the group of a controlling credit institution, it shall (Article 8, paragraph 3) maintain capital adequacy on a consolidated basis.

The Prudential Rules Decree applies to banks and credit unions. It sets the rules for the calculation of capital adequacy that include the procedures that are applied when calculating capital adequacy, as well as the rules for setting capital and also the rules for determining the various capital requirements. The Prudential Rules Decree also defines basic and special approaches for the calculation of capital requirements and sets the conditions for the use of such approaches. Articles 37 to 43 of the Decree instruct banks and credit unions to maintain a capital adequacy ratio on a solo and consolidated basis at 8%, and in part four chapter III (Articles 54 to 73) the Decree defines the elements of capital. In accordance with Basel II it places marked emphasis on the elements of capital that have a great ability to absorb losses. Capital on a solo or consolidated basis is derived from the balance sheet of a bank or credit union, or from the balance sheet of the relevant financial group that is a regulated consolidated unit. Balance sheets have to be drafted using accounting methods that are in accordance with accounting standards and, if that is not the case, such standards are used to at least show equity and liabilities. The condition of compliance with accounting standards does not have to be met on a solo basis for the capital of credit unions.

In addition to the duty to maintain capital adequacy, the Act on Banks [Article 4, paragraph 1, and Article 12a, paragraph 1,] instructs banks to maintain registered capital at no less than CZK 500 million. Under the Act on Credit Unions [Article 8, paragraph 1,], a credit union's capital has to be no less than CZK 35 million and a credit union must maintain it at no less than this amount.

2. At least for internationally active banks, the definition of capital, the method of calculation and the ratio required are not lower than those established in the applicable Basel requirement.

COMPLIANT

Regulation:

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 Prudential Rules Decree, corresponds to the definition of capital, the methods of calculation and the minimum level of capital required in accordance with Basel II - see essential criterion no. 1. The aforementioned definition applies both to internationally active banks and credit unions, as well as to banks and credit unions that are not internationally active institutions.

3. The supervisor has the power to impose a specific capital charge and/or limits on all material risk exposures.

COMPLIANT

Regulation:

The Prudential Rules Decree introduces capital requirements for each significant category of risk that a bank or credit union is exposed to. For the calculation of capital adequacy banks and credit unions are obliged to set capital requirements for credit, market and operational risk and to, on an ongoing basis, allocate capital to such requirements in a volume that is, at least, equal to the requirements and ensures a capital adequacy ratio of no less than 8%. Article 75 of the Decree defines the various categories of credit and market risk in detail. The CNB is also entitled to, in connection with how it assesses the risk profile of a bank or credit union, ask a bank or credit union to maintain a capital adequacy ratio of more than 8%. See additional criterion 5, below.

4. The required capital ratio reflects the risk profile of individual banks. Both on-balance sheet and off-balance sheet risks are included.

COMPLIANT

Regulation:

Under the Act on Banks (Article 12c) and the Act on Credit Unions (Article 8a), a bank or credit union is under a duty to adopt and apply reliable and effective strategies and procedures for setting and maintaining an internal capital adequacy assessment in an amount, structure and distribution sufficient cover risks it could be exposed to. The CNB is also entitled to, in connection with how it assesses the risk profile of such bank or credit union, ask the bank or credit union to maintain a capital adequacy ratio of more than 8%. See additional criterion 5, below.

The Prudential Rules Decree instructs a bank or credit union that each exposure, which is understood to be an asset or off-balance sheet item, be allocated to defined exposure classes used as bases when calculating capital requirements for credit or market risk. In addition to this, banks and credit unions are obliged to allocate capital to operational risk. The capital requirement for operational risk together with the capital requirements for the various categories of credit and market risk (see essential criterion no. 3, above), set for the various balance sheet and off-balance sheet items or portfolios of such items express the risk profile of a bank or credit union.

5. Capital adequacy requirements take into account the conditions under which the banking system operates. Consequently, laws and regulations in a particular jurisdiction may set higher capital adequacy standards than the applicable Basel requirement.

COMPLIANT

Regulation:

The EC directive on capital adequacy contains a number of provisions that enable a member state or the relevant supervisor to decide between two or more approaches, which is called national discretion. After considering the conditions in which the banking sector in the Czech Republic operates and based on discussions with the government [see Principle No. 1, paragraph 6,] and with professional organisations of credit institutions [see Principle No. 1, paragraph 3,] of the alternatives offered as a part of national discretions the Prudential Rules Decree contained those that:

- As far as possible, do not introduce unreasonable capital requirements;
- Support flexibility of approaches by banks and credit unions in the application of the capital adequacy concept;
- Maintain the approach the CNB has used over the long term to certain important areas.

Based on these principles, a stricter option offered as a part of national discretions was used in particular to take into account collateral in the form of real estate. In other cases, however, a more liberal alternative was used and the Prudential Rules Decree permits, for example, the use of unsolicited ratings.

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

COMPLIANT

Regulation:

The Act on Banks (Article 26a) states that if a bank's capital, on a solo basis, falls below two thirds of the sum of the various 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 a remedial measure under the Act on Banks, Article 26, paragraph 1, subparagraphs b), to i), on a bank. Under the Act on Banks (Article 34, paragraph 3), the CNB is under a duty to withdraw a licence 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 or a specially designated bank.

The Act on Credit Unions (Article 28, paragraph 3) characterises a breach or avoidance of the aforementioned act, other acts and implementing regulations issued under the Act on Credit Unions, as well as decisions issued by the CNB, as a shortcoming in activities by a credit union. Therefore, in the event that a credit union's capital falls under the required minimum ratio set by the Prudential Rules Decree or a CNB decision (see essential criterion no. 4 and additional criterion no. 5), this would be a shortcoming in the relevant credit union's activities. In such a case the CNB could, under the Act on Credit Unions [Article 28, paragraph 1, subparagraph a)], ask a credit union to effect a remedy by a set deadline or, according to the nature of the shortcoming ascertained, impose measures on the credit union in accordance with the Act on Credit Unions [Article 28, paragraph 1, subparagraphs b) to g)]. The Act on Credit Unions (Article 28g) gives the CNB the duty to withdraw a permit from a credit union if its capital falls under one third of the sum of the various capital requirements.

7. Where the supervisor permits banks to use internal assessments of risk as inputs to the calculation of regulatory capital, such assessments must adhere to rigorous qualifying standards and be subject to the approval of the supervisor. If banks do not continue to meet these qualifying standards on an ongoing basis, the supervisor may revoke its approval of the internal assessments.

COMPLIANT

Regulation:

Banks or credit unions can use special approaches (internal risk assessment) for the purpose of calculating capital requirements. They can do this

- Based on a decision on the granting of prior consent by the CNB under the Act on Banks (Article 12a, paragraph 4) or the Act on Credit Unions (Article 8, paragraph 5), where the CNB is entitled in a decision on the granting of consent to set binding conditions under which a bank or credit union is entitled to use an internal risk assessment as a part of a special approach (see essential criterion no. 2, above); or
- Based on an approved application submitted to the competent supervisory authority of another EU member state under the Act on Banks (Article 12a, paragraph 5) or the Act on Credit Unions (Article 8, paragraph 6), where the foreign competent supervisory authority works with the CNB to the extent defined in the capital adequacy directives when dealing with the application. In practice such co-operation is governed by agreements that the CNB has concluded with foreign competent supervisory authorities from EU member states [see Principle No. 1, paragraph 6,].

The Prudential Rules Decree (Articles 78 to 82) sets out the requisites of an application for consent to the use of a special approach or to a change to the approach used in detail. The CNB can reject an application for consent to the use of a special approach or a change to the approach used where, under the Act on Banks (Article 38i) or the Act on Credit Unions (Article 25i), it will consult the competent authority performing supervision on a consolidated basis of the consolidated unit of which the bank or credit union is a member about the matter, or consult other competent supervisory authorities that the matter also concerns. In the event that a matter is urgent, the CNB can reject an application without such consultations. If a bank or credit union stops meeting the aforementioned qualification standards, the CNB can regard this fact as a shortcoming in its activities and impose a remedial measure under the Act on Banks or Act on Credit Unions. Even though the Act on Banks and Act on Credit Unions do not expressly set out the withdrawal of consent to use special approaches, the CNB has a wide range of other effective remedial measures (see Principle No. 23).

Additional criteria

1. For non-internationally active banks, the definition of capital, the method of calculation and the capital required are broadly consistent with the principles of applicable Basel requirements relevant to internationally active banks.

COMPLIANT

Regulation:

The acts and the related Prudential Rules Decree that implement the capital adequacy directives and therefore the Basel II Accord define capital, the methods of calculating capital requirements and the required amount of bank and credit union capital without distinguishing whether a bank or credit union is internationally active or not.

- 2. For non-internationally active banks and their holding companies, capital adequacy ratios are calculated and applied in a manner generally consistent with the applicable Basel requirement, as set forth in the footnote to the Principle.**

COMPLIANT

See commentary to additional criterion 1.

- 3. The supervisor 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.**

COMPLIANT

Regulation:

Under the Act on Banks (Article 25, paragraph 3) and the Act on Credit Unions (Article 22, paragraph 8), the CNB is entitled to review and assess whether the arrangements, strategy, 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 exposed to. 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. Both the acts stipulate that the aforementioned review and assessment are performed to an extent and with a periodicity relevant to the size, importance and position of the bank or credit union on the financial market and the character, extent and complexity of its activities, but no less than once a year. This corresponds to the duty to, regularly with an annual periodicity, submit to the CNB information about the internal capital adequacy assessment system that is to assess the adequacy of the bank's capital at the current moment and in subsequent years. Regularly performed stress tests are a significant tool applied during an assessment of the adequacy of the capital of banks and other regulated entities from the viewpoint of possible future risks.

- 4. The supervisor requires adequate distribution of capital within different entities of a banking group according to the allocation of risks.**

COMPLIANT

Regulation:

The Act on Banks (Article 12a, paragraph 1) and the Act on Credit Unions (Article 8, paragraph 2) impose on a bank, branch of a foreign bank that does not enjoy the benefits of a single licence under EU law and a credit union the duty to, on a solo basis, maintain capital, in an ongoing fashion, in the amount of the sum of the various capital requirements. The CNB has the right to require the location of capital directly with a bank or credit union that is part of a banking group, or a regulated consolidated unit, with regard to the risks that the entity is exposed to.

- 5. The supervisor may require an individual bank or banking group to maintain capital above the minimum to ensure that individual banks or banking groups are operating with the appropriate level of capital.**

COMPLIANT

Regulation:

Under the Act on Banks (Article 25, paragraph 3) and the Act on Credit Unions (Article 22, paragraph 8), the CNB is entitled to review and assess whether the arrangements, strategy,

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 exposed to. The Act on Banks [Article 26, paragraph 1, subparagraph a)] and the Act on Credit Unions [Article 28, paragraph 1, subparagraph a)] entitle the CNB to, after assessing specific circumstances, request from a certain bank or credit union an increase in capital that ensures capital in addition to the minimum requested capital adequacy ratio of 8%. Under the Act on Banks [Article 26, paragraph 1, subparagraph h)] and the Act on Credit Unions [Article 28, paragraph 1, subparagraph g)] the CNB can impose the aforementioned increase in capital on a bank or credit union as a remedial measure [see also Principle No. 1, paragraph 4, and Principle No. 23]. The CNB can proceed in such a manner in particular if a bank or credit union has ineffective arrangements, strategy, procedures or mechanisms and other remedial measures seem insufficient to achieve a correction over a reasonable period of time.

Principle 7: 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.

Overall assessment of the Principle:
COMPLIANT

[Act No. 21/1992 Coll., on Banks, as amended](#) (hereinafter the “Act on Banks”) and [Act No. 87/1995 Coll., on Credit Unions and on the Amendment of Czech National Council Act No. 586/1992 Coll., on income taxes, as amended, as amended](#), (hereinafter the “Act on Credit Unions”) impose on banks, branches of foreign banks that do not enjoy the benefits of a single licence under EU Law and credit unions the duty to establish and maintain adequate system of governance. The system of governance of banks and credit unions shall be comprehensive and reasonable given the character, extent and complexity of their activities. One of the system’s key parts is the risk management system. The aforementioned credit institutions are therefore under a duty to establish and maintain a risk management system that corresponds to the nature, extent and complexity of their operations. Under the Act on Banks and the Act on Credit Unions, banks and credit unions are under a duty to comply with legislation stipulating the requirements of the risk management system on a solo and consolidated basis.

[Decree No. 123/2007 Coll., stipulating the prudential rules for banks, credit unions and investment firms](#) (hereinafter the “Prudential Rules Decree”) sets out in detail the requirements for a bank and credit union’s system of governance, including requirements for the risk management system. According to the decree, a bank or credit union’s risk management system is based on a risk management strategy and this strategy has to be implemented using appropriate risk management procedures. The risk management strategy and procedures have to be comprehensive and have to cover all the relevant risk categories. The Prudential Rules Decree also stipulates that banks and credit unions are obliged (Article 222) to inform the CNB of their internal capital adequacy assessment system, established and maintained based on the Act on Banks (Article 12c), or the Act on Credit Unions (Article 8a).

When performing supervision through an on-site examination, the CNB checks whether banks and credit unions, as well as the groups of which they are part, have a commensurate risk management system, whether the board of directors regularly approves and assesses the system, whether it regularly discusses risk management with the senior management and whether the board of directors or senior management corrects shortcomings found. The timely identification of financial institutions’ risks and the adoption of adequate measures is the main aim of on-site examination. The basis of on-site examination is compliance with the prudential rules with a focus on the state of system of governance with emphasis on the level of the management systems for the various risks. The CNB bases its actions on the fact that the level of the management systems for the various risks significantly influences the risk potential of entities doing business on the financial market and it therefore pays significant attention to this area. In this context it focuses on the method in which supervised entities identify, measure, assess, monitor and limit the various risks they undertake. The unit arranging supervision of the prudential rules is also broken down and specialised in the various types of risk. For the various areas a check methodology has been drafted and staff are

systematically educated in accordance with their focus. This enables the obtaining and maintenance of a high skill level by staff performing on site examination in various areas for management risks and quality output from supervisory activities. Remedial measures to correct shortcomings found are imposed based on examinations and their correction is monitored and verified thoroughly. In the case of serious shortcomings or non-compliance with remedial measures, additional tools are used up to the withdrawal of a licence.

Analysis of individual criteria

Essential criteria

1. Individual banks and banking groups are required to have in place comprehensive risk management policies and processes to identify, evaluate, monitor and control or mitigate material risks. The supervisor determines that these processes are adequate for the size and nature of the activities of the bank and banking group and are periodically adjusted in the light of the changing risk profile of the bank or banking group and external market developments. If the supervisor determines that the risk management processes are inadequate, it has the power to require a bank or banking group to strengthen them.

COMPLIANT

Regulation:

The Act on Banks (Article 8b) and the Act on Credit Unions (Article 7a) impose on banks and credit unions a duty to establish and maintain adequate system of governance.

Under the Act on Banks [Article 8b, paragraph 1, subparagraphs b) and c)] and the Act on Credit Unions [Article 7a, paragraph 1, subparagraphs b) and c)] the risk management system of banks and credit unions includes:

- The rules for an institution's approach to risks to which it is or could be exposed, including risks resulting from the external environment and liquidity risk;
- Effective procedures for recognising, assessing, measuring, monitoring and reporting risks;
- Effective procedures for taking measures leading to the limitation of possible risks; and
- The system of internal controls, which includes the internal audit and ongoing checks on compliance with an institution's legal duties.

The Act on Banks (Article 8b, paragraph 2) and the Act on Credit Unions (Article 7a, paragraph 2) stipulate that system of governance, including a risk management system, have to be comprehensive and commensurate to the character, extent and complexity of the activities of a bank or credit union. Banks and credit unions that are part of a financial group or consolidated unit with responsibility for compliance with requirements on a consolidated basis are, under the Act on Banks (Article 8b, paragraph 3) and under the Act on Credit Unions (Article 7b, paragraph 3), under a duty to introduce and maintain functional and effective system of governance on a solo and consolidated basis.

More detailed requirements for banks' and credit unions' system of governance are set out in the Prudential Rules Decree. This Decree (Article 26, paragraph 1) contains a requirement that a bank or credit union has a risk management strategy that corresponds to the nature, extent and complexity of its activities and to draft specific procedures for complying with the strategy. The risk management strategy must cover all the relevant risk categories (credit risk, market risk, operational risk, liquidity risk, concentration risk and other major risks that a

bank or credit union is or may be exposed to, in particular reputational risk, strategic risk, risk linked to capital sources and financing or risk linked to participation in a consolidated unit, including the risk of transactions with members of the consolidated unit, unless such risk is irrelevant or immaterial for a bank or credit union). The Decree (Article 26, paragraph 2) also states that the risk management strategy, procedures and limits concerning risk management should be regularly assessed and, if appropriate, altered.

If the CNB ascertains that a bank or credit union does not have adequate risk management procedures it can, in accordance with the Act on Banks (Article 26) or the Act on Credit Unions (Article 28), impose remedial measures, including imposing a fine.

2. The supervisor confirms that banks and banking groups have appropriate risk management strategies that have been approved by the Board. The supervisor also confirms that the Board ensures that policies and processes for risk-taking are developed, appropriate limits are established, and senior management takes the steps necessary to monitor and control all material risks consistent with the approved strategies.

COMPLIANT

Regulation:

The Prudential Rules Decree (Article 16) imposes on the board of directors of banks and credit unions a duty to meet regularly and assess:

- The risk management strategy (see essential criterion no. 1, above), as well as new products, activities and systems of fundamental importance for a bank or credit union;
- The set limits (see essential criterion no. 1, above) that a bank or credit union uses to limit risks, always for credit, market, concentration and liquidity risk, including requirements for the structure of assets, liabilities and off-balance sheet items, the board of directors can transfer such power to a committee it designates, without prejudice to the board of directors' final responsibility.

In accordance with the Prudential Rules Decree (Article 16) the board of directors has to regularly discuss with the senior management matters that concern system of governance, including risk management, at least once a year assess the overall functionality and effectiveness of the corporate governance, arrange any steps to remedy any shortcomings, assess regular reports and extraordinary findings that are submitted to it either by the senior management or by the internal audit, supervisory body, external auditor or supervisor on time, and take measures that are realisable based on these assessments without undue delay.

Under the Act on Banks (Article 8b, paragraph 3) and the Act on Credit Unions (Article 7a, paragraph 3), a bank or credit union is under a duty to ensure compliance with the risk management requirements not only on a solo basis but also, in the statutory cases, on a consolidated basis.

Supervision:

During supervision in the form of on-site examination the CNB checks whether banks, credit unions and groups of which they are part have a commensurate risk management strategy that has been approved by the board of directors, whether the board of directors ensures the creation of strategies and procedures for the acceptance of risks, whether the relevant limits are set and whether the senior management takes, in accordance with the approved strategy,

the necessary steps to monitor and manage all significant risks on a solo and consolidated basis.

3. The supervisor determines that risk management strategies, policies, processes and limits are properly documented, reviewed and updated, communicated within the bank and banking group, and adhered to in practice. The supervisor determines that exceptions to established policies, processes and limits receive the prompt attention of and authorisation by the appropriate level of management and the Board where necessary.

COMPLIANT

Regulation:

Under the Prudential Rules Decree (Article 10), the strategy, principles, procedures and limits for risk management by banks and credit unions have to be properly documented. The Decree imposes on banks and credit unions a duty to ensure that all approval and decision-making processes and control activities can be traced back (reconstructed), including the related responsibilities, powers and internal regulations. An information storage system, which a bank or credit union has to establish and maintain, serves to ensure this requirement. These requirements apply both to risk management and the system of governance. The Prudential Rules Decree also sets out (Article 23, paragraph 4) that a bank or credit union stores the data necessary for monitoring compliance with the prudential limits for no less than five years. Banks and credit unions are also under a duty (Article 33, paragraph 1 of the Prudential Rules Decree) to ensure the permanent and effective performance of the internal audit, which the risk management system, in addition to other things, is subject to. The external auditor shall, once a year—as at 31 December of the calendar year, verify a bank’s system of governance, and once every three years perform such verification for a credit union, including the risk management system (Article 35 of the Prudential Rules Decree). Banks and credit unions are also under a duty to arrange regular assessment and any alterations to the strategy for managing risks and procedures, as well as limits for managing risk (Article 26, paragraph 2, of the Prudential Rules Decree). In accordance with the Prudential Rules Decree (Article 26, paragraph 3), all staff whose activities have an influence on risk management have to be acquainted with the risk management strategy to the necessary extent and have to proceed in accordance with this strategy, as well as in accordance with the procedures and limits that result from it. The board of directors of a bank or credit union shall, without undue delay, be informed of all cases where limits are exceeded and this endangers the acceptable degree of credit, market and other significant risks, including liquidity risk. In cases where the liquidity situation undergoes a marked, unfavourable change, the board of directors is promptly informed [Article 21, paragraph 2, subparagraph b), of the Prudential Rules Decree]. Under the Act on Banks (Article 8b, paragraph 3) and the Act on Credit Unions (Article 7a, paragraph 3), banks and credit unions are under a duty to ensure compliance with the risk management requirements on a solo and consolidated basis.

Supervision:

During supervision in the form of on-site examination the CNB checks whether a bank, credit union and groups of which they are part have a risk management strategy, principles, procedures and limits, whether they are properly documented, verified and updated, whether information about them is given out within the bank, credit union and group, and whether the risk management strategy, principles and limits are complied with in practice. The CNB also checks how the option of making exceptions to adopted principles, procedures and limits are arranged in practice, who approves the limits, etc.

- 4. The supervisor determines that senior management and the Board understand the nature and level of risk being taken by the bank and how this risk relates to adequate capital levels. The supervisor also determines that senior management ensures that the risk management policies and processes are appropriate in the light of the bank's risk profile and business plan and that they are implemented effectively. This includes a requirement that senior management regularly reviews and understands the implications (and limitations) of the risk management information that it receives. The same requirement applies to the Board in relation to risk management information presented to it in a format suitable for Board oversight.**

COMPLIANT

Regulation:

A request that the supervisory body and board of directors of a bank or credit union knows the nature and level of the risk that the bank or credit union accepts and that the bodies are acquainted with what the relationship is between the risk and an adequate amount of capital is, in the general context, formulated in the Prudential Rules Decree (Article 21, paragraph 1). Here a bank or credit union is instructed to ensure that the board of directors and supervisory body, as well as staff and, finally, various units and committees, if established by a bank or credit union, have information that is current, reliable and comprehensive for their decisions and other set activities. Under the Prudential Rules Decree (Article 14, paragraph 2), the board of directors is responsible for the permanent maintenance of functional and effective system of governance, including the setting, maintenance and application of system of governance in such a way as to ensure the adequacy of information and communication when performing an obligated party's activities. The board of directors will also make sure (Article 15, paragraph 4, of the Prudential Rules Decree) to set requirements for the knowledge and experience of the persons who perform such activities, which are current and commensurate to the extent, nature and complexity of activities.

The board of directors shall be regularly informed, in addition to other things, of compliance with the rules for exposure and the concentration risk, the degree of credit, market and operational risk, the liquidity situation, the overall degree of risk, also when taking into account the internal control mechanisms, i.e. the total risk profile of the bank or credit union, as well as the relationship between the risk profile of the bank or credit union on the one hand and the adequate amount of its capital on the other, i.e. on its capital adequacy. The senior management is responsible to the board of directors for realisation of strategies, principles and aims, as well as the procedures for implementing the strategies, principles and aims, including risk management, and also for the everyday management of the bank or credit union (Article 18, paragraph 1, of the Prudential Rules Decree). The Prudential Rules Decree requires that senior management regularly verifies information about risk management that it receives and knows its implications and limitations. The same requirement applies to the board of directors in relation to information about risk management that is submitted to it, in particular so the board of directors is not only reliant on information submitted to it by the senior management, but can also base considerations on the internal audit. All activities of a bank or credit union are subject to independent review by the internal audit, which includes the risk management system. A bank or credit union has to ensure that when performing an internal audit a risk analysis is also drafted at least once a year (Article 33, paragraph 5, of the Prudential Rules Decree).

Supervision:

During supervision through an on-site examination, the CNB checks whether the board of directors and the bank or credit union's senior management knows the nature and level of the risk that the bank or credit union is accepting, whether the two bodies know what the relationship is between the risk and the adequate amount of capital, whether the senior management ensures that the risk management strategy and procedures correspond to the bank or credit union's risk profile and business plan and whether the senior management ensures that the procedures are applied effectively. The CNB checks whether a bank or credit union's board of directors and its senior management regularly check information about risk management that they receive and whether they know its implications and limitations.

5. The supervisor determines that banks have an internal process for assessing their overall capital adequacy in relation to their risk profile, and reviews and evaluates banks' internal capital adequacy assessments and strategies. The nature of the specific methodology used for this assessment will depend on the size, complexity and business strategy of a bank. Non-complex banks may opt for a more qualitative approach to capital planning.

COMPLIANT

Regulation:

Under the Act on Banks (Article 12c) and the Act on Credit Unions (Article 8a) every bank and credit union is under a duty to accept and apply reliable, effective and complete strategies and procedures for setting, assessing and maintaining an internal capital adequacy assessment in an amount, structure and distribution to sufficiently cover the risks it could be exposed to, and also regularly check these strategies to ensure that they are functional, effective and reasonable given the character, extent and complexity of the bank or credit union's activities.

A bank and credit union shall ensure that the monitoring and assessment of the functionality of the internal capital adequacy assessment system was performed in an ongoing fashion at all management and organisational levels (Article 34 of the Prudential Rules Decree). The internal capital adequacy assessment shall:

- Correspond to the size, method of management, number of staff, nature, extent and complexity of activities that a bank or credit union performs or intends to perform (Article 8 of the Prudential Rules Decree);
- Be introduced on a solo and possibly consolidated basis (the Act on Banks and the Act on Credit Unions—see criterion no. 1).

The Prudential Rules Decree stipulates that once a year a bank or credit union will inform the CNB in writing of its internal capital adequacy assessment system (Article 222, paragraph 4). A bank or credit union itself is obliged to take remedial measures in the event that the total degree of risk undergone, even after taking the internal control mechanisms into account (overall risk profile) is not reasonably covered by capital or in another manner (Article 29, paragraph 4, of the Prudential Rules Decree).

Under the Act on Banks (Article 25, paragraph 3) and the Act on Credit Unions (Article 22, paragraph 8), the CNB is entitled to review and assess whether the arrangements, strategy, procedures and mechanisms introduced by a bank or credit union and the bank or credit union's capital ensure its safe and reliable operation and coverage of risks that it is or could be exposed to. The Act on Banks, in Article 26, paragraph 1, subparagraph a), item 8, and the Act on Credit Unions, in Article 28, paragraph 1, subparagraph a), item 9, entitle the CNB to, after assessing specific circumstances, request from a certain bank or credit union an increase

in capital that ensures capital in addition to the minimum requested capital adequacy ratio of 8% - see also Principle No 1, paragraph 4.

6. Where banks and banking groups use models to measure components of risk, the supervisor determines that banks perform periodic and independent validation and testing of the models and systems.

COMPLIANT

Regulation:

The Prudential Rules Decree (Article 76 and Article 77) stipulates what approaches and related models for the calculation of capital requirements can be used by a bank or credit union.

If a bank or credit union uses, based on the CNB's consent, special approaches for measuring risk, whether on a solo or consolidated basis, then it shall periodically and independently validate the models used and test them in accordance with the requirements set by the Prudential Rules Decree.

The requirements for internal validation and testing models for measuring credit risk are set by the Prudential Rules Decree in annex no. 10 (item D). In this annex to the Prudential Rules Decree (item E), in addition to other things, a bank or credit union is instructed to ensure that the internal audit department or other similarly independent unit, at least once a year, checks the models for credit risk, performs stress testing of the models for credit risk and regularly informs the bank or credit union's management of the results of such tests.

Detailed requirements for validation and testing of models for measuring market risk are set by the Prudential Rules Decree in annex no. 21 (section VII). A bank or credit union is under a duty to regularly put its VaR model for market risks through stress testing and regularly inform the senior management of the results. The CNB can also ask a bank or credit union to document a plan to use its own VaR model with a report on verification of the model's precision. In addition, a VaR model for market risks has to be verified by a person that is independent of the process of developing the model. A model shall be reviewed regularly and the verification is not limited only to back testing, but shall also contain a verification of the assumptions on which the model is built, subsequent validation over the framework of back testing and the use of hypothetical portfolios.

Annex No. 22 (item IV) of the Prudential Rules Decree instructs a bank or credit union that uses its own models to measure operational risk (AMA) to establish an independent function with responsibility for managing operational risk and to ensure that the models that a bank or credit union uses as a part of special approaches for the calculation of the capital requirement for operational risk are subject to regular validation and that data and processes related to the system of measuring operational risk to be transparent and available.

Supervision:

A check on whether banks perform periodical and independent validation and testing of models and systems is part of the content of supervision of banks and credit unions. When approving advanced approaches (IRB, VaR, AMA), the CNB checks whether there is an independent function that is responsible for the regular validation of models used for such approaches. In the case of on-site examination and in the case of subsequent checks on the implementation of advanced approaches, the CNB also checks whether and how often

validation and testing of models are performed and whether they are performed by an independent body.

7. The supervisor determines that banks and banking groups have adequate information systems for measuring, assessing and reporting on the size, composition and quality of exposures. It is satisfied that these reports are provided on a timely basis to the Board or senior management and reflect the bank's risk profile and capital needs.

COMPLIANT

Regulation:

Under the Prudential Rules Decree (Article 21, paragraph 1), a bank or credit union is under a duty to ensure that the relevant bodies, including the relevant supervisory bodies, as well as staff and units and, finally, committees, if established, have information that is current, reliable and complete for the decisions and other stipulated activities. The aforementioned decree also says that the senior management is responsible for creating and maintaining a functional and efficient system for obtaining, using and storing information (Article 18, paragraph 3). Both the aforementioned provisions fully apply to information systems for measuring, assessing and reporting the size, composition and quality of exposures and information about the size, composition and quality of exposures. Banks and credit unions shall ensure that the board of directors is regularly informed about the risk profile of the bank or credit union and of its capital adequacy (Article 21, paragraph 3, of the Prudential Rules Decree). Annex No. 1 to the Prudential Rules Decree sets out detailed requirements for systems for measuring, assessing and reporting the size, composition and quality of exposures, as well as detailed requirements for information about the size, composition and quality of exposures broken down by basic risks (credit, market, operating, liquidity and concentration risk).

Under the Act on Banks (Article 8b, paragraph 3) and the Act on Credit Unions (Article 7a, paragraph 3), banks and credit unions are under a duty to ensure compliance with the requirements for managing credit, market and other risks, including liquidity risk, not only on a solo, but also on a consolidated basis.

Supervision:

During supervision in the form of on-site examination, the CNB verifies whether a bank, credit union and groups of which they are part have the appropriate information systems for measuring, assessing and reporting the size, composition and quality of the exposures and whether they ensure regular and timely reports of the risk profile and the need for capital to the board of directors and senior management.

8. The supervisor determines that banks have policies and processes in place to ensure that new products and major risk management initiatives are approved by the Board or a specific committee of the Board.

COMPLIANT

Regulation:

The Prudential Rules Decree stipulates that new products, activities and systems of fundamental importance for a bank or credit union are approved by the board of directors, unless such power was transferred by the board of directors to a committee designated thereby [Article 16, paragraph 2, subparagraph a)].

The Prudential Rules Decree (Article 30) governs key aspects of the innovation of products and systems, specifically the recognition of risks linked to a change or new form of products, activities and systems. A bank or credit union clearly defines changes or new products, activities and systems and checks them before they are put into practice. The Decree also defines the requisites for procedures for checks and approvals of a new product, activities or systems and imposes on a bank or credit union the duty to announce a ban on the agreement of transactions in non-approved products.

Supervision:

When performing supervision in the form of on-site examination the CNB checks that a bank, credit union and groups of which they are part have a commensurate strategy and procedures that ensure that the board of directors or a committee designated thereby approves new products and fundamental projects for risk management.

9. The supervisor determines that banks and banking groups have risk evaluation, monitoring, and control or mitigation functions with duties clearly segregated from risk-taking functions in the bank, and which report on risk exposures directly to senior management and the Board.

COMPLIANT

Regulation:

The Prudential Rules Decree sets out in general that the senior management is responsible for maintaining functional and effective arrangements including the division of incompatible functions and the prevention of a possible conflict of interests (Article 18, paragraph 2). It also states a number of activities whose performance shall be arranged independently of commercial activities. These activities include, in addition to other things, the further creation of quantitative and qualitative information about credit and market risk, as well as the risk of concentration, and reporting of the aforementioned information to members of the senior management and board of directors. The aforementioned activities include measuring and monitoring the liquidity position and reporting the position to members of the senior management and board of directors.

10. The supervisor issues standards related to, in particular, credit risk, market risk, liquidity risk, interest rate risk in the banking book and operational risk.

COMPLIANT

Regulation:

The Prudential Rules Decree, in annex no. 1, part 1, stipulates standards for managing credit risk and, in part 2, standards for managing market risk, where such requirements apply to both credit risk in an investment portfolio and credit risk in a trading portfolio and to equity, currency and commodity risk. In annex no. 1, the Prudential Rules Decree also sets out the standards for managing operational risk (part 3) and the standards for managing liquidity risk (part 4).

Additional criteria

1. The supervisor requires larger and more complex banks to have a dedicated unit(s) responsible for risk evaluation, monitoring, and control or mitigation for material risk areas. The supervisor confirms that this unit (these units) is (are) subject to periodic review by the internal audit function.

COMPLIANT

Regulation:

The duty to separate the unit(s) responsible for assessing, monitoring and managing or reducing significant risks from trading activities and, in this sense, ensure that they are a specialised unit, result from the Prudential Rules Decree (Article 20)- see criterion no. 9). The Prudential Rules Decree (Article 8) imposes on a bank or credit union a duty to meet requirements set for system of governance with regard to its size and structure (method of management, number of staff) and also with regard to the nature, extent and complexity of activities that it performs or intends to perform. In connection with this requirement, the CNB is entitled to require larger and more complex banks to have a dedicated unit(s) responsible for risk assessment, monitoring, and control or mitigation for material risk areas.

Supervision:

This authorisation, however, does not yet have a practical meaning for supervision, as banks licensed in the Czech Republic do not have the size or structure to be large, internationally active institutions; this conclusion applies all the more to credit unions.

2. The supervisor requires banks to conduct rigorous, forward-looking stress testing that identifies possible events or changes in market conditions that could adversely impact the bank.

COMPLIANT

Regulation:

The Prudential Rules Decree requires that a bank or credit union, when assessing capital adequacy, uses reliable processes for stress testing and that stress testing takes into account possible events or changes to market conditions that could have a negative influence on a bank or credit union. For stress testing in the field of credit risk the requirement is formulated in annex no. 10 (A.7), under which stress testing includes the identification of possible events or future changes to economic conditions that can unfavourably influence credit exposures, and an assessment of the ability of an obligated person to resist such changes. For stress testing of market risks, specific credit or equity risk, the relevant requirement is formulated in annex no. 21 (V.4), which instructs a bank or credit union to verify through its own series of stress scenarios its resistance to unfavourable market conditions and establish stress tests that influence the value of its portfolio in the most unfavourable way. For operational risk meeting this criterion it results in particular from the requirement formulated in annex no. 22 (IV.c.1.), for the measurement of an operational risk, when using one's own model, to be comparable with a possible not-very-frequent event with a high impact and to achieve a standard comparable with a reliability level of 99.9% over the course of one year.

3. The supervisor requires banks and banking groups to have in place appropriate policies and processes for assessing other material risks not directly addressed in the subsequent CPs, such as reputational and strategic risks.

COMPLIANT

Regulation:

The Prudential Rules Decree, as one of a number of requirements for the risk management system, sets out that a bank or credit union, in addition to credit, market, operating, liquidity and concentration risk systematically manages other major risks that it is or could be exposed to, in particular reputational or strategic risk, and risk related to sources of capital and finance or related to participation in a consolidated unit, including the risk of transactions with

members of the same consolidated unit, unless for a bank or credit union this risk cannot be taken into consideration or is not material [Article 27, paragraph 1, subparagraph b)].

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.

Overall assessment of the Principle:

COMPLIANT

[Act No. 21/1992 Coll., on Banks, as amended](#) (hereinafter the “Act on Banks”) and [Act No. 87/1995 Coll., on Credit Unions and the Amendment of Czech National Council Act No. 586/1992 Coll., on income taxes, as amended, as amended](#), (hereinafter the “Act on Credit Unions”) impose on banks, branches of foreign banks that do not enjoy the benefits of a single licence under EU Law and credit unions the duty to establish and maintain adequate system of governance, which must be comprehensive and commensurate to the character, extent and complexity of their activities. This duty also applies to the credit risk management system, which is a major part of system of governance of the aforementioned institutions. The credit risk management system must take into account an institution’s risk profile.

Under [Decree No. 123/2007 Coll., stipulating the prudential rules for banks, credit unions and investment firms](#) (hereinafter the “Prudential Rules Decree”), the credit risk management system must capture all significant sources of credit risk. This system must 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. As far as concerns the management of credit risk, the Prudential Rules Decree (Article 26) stipulates that a bank or credit union’s overall risk management strategy shall always contain a credit risk management strategy, including an internal definition of credit risk, principles for determining or assessing the materiality of credit risk, the principles of managing credit risk, the methods of managing credit risk, setting the accepted degree of credit risk and, finally, principles for defining permitted products, currencies, countries, geographical areas, markets and counterparties. The Prudential Rules Decree sets out, in addition to general requirements for the management, acceptance, measuring and monitoring of credit risk, also requirements for limits for managing credit risk and for analyses and stress testing of the portfolio of financial instruments with which credit risk is related. The Prudential Rules Decree, part six, chapter II, sets out detailed rules for assessing assets, including off-balance sheet items, where the rules include the rules for classification, or categorisation of receivables from financial activities, the procedures for determining losses on the impairment of selected exposures of an investment portfolio and the requirements for creating reserves to off-balance sheet items. For more details see Principle No. 9.

Under the Act on Banks and the Act on Credit Unions, every bank or credit union is under a duty to ensure compliance with the credit risk management requirements on a solo and consolidated basis. This duty is set out in more detail in the Prudential Rules Decree.

When performing an on-site examination, the CNB checks whether banks, credit unions and groups of which they are part have an appropriate strategy for managing credit risk (including counterparty risk), whether the strategy is reflected in the organisational rules and other

internally set principles, rules and procedures and whether they are applied and complied with in the everyday activity of the bank or credit union.

Analysis of individual criteria

Essential criteria

1. The supervisor determines, and periodically confirms, that a bank's Board approves, and periodically reviews, the credit risk management strategy and significant policies and processes for assuming, identifying, measuring, controlling and reporting on credit risk (including counterparty risk). The supervisor also determines, and periodically confirms, that senior management implements the credit risk strategy approved by the Board and develops the aforementioned policies and processes.

COMPLIANT

Regulation:

The Act on Banks (Article 8b) and the Act on Credit Unions (Article 7a) impose on banks and credit unions a duty to establish and maintain adequate system of governance - see Principle 7. This duty also applies to the credit risk management system, which is a major part of a credit institution's system of governance. In the above context, the Prudential Rules Decree stipulates for banks and credit unions that a bank or credit union's risk management strategy shall always contain a credit risk management strategy, including an internal definition of credit risk, principles for determining or assessing the materiality of credit risk, principles for managing credit risk, methods for managing credit risk, a determination of the accepted degree of credit risk and principles for defining permitted products, currencies, countries, geographical areas, markets and counterparties (Article 26, paragraph 4). The Prudential Rules Decree stipulates the general conditions for managing credit risk (annex no. 1, part 1.A.) and also specifies in more detail the requirements for the system for performing credit transactions (annex no. 1, part 1.B), i.e. for accepting credit risk, for measuring and monitoring credit risk, as well as limits for managing credit risk and also analyses and stress testing of the credit portfolio. A bank or credit union's board of directors is under a duty to regularly approve and assess the credit risk management strategy. A bank or credit union's board of directors - unless it transfers this power to a committee it designates—also approves new products, activities, systems and the set of limits that a bank or credit union uses to limit credit risk (Article 16 of the Prudential Decree Rules). The Prudential Rules Decree instructs a bank or credit union to ensure that the relevant bodies have information that is current, reliable and complete for their decisions and other stipulated activities (Article 21, paragraph 1).

A bank or credit union's senior management is responsible to the board of directors for realisation of strategies, (this includes the development of the credit risk management strategy), principles and aims, including drafting procedures for their implementation (Article 18, paragraph 1, of the Prudential Rules Decree). Annex no. 1 to the Prudential Rules Decree, which defines in detail the requirements for credit risk management, includes a requirement for the creation of a system that clearly sets the principles and procedures for adopting, determining, measuring and managing credit risk. The Prudential Rules Decree (annex no. 1, part 1 B.II, item 4) imposes on banks and credit unions the duty to ensure that the relevant staff, including members of senior management (and the relevant committees, if established) understand the assumptions on which the credit risk measurement and monitoring system is based, and that these assumptions were sufficiently documented.

Under the Act on Banks (Article 8b, paragraph 3) and the Act on Credit Unions (Article 7a, paragraph 3), every bank or credit union is under a duty to ensure compliance with the credit risk management requirements not only on a solo basis but also on a consolidated basis.

Supervision:

During supervision through on-site examination, the CNB verifies whether banks, credit unions and groups of which they are part have an appropriate strategy for managing credit risk that has been approved by the board of directors, and whether a bank's board of directors regularly checks the implementation of this strategy and its adequacy. In addition, there is a check on whether each bank and credit union has created an effective control system for the compliance of its own principles and procedures important for assuming, identifying, measuring, managing and reporting credit risk (including counterparty risk) with valid legislative and regulatory standards and its own risk management strategy, as well as a check on compliance with the aforementioned principles and procedures in the bank's everyday activities.

2. The supervisor requires, and periodically confirms, that such policies and processes establish an appropriate and properly controlled credit risk environment, including:

- **a well documented strategy and sound policies and processes for assuming credit risk;**
- **well defined criteria and policies and processes for approving new exposures as well as renewing and refinancing existing exposures, identifying the appropriate approval authority for the size and complexity of the exposures;**
- **effective credit administration policies and processes, including continued analysis of a borrower's ability and willingness to repay under the terms of the debt, monitoring of documentation, legal covenants, contractual requirements and collateral, and a classification system that is consistent with the nature, size and complexity of the bank's activities or, at the least, with the asset grading system prescribed by the supervisor;**
- **comprehensive policies and processes for reporting exposures on an ongoing basis;**
- **comprehensive policies and processes for identifying problem assets; and**
- **prudent lending controls and limits, including policies and processes for monitoring exposures in relation to limits, approvals and exceptions to limits.**

COMPLIANT

Regulation:

In more detail for the individual requirements.

- **A well documented strategy and sound policies and processes for assuming credit risk;**
- **Well defined criteria and policies and processes for approving new exposures as well as renewing and refinancing existing exposures, identifying the appropriate approval authority for the size and complexity of the exposures;**

The Prudential Rules Decree (annex no. 1, part 1.A.I) instructs a bank or credit union to provide loans in accordance with reliable and clearly defined criteria and to clearly set the procedure for approving, altering, amending, renewing and refinancing loans. In addition, the Prudential Rules Decree (annex no. 1, part 1.B) sets out a number of more detailed requirements, which include:

- Limitation on unsuitable subjective aspects of the decision-making process that do not contribute to its quality;
- Respecting of market conditions in transactions with entities (legal entities and individuals) with a special relationship to the bank or credit union (c.f. criterion no. 11);
- Assessing the credit quality of the counterparty, also in the case of syndicated loans, the use of techniques and tools that limit credit risk, for example ensuring that the use of these techniques and tools cannot replace an assessment of the counterparty's credit quality;
- Assessing a transaction with regard to its amount and complexity, in particular from the viewpoint of the financial and economic situation of the counterparty, the purpose of the transaction, the source of repayment, quality and sufficiency of collateral, the situation in the counterparty's economic sector and the proposed conditions for the transaction's execution;

All the aforementioned requirements apply to both new exposures and to re-financing of current exposures.

- **Effective credit administration policies and processes, including continued analysis of a borrower's ability and willingness to repay under the terms of the debt, monitoring of documentation, legal covenants, contractual requirements and collateral, and a classification system that is consistent with the nature, size and complexity of the bank's activities or, at the least, with the asset grading system prescribed by the supervisor;**

The Prudential Rules Decree (annex no. 1, part 1.B.II, item 3) instructs banks and credit unions to ensure that their credit risk measurement and monitoring system, in particular:

- Monitors a counterparty's financial and economic situation with regard to the type of transactions agreed with the counterparty;
- Monitors compliance with the contractual terms by the counterparty;
- Monitors the valuation of collateral;
- Monitors current problems that urgently require remedial measures;
- Monitors the reasonableness of the amount of reserves and provisions.

The Prudential Rules Decree sets out detailed rules for assessing assets, where the rules include the rules for classification, or categorisation of receivables from financial activities, the procedures for determining losses on the impairment of selected exposures of an investment portfolio and, finally, the requirements for creating reserves to off-balance sheet items (Articles 194 to 205).

- **Comprehensive policies and processes for reporting exposures on an ongoing basis;**

Under the Prudential Rules Decree (annex no. 1, part 1.B.II, item 1), a bank or credit union has to have a system for measuring and monitoring credit risk that is commensurate to the nature, extent and complexity of the activities, shows all major sources of credit risk and enables an assessment of the impact on revenues and costs and the value of assets, liabilities and off-balance sheet items in such a manner that it provides an undistorted view of the degree of risk undertaken. For the details for exposures see principle no. 10.

- **Comprehensive policies and processes for identifying problem assets;**

The Prudential Rules Decree, in part six, chapter II, stipulates detailed rules for assessing assets, including the creation of provisions for off-balance sheet items, where the rules include rules for the classification or categorisation of receivables. The categorisation of receivables applies to receivables from financial activities, regardless of whether a bank or credit union uses a standardised or IRB approach (Article 194, paragraph 1) to calculating the capital requirement for investment portfolio credit risk. Receivables from financial activities are, in particular, loans provided, receivables on financial leasing, receivables from deposits, receivables from guarantees, receivables from letter of credit, factoring receivables, advances provided for the acquisition of securities for a period of more than 30 calendar days, receivables from sale from securities with a deferral of the sale price for a period of more than 30 calendar days, receivables on the sale of securities unsettled for 30 days after the set settlement day. The categorisation, on the contrary, does not apply to receivables on the holding of securities, receivables from derivatives and receivables from other than financial activities, in particular receivables from labour law and similar relations, operating deposits paid and deposits paid on acquisition of tangible and intangible assets, receivables from the sale of inventories, tangible and intangible assets (Article 194, paragraph 2). The Prudential Rules Decree distinguishes two categories of receivables, the first of them includes receivables without borrower default, which are further divided into two subcategories - standard receivables and watch receivables (Article 195). The second category is receivables with borrower default, which are included in three subcategories of receivables - substandard, doubtful and loss (Article 197). Banks and credit unions can assess whether there has been an impairment of the book value of a receivable either for individual receivables or portfolios of receivables with similar characteristics (Article 199). When determining the loss from the impairment of a receivable or portfolio of receivables, banks and credit unions can use the method of discounting expected future cash flows, the coefficient method or the statistical models method (Article 201). For more details see Principle No. 9.

The Prudential Rules Decree (annex no. 1, part 1.B.III) requires that the set of limits and procedures used for measuring and monitoring credit risk are comprehensive and interconnected and that the set of limits takes into consideration the other risks that a bank or credit union is or could be exposed to, in particular market risk and liquidity risk. The set of limits shall correspond to the size and method of managing a bank or credit union, the nature, extent and complexity of activities that it performs and the capital adequacy it should comply with. In connection with these factors, partial limits must be set, for example for individual counterparties, individual countries, geographical areas or individual activities. Partial credit risk limits shall be used in such a way that the total accepted degree of credit risk is not exceeded and that when taking into account the limits the positions resulting from the overall structure of assets, liabilities and off-balance sheet items is taken into consideration. A bank or credit union shall also, for each limit, set commensurate procedures for when it is exceeded. The board of directors of a bank or credit union shall, without undue delay, be informed of all cases where limits are exceeded and this endangers the acceptable degree of credit risk (Article 21, paragraph 2, subparagraph b), of the Prudential Rules Decree).

Under the Act on Banks and the Act on Credit Unions, every bank or credit union is under a duty to ensure compliance with the credit risk management requirements on a solo and consolidated basis. This duty is also imposed by the Prudential Rules Decree.

Supervision:

When performing supervision in the form of on-site examination, the CNB verifies whether a bank, credit union or group of which it is part has principles and procedures that are in accordance with valid legislative and regulatory standards and its own risk management strategy. There is also verification of the adequacy of the set system for measuring and managing credit risk against a specific bank or credit union's risk profile and compliance with the set principles and procedures in the everyday practice of the aforementioned institutions.

3. The supervisor requires, and periodically confirms, that banks make credit decisions free of conflicts of interest and on an arm's length basis.

COMPLIANT

Regulation:

The Prudential Rules Decree instructs a bank or credit union to ensure that bodies, staff, units and committees, if established, are, at all managerial and organisational levels, given responsibilities and powers in such a manner that sufficiently prevents a conflict of interests and also enables the identification in advance of possible conflicts of interests, and sets out procedures so that a bank or credit union prevents conflicts of interests (Article 20, paragraph 1). The areas of a conflict of interests and areas where one could arise are also the subject of ongoing independent monitoring by the internal audit department. These duties set out in the Decree fully apply to the management of credit risk. Independent of commercial activities that expose a bank or credit union to credit risk, the following is performed: the approval of systems and methods for valuing collateral, settlements and checks on data reconciliation for agreed credit transactions or transactions agreed on financial markets, the release of funds provided, the approval of limits for managing credit risk through the approval of valuation systems and models used for measuring and monitoring credit risk, the management of credit risk, the creation of quantitative and qualitative information about credit risk for all members of senior management and the board of directors (Article 20, paragraph 2).

The Prudential Rules Decree also instructs a bank or credit union to ensure, up to the level of senior management, the division of responsibility for managing commercial activities from responsibility for managing credit risk, and that the development of information systems is separate from the operation of such systems. A bank or credit union shall also ensure the appropriate independence and prevent a conflict of interests when arranging control mechanisms and activities, where the internal audit function is performed independently of all activities carried out (Article 30, paragraphs 3 to 5 of the Prudential Rules Decree).

Supervision:

When performing supervision in the form of an on-site examination, the CNB verifies whether the organisational structure (including the defined content of various departments' activities) of banks and credit unions is in compliance with the principles stipulated by the Prudential Rules Decree and whether the internal regulations and everyday practice in processes for providing and monitoring loans exclude potential conflicts of interest. Together with this they will comply with the principle for providing the credit or similar transactions under arms-length principles and under comparable conditions to all clients of a bank or credit union.

4. The supervisor has full access to information in the credit and investment portfolios and to the bank officers involved in assuming, managing, controlling and reporting on credit risk.

COMPLIANT

Supervision:

The CNB is entitled to require from credit institutions over which it performs supervision all the information and documents it needs to perform supervision on a solo and individual basis, including information about the credit and investment portfolio. As a part of regular reporting in accordance with the CNB provision on submitting statements, there is information about the volume of credits provided, their categorisation, industry and sector structure, etc. In addition to reports that a bank or credit union regularly sends to the CNB as a part of the performance of remote supervision, the CNB regularly requires other source documents before an on-site examination. Their extent and character depends primarily on the set aim of the on-site examination, partially on the character of the authorised financial institution and its risk profile. The CNB can also request from members of the board of directors and senior management that bear final responsibility for the management of a bank or credit union's credit risk explanations, additional information or measures, including enabling conversations with bank or credit union employees that are involved in accepting, managing, checking and reporting credit risk. Managed interviews with such staff are usually an ordinary part of an on-site examination. Banking supervision also has the option, in the cases specified in an internal supervision regulation, to take advantage of the information contained in the Central Credit Register, which the CNB operates for the exchange of information about credit portfolios between the various banks (this only concerns receivables from legal entities and individuals - entrepreneurs).

Additional criteria

- 1. The supervisor requires that the credit policy prescribes that major credit risk exposures exceeding a certain amount or percentage of the bank's capital are to be decided by the bank's senior management. The same applies to credit risk exposures that are especially risky or otherwise not in line with the mainstream of the bank's activities.**

NON-COMPLIANT

Regulation:

The Prudential Rules Decree sets out that the senior management is responsible for the realisation of the strategies, principles and aims approved by the board of directors, which means also the realisation of the principles and aims set in the risk management strategy for credit risk, as well as setting the procedures for complying with the aforementioned principles and aims, i.e. for procedures for accepting and managing credit risk, and finally for the everyday management of the bank or credit union (Article 18, paragraph 1). The aforementioned decree, however, does not explicitly instruct banks and credit unions to have their credit policy state that senior management teams decide on large credit exposures exceeding a certain amount or percentage of the bank's capital and credit exposures that are especially risky or not entirely in accordance with the main focus of the bank's activities. For this reason the result is "non-compliant."

- 2. The supervisor determines that banks have in place policies and processes to identify, measure, monitor and control counterparty credit risk exposure, including potential future exposure sufficient to capture the material risks inherent in individual**

products or transactions. These processes should be commensurate with the size or complexity of the individual bank.

COMPLIANT

Regulation:

The Prudential Rules Decree (annex no. 1, part 1.B.II.) sets out more detailed requirements for managing credit risk. The system for measuring and monitoring credit risk has to be commensurate to the nature, extent and complexity of the activities of a specific bank or credit union. The aforementioned system should capture all significant sources of credit risk and provide an undistorted picture of the risk undertaken. The aforementioned system should also ensure that the following is ensured:

- Monitoring of a counterparty's financial and economic situation with regard to the type of transactions agreed with the counterparty;
- Monitoring of compliance with the contractual terms by the counterparty;
- Monitoring of the valuation of collateral;
- Monitoring of current problems that urgently require remedial measures;
- Monitoring of the reasonableness of the amount of reserves and provisions.

In accordance with the Act on Banks (Article 8b) and the Act on Credit Unions (Article 7a), each bank or credit union shall have procedures for monitoring and measuring risk that are part of comprehensive system of governance, commensurate to the character, extent and complexity of the activities of a specific bank or credit union. The same requirements are placed on banks and credit unions by the Prudential Rules Decree (Article 25), the risk management strategy and its content are further set out by Article 26 of the decree - see essential criteria 1 and 2.

3. The supervisor determines that banks have policies and processes to monitor the total indebtedness of entities to which they extend credit.

COMPLIANT

Regulation:

The total indebtedness of entities to which a bank or credit union provides credit is a major parameter for the counterparty's financial and economic situation and an assessment of the situation is, according to annex no. 1 to the Prudential Rules Decree, an integral part of the system that a bank or credit union is under a duty to establish for performing transactions with which credit risk is linked. See also above, additional criterion no. 2 and essential criterion no. 2.

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. ⁴⁾

Overall assessment of the Principle
COMPLIANT

[Decree No. 123/2007 Coll., stipulating the prudential rules for banks, credit unions and investment firms](#) (hereinafter the “Prudential Rules Decree”) stipulates for banks, branches of foreign banks that do not enjoy the benefits of a single licence in accordance with the EU law and for credit unions the duty to, as a part of the credit risk management strategy, introduce and comply in practice with a strategy and procedures for managing problem assets and for sufficient creation of provisions (credit allowances) and reserves. Banks and credit unions shall identify problem assets, in accordance with the rules that are set out in the Prudential Rules Decree, systematically and in time. In accordance with these rules, not only credits, but all receivables from financial activities in an investment portfolio are subject to assessment. These receivables are differentiated by category - receivables without borrower’s default, further broken down into standard and watch receivables, and receivables with borrower’s default, or non-performing receivables (in the diction of this principle problem receivables), further broken down into substandard, doubtful and loss receivables. The definition of default is similar to that for the purposes of capital adequacy. In the case of retail exposures, banks and credit unions can apply the definition of default at a transaction level, assuming that they proceed in such a way for the purposes of capital adequacy. When assessing whether a receivable is in default or not, collateral is not taken into account. Banks and credit unions can assess whether there has been an impairment of the book value of a receivable either for individual receivables or portfolios of receivables with similar characteristics. In the second case, however, the portfolio has to comprise receivables with similar characteristics with regard to the credit risk (portfolio of homogenous receivables) and also has to comprise individually insignificant receivables or receivables for which impairment has not been identified individually. If there is impairment of a receivable, banks and credit unions are under a duty to alter its valuation (value adjustments). If receivables or parts thereof that correspond to a loss due to impairment are not written off, a provision (credit allowance) shall be created for this loss. A loss can be determined using the method of discounting expected future cash flows, the coefficient method or the use of statistical models for portfolios of insignificant receivables, but always consistent with accounting methods used. Compliance with accounting methods is requested when taking into account collateral for the purposes of calculating loss on impairment of receivables. Every bank or credit union is under a duty, no less than once a quarter, to check the correctness of classification of receivables in categories and subcategories and, in accordance with the results of reviews, make the relevant changes to their classification. The correctness of classification of receivables whose volume is insignificant can be checked over a period longer than a quarter, but no less than once a year, if a bank or credit union is able to prove sufficient caution when applying the procedure. A bank or credit union is under a duty to ensure that the board of directors is regularly informed about the degree of credit risk undertaken. A bank or credit union shall also have available information about a comparison of the degree of credit risk undertaken with the internal limits and regulatory requirements

⁴⁾ Principle no. 8 deals in detail with asset valuation; principle no. 9 deals with the management of problem assets.

and information about the result of the analyses of the credit portfolio. A bank or credit union shall also ensure the creation and maintenance of internal control mechanisms ensuring the completeness and correctness of the calculation of reserves. Banks and credit unions are under a duty to hand over to the CNB monthly reports on the structure of receivables by default and by impairment. They also submit information about the reconciliation of provisions (information about the balance of provisions as at the start and end of a monitored period, information about the creation and use of provisions, information about the expensing of provisions due to their not being used). Banks and credit unions are also under a duty to, quarterly at their website, publish information about receivables from financial activities broken down by default and impairment, including information about provisions.

When performing banking supervision, the CNB checks the adequacy of the classification of various receivables in the relevant category and subcategory, the calculation of the need for and creation of provisions and the administration of problem assets. If the CNB regards provisions or the valuation of instruments to reduce risk as inadequate, it is entitled to request that the bank or credit union adopts stricter rules for the creation of provisions and creates provisions in an amount that corresponds to the risk undertaken. In such a case the CNB can impose another remedial measure.

Analysis of individual criteria

Essential criteria

1. Laws, regulations or the supervisor require banks to formulate specific policies and processes for identifying and managing problem assets. In addition, laws, regulations or the supervisor require periodic review by banks of their problem assets (at an individual level or at a portfolio level for credits with homogenous characteristics) and asset classification, provisioning and write-offs.

COMPLIANT

Regulation:

The Prudential Rules Decree (Articles 25 and 26) instructs banks and credit unions to have a strategy and procedures for managing credit risk that shall include, in addition to other things, procedures for administering credits, including problem credits—see principle 8, essential criterion 2. This obviously assumes that problem assets will be identified in time and systematically. For this purpose the decree sets out the rules and procedures for assessing selected exposures of an investment portfolio (Articles 194 to 205), determining in particular:

- The extent of application of the rules for their categorisation;
- The categories and subcategories of the aforementioned exposures;
- The criteria for their assessment by default, which means for their inclusion in the categories and the relevant subcategories (categorisation serves as a tool to identify problem assets);
- The criteria and principles of assessment of exposures by impairment, individually or at the portfolio level;
- The minimum frequency of assessment of the aforementioned exposures;
- The methods for calculating the need for and creation of provisions.

The categorisation of receivables applies to receivables from investment portfolio financial activities, regardless of whether a bank or credit union uses a standardised or IRB approach to measure credit risk. The categorisation, on the contrary, does not apply to receivables from the holding of securities, receivables from derivatives and receivables from other than

financial activities, in particular receivables from labour law and similar relations, operating deposits paid and deposits paid on acquisition of tangible and intangible assets, receivables from the sale of inventories, tangible and intangible assets.

In accordance with the Prudential Rules Decree (Article 195), two categories of receivables are differentiated - receivables without borrower's default and receivables with borrower default. An essential criterion for assessing receivables is whether a borrower performs in full its obligations linked to a receivable, or whether, when performing the receivables, it fails or does not fail. A borrower's default shall be understood to be a situation where at least one of the following conditions is met:

- It can be assumed that the borrower will probably not settle its obligation in full and on time without the creditor having the receivable satisfied from the collateral;
- At least one instalment on the principle or interest on any obligation of the borrower to the creditor is more than 90 days overdue; an obligated party does not have to have regard to this condition if the amount overdue is not significant, where the materiality threshold is set by the obligated person with regard to what amount it is not collecting after a receivable's write-down.

The Prudential Rules Decree defines in detail the default criteria for overdrafts and similar instruments, as well as other receivables, and sets the conditions under which a bank or credit union can have regard to the exposure that occurred before default as exposure without default (Article 49).

Receivables without borrower default (Article 196 of the Prudential Rules Decree) are classified in two subcategories (standard receivables and watch receivables). This breakdown only applies to individually assessed receivables. The portfolios of individually insignificant receivables without borrower default are not broken down into subcategories.

Receivables with borrower default (Article 197, paragraph 1, of the Prudential Rules Decree) are regarded as at-risk and are included in three subcategories (substandard receivables, doubtful receivables and loss receivables). For more details see essential criterion 10.

As far as concerns the criteria and principles for assessing selected exposures of an investment portfolio by impairment, banks and credit unions assess reductions in their book value either at the level of individual receivables (see above) or at the level of portfolios of homogenous receivables (Article 199, paragraph 1, of the Prudential Rules Decree). The conditions under which a bank or credit union applies the second approach and under which it makes use of statistical models for assessing portfolios of individually insignificant receivables are set out in the Prudential Rules Decree (Article 199, paragraph 2, and Article 204).

The Prudential Rules Decree (Article 201) enables the use of several methods for the creation of provisions - the method of discounting expected future cash flows, the coefficients method and the statistical models method. For more details see criterion 4.

A bank or credit union is under a duty, under the Prudential Rules Decree (Article 198, paragraph 5), no less than once a quarter, to check the correctness of classification of receivables in categories and subcategories and, in accordance with the results of reviews, make the relevant changes to their classification. The correctness of classification of receivables whose volume is insignificant can be checked by a bank or credit union over a period longer than a quarter, but no less than once a year, if this corresponds to the character

of the receivable or borrower, and if it is able to prove sufficient prudence when applying this procedure. A bank or credit union is under a duty, under the Prudential Rules Decree (Article 198, paragraph 5), to include a receivable in the relevant category and subcategory and regularly check this inclusion. Analogically, when using the portfolio approach a bank or credit union is under a duty, according to the decree (Article 204, paragraph 4), to regularly check the statistical model that it uses for statistical estimates of the losses and, in connection with this, to set provisions for the portfolio of individually insignificant receivables.

2. The supervisor confirms the adequacy of the classification and provisioning policies and processes of a bank and their implementation; the reviews supporting this opinion may be conducted by external experts.

COMPLIANT

Supervision:

Verification of the adequacy of the principles of categorisation and creation of provisions and procedures in banks and credit unions is included in the standard activities of the CNB, as the authority performing supervision of such entities, in particular during on-site examination. As a part of the aforementioned checks, the CNB examines the system of classifying receivables in the relevant categories, the system of calculating the need for provisions and their adequacy given the risk profile of the controlled institution. There is also a check not only on the compliance of the aforementioned procedures with valid regulatory rules and accounting procedures, but also their functionality in everyday practice. When verifying procedures related to the classification and creation of provisions, the CNB does not use the services of external specialists, but is interested in the manner in which the procedures were assessed in a specific bank or credit union by, for example, an external auditor or the parent company's auditor.

3. The system for classification and provisioning takes into account off-balance sheet exposures.

COMPLIANT

Regulation:

Off-balance sheet items where a bank or credit union is under a duty, under the Prudential Rules Decree (Article 205, paragraphs 1 and 2), to quarterly check the sufficiency and justification of provisions and, if appropriate, alter the amount of the provisions, include, in particular, guarantee receivables, letter of credit receivables and factoring receivables. The Prudential Rules Decree (annex no. 1, part 1 A.I.) also expressly instructs banks and credit unions to, through their effective systems, ensure ongoing administration and monitoring of various portfolios and exposures, including exposures that have the nature of off-balance sheet items.

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

COMPLIANT

Regulation:

When determining the loss from the impairment of a receivable or portfolio of receivables, a bank or credit union can use the method of discounting expected future cash flows, the coefficient method or the statistical models method - see essential criterion 1. For the

purposes of compliance with the prudential rules, a bank or credit union sets the amount of a loss on impairment using the same method as for the purposes of maintaining accounts and drafting financial statements (Article 201, paragraph 1, of the Prudential Rules Decree). Specific requirements for the application of these methods so that their use ensures that provisions and writing off of receivables reflect realistic expectations of payment and the proceeds of receivables are set out by the Prudential Rules Decree (Article 202 to 204).

5. The supervisor determines that banks have appropriate policies and processes, and organisational resources for the early identification of deteriorating assets, for ongoing oversight of problem assets, and for collecting on past due obligations.

COMPLIANT

Regulation:

A bank or credit union shall have, in its risk management system, a system for managing credit risk and this system shall include the principles and procedures for administering credits and other exposures (including off-balance sheet items) with which a credit risk is linked, including timely identification and management of problem exposures - see essential criterion 1. These principles are part of the credit administration system that was mentioned in principle 8, essential criterion 2, and this system must, in addition to other things, ensure a systematic analysis of a borrower's ability and willingness to pay its debt in accordance with the set conditions and terms, monitoring of documentation, legal contracts, contractual requirements and collateral. All this concerns, in full, problem receivables including the collection of overdue receivables.

6. The supervisor is informed on a periodic basis, and in relevant detail, or has access to information concerning the classification of credits and assets and provisioning.

COMPLIANT

Supervision:

As the supervisory authority for the financial market, the CNB is entitled to request regular and detailed information from credit institutions, see principle 1(3), essential criterion 2. This information includes information from banks and credit unions concerning the structure of receivables by categorisation, broken down by category and provisioning for the various categories and subcategories of receivables and further broken down into provisions for individually assessed receivables and portfolios of receivables (Receivable categorisation reports). This information is submitted as a part of regular reporting defined by the relevant CNB provision on the submission of reports with monthly periodicity. In a report entitled "Supplemental information to financial statements" of a bank or credit union, they will submit information about assets by impairment and also the reconciliation of provisions and reserves. Each bank or credit union is under a duty to verify the completeness and correctness of data contained in reports and statements submitted. The reports are assessed as a part of remote supervision. The quality of assets, provisioning and administration of problem credits are analysed during on-site examination in each bank or credit union once every two or three years.

7. The supervisor has the power to require a bank to increase its levels of provisions and reserves and/or overall financial strength if it deems the level of problem assets to be of concern.

COMPLIANT

Regulation:

The CNB's power to use the procedure specified for this criterion against banks is based on the relevant provisions of the Act on Banks (Article 26). As a part of a remedial measure the CNB can require a bank to create provisions and reserves in an amount that corresponds to the risk undergone, the acceptance of stricter rules for creating provisions for assets and reserves or for setting capital requirements or requiring a limitation on credits provided. The CNB can order an extraordinary audit. Analogical powers of the CNB regarding credit unions are anchored in the Act on Credit Unions (Article 28). The Act on Banks [Article 26, paragraph 1, subparagraph a)] and the Act on Credit Unions [Article 28, paragraph 1, subparagraph a)] entitle the CNB to, after assessing specific circumstances, request from a certain bank or credit union an increase in capital that ensures capital adequacy higher than the minimum requested capital adequacy ratio (see also principle 1(4) and principle 6).

8. The supervisor assesses whether the classification of the credits and assets and the provisioning is adequate for prudential purposes. If provisions are deemed to be inadequate, the supervisor has the power to require additional provisions or to impose other remedial measures.

COMPLIANT

See commentary to essential criterion 7.

9. The supervisor requires banks to have appropriate mechanisms in place for periodically assessing the value of risk mitigants, including guarantees and collateral. The valuation of collateral is required to reflect the net realisable value.

COMPLIANT

Regulation:

The Prudential Rules Decree (annex no. 1, part 1.A.III, item 2) instructs banks and credit unions to ensure the suitability and reliability of principles and procedures for managing remaining risk linked to the use of recognisable techniques for reducing credit risk and the correctness of their application. A significant part of these principles and procedures are rules governing how a bank or credit union acts when regularly valuing risk mitigants, including guarantees and collateral received, for the purposes of capital adequacy and exposure. The rules are set out in the Prudential Rules Decree in annex no. 16, which sets out:

- The principles for the selection of the method for taking into account the effects of collateral, where the use of a specific method is derived from whether it is asset collateral (e.g. cash, an agreement on setting off, securities, real estate, receivables, movables and leased items) or personal collateral (e.g. guarantees, credit derivatives).
- The methods, principles and conditions under which the value of exposure is set out depending on collateral.

10. Laws, regulations or the supervisor establish criteria for assets to be identified as impaired, eg loans are identified as impaired when there is reason to believe that all amounts due (including principal and interest) will not be collected in accordance with the contractual terms of the loan agreement.

COMPLIANT

Regulation:

In accordance with the Prudential Rules Decree, receivables with borrower default are regarded as being at risk (Article 197, paragraph 1). Banks and credit unions classify such

receivables in one of the following three subcategories—substandard receivables, doubtful receivables and/or loss receivables, where:

- A receivable is regarded as substandard if its full payment is, in particular with regard to the borrower's financial and economic situation, uncertain. Its partial payment is highly probable without the bank or credit union satisfying its claim from the collateral. A receivable is also regarded as substandard if instalments on the principal or interest are paid with problems, but none of them is more than 180 days overdue;
- A receivable is regarded as doubtful if its full payment is, in particular with regard to the borrower's financial and economic situation, highly improbable. Its partial payment is possible and probable without the bank or credit union satisfying its claim from the collateral. A receivable is also regarded as doubtful if instalments on the principal or interest are paid with problems, but none of them is more than 360 days overdue;
- A receivable is regarded as loss-making if its full payment is, in particular with regard to the borrower's financial and economic situation, impossible. It is expected that the receivable will not be satisfied or will be satisfied only partially in a very small amount, without the bank or credit union satisfying its claim from the collateral. A receivable is also regarded as loss-making if instalments on the principal or interest are more than 360 days overdue. A receivable from a borrower in composition proceedings, or a receivable from a borrower on whose assets an application for a bankruptcy order has been granted, unless it is a receivable arising after the granting of the bankruptcy order, shall also be regarded as loss-making.

The Prudential Rules Decree (Article 198, paragraphs 1 to 4) stipulates further rules for the classification of receivables in categories and subcategories. The rules state how to assess:

- More than one receivable from one borrower;
- A receivable that meets the criteria for classification in more than one subcategory;
- A restructured receivable;
- A receivable that a bank or credit union has in connection with the assignment of a group of other receivables.

The Prudential Rules Decree (Article 199, paragraphs 3 and 4) also defines what can be considered objective evidence of impairment of a portfolio of homogenous receivables. Such evidence is the existence of comparable data that indicates a reduction in the expected future cash flows from the portfolio, although the reduction cannot yet be identified by individual receivables included in a portfolio. An indicator can be, in particular:

- An increase in unemployment in the relevant areas;
- A reduction in property prices in the relevant areas;
- Unfavourable conditions in industries in which the borrowers are active;
- An increase in the number of borrowers that fully draw their limit and settle their obligations in the minimum possible amount.

11. The supervisor determines that the Board receives timely and appropriate information on the condition of the bank's asset portfolio, including classification of credits, the level of provisioning and major problem assets.

COMPLIANT

Regulation:

The Prudential Rules Decree (Article 21) instructs a bank or credit union to ensure that the relevant bodies, including the board of directors, have information that is current, reliable and

complete for their decisions and other stipulated activities. The board of directors shall be regularly informed, in addition to other things, about the degree of credit risk undertaken, and shall be informed without undue delay of all limits exceeded endangering compliance with the accepted degree of credit risk (and other material risks undertaken).

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

COMPLIANT

Regulation:

The Prudential Rules Decree (Article 204) states that the portfolio method of assessing receivables and the related statistical method for determining loss on impairment of a receivable, or portfolio of receivables, can be used only for the portfolio of individually insignificant receivables. A bank or credit union shall value and classify large exposures in accordance with individual items and, for individual items, also create provisions, in accordance with rules stipulated by the Prudential Rules Decree - see essential criterion 4. In the case of homogenous receivables where there has been no individual identification of impairment, there is an assessment of impairment on a portfolio basis.

Additional criterion

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

COMPLIANT

Regulation:

The duty to classify receivables is set out by the Prudential Rules Decree (Article 197) - see essential criterion 10. A bank or credit union is under a duty, under the decree (Article 198, paragraph 3), to, at the moment of restructuring, include a restructured receivable in the subcategory in which the receivable was or should have been classified before restructuring. Restructuring means a situation in which the borrower is provided with relief, as the creditor has assessed that otherwise it would probably make a loss (for which reason the refinancing of a loan whose instalments would be late if the refinancing did not occur is understood to be restructuring). Only if a bank or credit union is able to prove that the degree of risk of non-payment of such receivable has fallen compared to the situation before restructuring can it classify it in a better subcategory, provided compliance with the approach to the receivable is maintained also for the purposes of capital adequacy and provided this does not affect other provisions of the Prudential Rules Decree that define the characteristics of a receivable without borrower default (Article 196).

Principle 10: 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.

Overall assessment of the principle:

LARGELY COMPLIANT

Essential criteria

[Act No. 21/1992 Coll., on Banks, as amended](#) (hereinafter referred to only as the “Act on Banks”), and [Act. No 87/1995 Coll., on Credit Unions and Certain Related Measures and on the Amendment of Czech National Council Act No. 586/1992 Coll., on Income Tax, as amended](#), (hereinafter referred to only as the “Act on Credit Unions”) imposes on banks, foreign bank branches, which do not enjoy the advantages of the single licence under the EU law and credit unions the obligation to set up and maintain an adequate system of governance. The system of governance of banks and credit unions has to be integrated and correspond to the nature, scope and complexity of their activities. This obligation relates also to the management system for concentration risk, which forms a significant component of the system of governance of the above named institutions. The management system for concentration risk has to take into consideration the risk profile of the given institution. More detailed regulatory requirements for this system are set out for banks and credit unions in [Decree No. 123/2007 Coll., stipulating the prudential rules for banks, credit unions and investment firms](#) (hereinafter referred to only as the “Prudential Rules Decree”).

The Prudential Rules Decree imposes on the banks as well as credit unions the obligation that within the risk management strategy (approved by the board of directors) the rules and methods are to be set out for concentration risk management. The responsibility for the performance of this strategy including the development of the procedures for its implementation lies with a bank’s senior management. Banks and credit unions must set the procedures for identifying, evaluating or measuring, monitoring, reporting and possibly mitigating risks, along with a set of limits used for risk management and the rules of control mechanisms and activities in the risk management. Proceeding from this, banks or credit unions are obliged to comply, on the solo and consolidated basis, with the prudential limits of exposure both to single counterparties or groups of connected counterparties,. Exposure limits are determined for the investment portfolio and upon compliance with the set conditions also for the trading portfolio. Limits include claims and transactions, on-balance sheet as well as off-balance sheet. Banks and credit unions have to adhere to the limit continually. The board of directors must be regularly informed about the adherence to exposure rules and moreover must be immediately informed about all exceeded limits endangering the compliance with the acceptable degree of the credit risk. Should the concentrations on the solo and consolidated basis exceed the set limits, the Act on Banks and the Act on Credit Unions authorise the CNB to demand rectification be made or possibly to impose other remedial measures on the bank or the credit union.

When performing banking supervision, the CNB checks that the banks or credit unions have strategies and procedures, enabling their management to identify and manage concentrations within the portfolio and that their senior management monitors the limits of the credit exposure and that these limits are not exceeded, either on the solo or consolidated basis.

Monthly on the solo basis and quarterly on the consolidated basis, within the regular reporting, banks and credit unions submit to the CNB a summary of all the large exposures exceeding 10 % of the bank's capital, both to a single counterparty or groups of connected counterparties. With respect to monitoring the concentration, other quarterly reports are submitted, specifically the information about the 15 largest claims and debts in relation to individual debtors, or creditors, structured according to banks and non-bank clients, and about the selected assets, liabilities and off-balance sheet exposures according to countries. The currency and bank statistical returns provide information about sectoral and branch classification of claims and debts, whereas capital adequacy reports also monitor the currency structure of assets and liabilities, including the off-balance sheet figures.

The assessment grade has been lowered due to the assessment of criterion 5, because although the credit unions submit capital adequacy reports of the credit union, in comparison with banks the currency structure itself of assets and liabilities is not monitored.

Additional criterion

The large exposure of the investment portfolio to a single counterparty or groups of connected counterparties is defined by the Prudential Rules Decree in Article 189a, paragraph 2. It is understood as the exposure, whose value equals or exceeds 10 % of the sum of the original and additional capital on the solo or consolidated basis. The items deductible from the capital are deducted from this exposure. The Prudential Rules Decree sets the limit of 25 % of the capital of a bank or credit union for a single large exposure of a bank or credit union to a single counterparty or groups of connected counterparties.

Analysis of individual criteria

Essential criteria

1. Laws or regulations explicitly define, or the supervisor has the power to define, a “group of connected counterparties” to reflect actual risk exposure. The supervisor may exercise discretion in applying this definition on a case by case basis.

COMPLIANT

Regulation:

The Prudential Rules Decree [Article 2, paragraph 1, subparagraph d)] defines a group of connected counterparties as two or more natural or legal entities that unless proven otherwise, represent a single risk because:

1. They are mutually interconnected due to their relation of controlling entity and controlled entity, or
2. 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 connecting the entities into groups of connected counterparties are also regulated by the CNB Official Information, supplementing and specifying the above quoted Article of the Decree.

2. Laws, regulations or the supervisor set prudent limits on large exposures to a single counterparty or a group of connected counterparties. “Exposures” include all claims and transactions, on-balance sheet as well as off-balance sheet. The supervisor confirms that senior management monitors these limits and that they are not exceeded on a solo or consolidated basis.

COMPLIANT

Regulation:

The Act on Banks (Article 13) stipulates that a bank shall observe the rules, which limit the amount of assets and off-balance sheet items in relation to a single counterparty or a group of counterparties depending on the capital (exposure rules) on the solo basis. Moreover, a bank shall also comply with the exposure rules on a consolidated basis if it is:

- a domestic parent bank,
- a parent bank but not a domestic parent bank or a responsible bank in a financial holding entity group, where a foreign bank or financial institution having its registered office in a non-Member State is a member of its consolidated group,
- a responsible bank in a financial holding entity group, or
- a responsible bank in a foreign parent bank group.

The Act on Credit Unions (Article 11, paragraph 1) stipulates that a credit union shall observe the rules, which limit the amount of the assets and off-balance sheet items in relation to a single counterparty or a group of counterparties depending on the capital (exposure rules) on the solo basis. Moreover, a credit union shall also comply with the exposure rules on a consolidated basis if it is a responsible credit institution in a financial holding entity group or a responsible credit union in a parent credit institution group.

The Prudential Rules Decree (Article 180) defines investment portfolio exposure and imposes on banks and credit unions the obligation to comply with prudential limits of credit exposure both to a single counterparty and groups of connected counterparties. These limits are set for an investment portfolio (Article 181 of the Prudential Rules Decree) and for a trading portfolio (Article 186 of the Prudential Rules Decree). Moreover, the Prudential Rules Decree (Articles 187 and 188) specifies the conditions under which the capital requirement for exposure risk in the trading portfolio is to be determined and its actual calculation.

In compliance with the Prudential Rules Decree (Article 180, paragraph 1, or Article 186, paragraph 1) the investment and trading portfolio exposure is set applying procedures pursuant to Articles 44 to 53 therein, where Article 44, paragraph 1, states that assets, liabilities and off-balance sheet items are included in the trading or investment portfolio.

Senior management shall be responsible for performing the strategies, rules and targets approved by the board of directors, including the development of procedures for their implementation and the daily management of the bank or credit union (Article 18, paragraph 1 of the Prudential Rules Decree). This obligation also fully applies to concentration risk management. Furthermore, senior management is also liable for the performance of more detailed requirements for concentration risk management, which are provided for in Annex No. 1 (Part 5) of the Prudential Rules Decree. The provisions therein specify that the bank or credit union shall have due managerial, administrative and accounting procedures and the appropriate internal control mechanisms to identify and record important concentrations, including all exposures, and to monitor and evaluate all cases of important concentrations and exposures with regard to the internal policies of the bank or credit union for this area.

A bank or credit union shall establish and maintain a set of limits for credit risk management, and the procedures for their use and observance, which shall ensure that the degree of credit risk accepted by the board of directors, or stipulated by the competent supervising authority, is not exceeded (Annex No. 1, Part 1, B III of the Prudential Rules Decree). For this purpose it shall ensure that the set of limits is adequate with regard to its size and the management method, the nature, scope and complexity of the activities and the stipulated capital adequacy. The board of directors shall, on a timely and sufficient basis, assess regular reports and extraordinary findings which are submitted to it particularly by senior management. They shall also discuss the matters relating to the system of governance (Article 16 of the Prudential Rules Decree).

On a monthly basis a bank and credit union report all large exposures in the data file *Exposure Report* pursuant to the Prudential Rules Decree (Article 189a, paragraph 2). Moreover, in accordance with Article 221a, paragraph 2 therein the liable entity shall inform the CNB without needless delay of the exposure limits having been exceeded pursuant to Article 181.

3. The supervisor determines that a bank's management information systems identify and aggregate on a timely basis exposure to individual counterparties and groups of connected counterparties.

COMPLIANT

Regulation:

The Prudential Rules Decree (Article 21, paragraph 1) imposes on banks and credit unions the obligation to ensure that the relevant bodies (including supervisory bodies), employees, departments and committees, if these have been established, have, in their decision-making and when pursuing other laid down activities, access to up-to-date, reliable and comprehensive information. This fully applies also to concentration risks, including monitoring credit exposure on the solo and consolidated basis.

4. The supervisor confirms that a bank's risk management policies and processes establish thresholds for acceptable concentrations of credit and require that all material concentrations be reviewed and reported periodically to the Board.

COMPLIANT

Regulation:

The Prudential Rules Decree [Article 25, subparagraph b)] imposes on banks and credit unions the obligation to stipulate a set of limits used in risk management, including procedures and information flows where limits are exceeded. The set of limits used for risk reduction by a bank or credit union is approved by the board of directors of the bank or the credit union, unless the board of directors designates this power to a committee appointed by the board; see Article 16, paragraph 2, subparagraph b of the Decree. This set of limits shall always include the limits for credit, market, concentration and liquidity risk, including the requirements for the structure of assets, liabilities and off-balance sheet items. In compliance with the Prudential Rules Decree (Article 21, paragraph 3) the board of directors is regularly informed of the compliance with the rules of exposure and the risk of concentration.

5. The supervisor regularly obtains information that enables concentrations within a bank's portfolio, including sectoral, geographical and currency exposures, to be reviewed. The supervisor has the power to require banks to take remedial actions in cases where concentrations appear to present significant risks.

LARGELY COMPLIANT

Regulation:

The power of the CNB to demand remedial actions from a bank if concentrations represent significant risks is based on the relevant provisions of the Act on Banks (Article 26). The analogical power of the CNB with respect to credit unions is laid out in the Act on Credit Unions (Article 28). Apart from the requirement for remedial action, the CNB may impose other measures for remedy; the provisions of the Act on Banks [Article 26, paragraph 1, subparagraph h)], and the Act on Credit Unions [Article 28, paragraph 1, subparagraph g)] authorise CNB to require, after having evaluated specific circumstances, that a bank or credit union restrict their activities or increase the capital to a level ensuring capital adequacy being higher than the minimum required level of 8 %. See also Principle No. 1(4) and Principle No. 6.

In accordance with the Provision of the CNB, concerning the submitting of statements by banks and foreign bank branches to the CNB and the Provision concerning the submitting of statements by credit unions (hereinafter referred to only as the "Statement Submission Provision"), monthly on the solo basis and quarterly on the consolidated basis, within the regular reporting, banks and credit unions submit to the CNB a summary of all the large exposures exceeding 10 % of the bank's capital, both to a single counterparty or groups of connected counterparties. With respect to monitoring the concentration, banks and credit unions submit, on a quarterly basis, information about the 15 debtors or creditors, structured according to banks and non-bank clients with the largest volume of claims or debts. With respect to monitoring the concentration aspect in relation to individual countries, it is only banks that submit quarterly reports containing selected assets, liabilities and off-balance sheet exposure according to individual countries. The currency concentration risk is regulated by Article 223 of the Prudential Rules Decree, which stipulates that a bank shall inform the CNB without unnecessary delay if the absolute value of the bank's net foreign exchange position exceeds 15% of the bank's capital on an individual basis, or if the total foreign exchange position of the bank exceeds 20% of the bank's capital on an individual basis. The currency and bank statistical returns provide information about the sectoral and branch classification of claims and debts of the banks. The capital adequacy reports also monitor the bank's currency structure of assets and liabilities, including the off-balance sheet figures.

Credit unions manage the currency risk in the same way as banks pursuant to Part 2 of Annex No. 1 to Prudential Rules Decree. Information on currency risk exposure is included in regular reporting, specifically the capital adequacy reports of a credit union. However, unlike the banks the currency structure itself of assets and liabilities is not monitored (for this reason the compliance has been assessed only as largely compliant).

Supervision:

The CNB analyses the relevant reports within the remote supervision. During the on-site examination the setting of the systems used by banks or credit unions for risk concentration measurement and management is checked. Moreover, an assessment is made as to whether the said systems are functional, whether they match the risk profile of the reviewed institution and

whether the information provided in reports (see above) submitted to the CNB is complete and credible.

Additional criterion

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

- **ten per cent or more of a bank's capital is defined as a large exposure; and**
- **twenty-five per cent of a bank's capital is the limit for an individual large exposure to a private sector non-bank counterparty or a group of connected counterparties.**

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

COMPLIANT

Regulation:

The Prudential Rules Decree (Article 189a, paragraph 2) stipulates that a large investment portfolio exposure to a single counterparty or groups of connected counterparties shall mean an exposure whose value is equal to or higher than 10% of the sum of the original and additional capital reduced by deductible items. The Prudential Rules Decree provides for at which scope and what exposures can be excluded from the investment portfolio exposure. Simultaneously, the Decree sets the limit of the investment portfolio exposure to a single counterparty or groups of connected counterparties and this limit must not exceed 25 % of the sum of the original and additional capital reduced by deductible items.

Principle 11: 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.

Overall assessment of the principle:

LARGELY COMPLIANT

Essential criteria:

[Act No. 21/1992 Coll., on Banks, as amended](#) (hereinafter referred to only as the “Act on Banks”) and [Act No. 87/1995 Coll., on Credit Unions and Certain Related Measures and on the Amendment of Czech National Council Act No. 586/1992 Coll., on Income Tax, as amended](#), (hereinafter referred to only as the “Act on Credit Unions”) enumerates and defines entities enjoying a “special relation” with a bank or credit union. The CNB cannot include, in the definition, beyond the scope of law, the entities which do not exactly match the definition. Providing loans to these parties under non-standard terms and conditions is prohibited by law. Moreover, the Act on Banks and the Act on Credit Unions stipulate that loans and guarantees granted to these parties are to be approved by the board of directors. The Act on Credit Unions further provides that board members, loan committee members of a credit union and related parties may be granted a loan only with the previous approval of the control committee.

The assessment grade has been lowered in connection with the Essential criteria Nos. 3 and 5, for the reason of the Act on Banks not explicitly regulating the obligation (the reason for lowering the grading to the level: largely compliant) of board members with conflicts of interest being excluded from this approval process, and moreover for the reason that under the Prudential Rules Decree [Article 182, paragraph 2, subparagraphs b) c) and d)] exposure limits do not apply to some related parties.

Analysis of individual criteria

Essential criteria

1. Laws or regulations explicitly provide, or the supervisor has the power to provide, a comprehensive definition of “related parties”. This should consider the parties identified in the footnote⁶⁾ to the Principle. The supervisor may exercise discretion in applying this definition on a case by case basis.

COMPLIANT

⁶⁾ Note. – Explanation from the BCP Methodology. Parties with a special relation to the bank can also be subsidiaries as well as companies, which are members of the same group, and also another entity, which the bank controls or which controls the bank. Furthermore, parties with a special relation can also be major shareholders, board members, senior management and other key employees of the bank, companies, which the bank controls or which control the bank as well as the closest family members of the above said entities.

Regulation:

The provisions of Article 19 of the Act on Banks⁷⁾ define parties with a special relation to the bank, and these are:

- a) members of the board of directors and the bank officers of the bank,
- b) members of the supervisory board of the bank,
- c) entities controlling the bank, persons having qualifying holdings in those entities, and members of the management of those entities,
- d) persons close to the members of the board of directors, the supervisory board, the bank officers and the persons controlling the bank,
- e) legal entities in which any of the persons listed in subparagraphs a), b) and c) have a qualifying holding,
- f) persons having qualifying holdings in the bank, and any legal entities controlled by them,
- g) members of the Bank Board of the CNB,
- h) entities which the bank controls.

The Act on Credit Unions (Article 8b, paragraph 4) stipulates that entities with a special relation towards a credit union for the purpose of this Act shall be considered to be members of credit unions, members of elected bodies of credit unions, managerial persons and persons close to them under the Civil Code. Pursuant to the Act on Credit Unions (Article 1, paragraph 8) a credit union is not entitled to acquire a holding in or exert influence over a different legal entity, i.e. therefore the definition of related parties does not include entities, which a credit union controls.

The relevant laws give an enumeration of parties with a special relation to a bank or credit union. 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.

2. Laws, regulations or the supervisor require that exposures to related parties may not be granted on more favourable terms (i.e. for credit assessment, tenor, interest rates, amortisation schedules, requirement for collateral) than corresponding exposures to non-related counterparties.

COMPLIANT

Regulation:

Article 18 of the Act on Banks stipulates that a bank may not enter into transactions with persons having a special relation therewith, which would otherwise, owing to their nature, purpose or risk, not be entered into with other clients. If a bank entered into transactions with persons having a special relation therewith, which would otherwise, owing to their nature, purpose or risk, not be entered into with other clients, such conduct would meet the merits of the so-called shortcoming in the activities pursuant to the Act on Banks [Article 26, paragraph 3, subparagraph b)]. One of the remedial measures, which such a shortcoming in the activities may be rectified with, is the institute of the prohibition or restriction of the execution of transactions with related parties [Article 26, paragraph 1, subparagraph g) of the Act on Banks].

⁷⁾ Referring to Article 18d of the Payment System Act, this definition shall apply also for the institute of electronic money as appropriate.

The Act on Credit Unions (Article 7, paragraph 1) stipulates that loans to members of elected bodies of a credit union, its members employed in the credit union, and persons close to them under the Civil Code may be granted only under the terms and conditions under which loans are provided to other members of the credit union. If a credit union granted a loan to these entities under more favourable terms than are the terms and conditions that it loans to other of its members (Article 7, paragraph 1), it would commit an administrative offence carrying a fine of up to CZK 20 million. Simultaneously, such conduct meets the merits of the so-called shortcoming in the business activities pursuant to the Act on Credit Unions [Article 28, paragraph 4, subparagraph c)].

Article 27 of [Decree No. 123/2007 Coll., stipulating the prudential rules for banks, credit unions and investment firms](#) (hereinafter referred to only as the “Prudential Rules Decree”) states that a bank and a credit union systematically manage credit risk. More detailed requirements associated with the credit risk management are contained in Annex No. 1 to this Decree. These requirements for example stipulate that a bank or credit union shall ensure that the transactions with entities (natural or legal persons) with a special relation to the bank or credit union are concluded according to conditions customary to the relevant market (Annex No. 1, Part 1, B I, Item 2 of the Prudential Rules Decree).

3. The supervisor requires that transactions with related parties and the write-off of related-party exposures exceeding specified amounts or otherwise posing special risks are subject to prior approval by the bank’s Board. The supervisor requires that Board members with conflicts of interest are excluded from the approval process.

LARGELY COMPLIANT

Regulation:

The Act on Banks (Article 18, paragraph 2) stipulates that a bank may provide loans to, and secure the commitments of, the related parties only if its board of directors so decides after analysing the banking transaction in question and the applicant’s financial standing. The Act on Banks does not explicitly regulate the obligation (the reason for lowering the grading to the level: largely compliant) of board members with conflicts of interest being excluded from this approval process. Other transactions are not directly regulated in the Act, nevertheless it is required that the internal methodology cover such transactions – see Essential Criterion 4.

The provisions of the Act on Credit Unions (Article 7, paragraph 1) stipulate that loans and commitments may be provided to and for members of the control committee, members in an employment relationship and close persons only with the previous consent of the board. The board members, credit committee members of a credit union and close persons can be granted a loan only with the previous consent of the control committee. Furthermore, the Act on Credit Unions (Article 7, paragraph 2) specifies that a member of a credit committee and member who was delegated the power to make a decision about the loan subject to the statutes cannot guarantee the loan, which they decided should be granted. In accordance with the Act on Credit Unions (Article 7, paragraph 3) the members of the elected body of a credit union are always excluded from the discussions and decision-making of such a body, if their interests are being discussed and decided on. The annual report always has to contain the information about loans granted to persons related to the credit union (Article 7, paragraph 4 of the Act on Credit Unions).

4. The supervisor requires that banks have policies and processes in place to prevent persons benefiting from the exposure and/or persons related to such a person from

being part of the process of granting and managing the exposure.

COMPLIANT

Regulation:

The Act on Banks (Article 8b, paragraph 1, subparagraph a) item 2) stipulates that a bank shall have a system of governance that includes organisational arrangements, with an adequate, transparent and comprehensive specification of responsibilities and decision-making powers, within which conflicting duties shall simultaneously be defined, and the procedures for preventing potential conflicts of interest.

The Prudential Rules Decree stipulates that the board of directors is liable for the establishment and evaluation of the management and system of governance and permanent maintenance of its functionality and efficiency. A bank and credit union are obliged to have the risk management strategy in force as well as the risk management procedures and limits, which are regularly evaluated. The board of directors shall approve and regularly evaluate the overall strategy, organisational structures, rules for the internal control system, including the rules to prevent a possible conflict of interests. This is connected with the obligation of a bank or credit union to ensure that bodies, employees, departments and committees, if these have been established, are allocated responsibilities and powers so as to adequately prevent a possible conflict of interests. Areas in which a conflict of interests may occur shall be promptly identified. Procedures are stipulated so as to prevent a possible conflict of interests. Areas of the possible occurrence of a conflict of interests are also subject to ongoing independent monitoring. In order to prevent a conflict of interests, independently of the business activities, the following measures have to be performed: approval of limits, evaluation systems and models used to measure and monitor credit, market and concentration risk, systems and methods for evaluating credit protection, and the settlement of transactions.

Supervision:

When performing supervision in the form of an on-site examination the CNB checks whether a bank or credit union applies such an organisation of the entire credit process, which reduces the risks of misuse of powers when granting loans to the maximum level possible. It concerns particularly the examination of the adequate division of powers and the limit system with respect to loan approvals.

5. Laws or regulations set, or the supervisor has the power to set on a general or case by case basis, limits for exposures to related parties, to deduct such exposures from capital when assessing capital adequacy, or to require collateralisation of such exposures. When limits are set on aggregate exposures to related parties those are at least as strict as those for single counterparties, or groups of connected counterparties.

LARGELY COMPLIANT

Regulation:

Pursuant to the Prudential Rules Decree the exposure of the investment portfolio of banks and credit unions to a single counterparty or groups of economically connected counterparties must not exceed 25 % of the sum of the original and additional capital. However, under the Prudential Rules Decree [Article 182, paragraph 2, subparagraphs b) c) and d)] the exposure limits do not apply to some related parties (the reason for lowering the grading to the level: largely compliant).

In accordance with the Act on Banks (Article 26a) the CNB has the power to impose on the bank the obligation not to provide any loan to a person having a special relation to the bank, if the bank's capital adequacy on a solo basis is lower than two thirds of the ratio set by the CNB. Neither the Act on Banks, the Act on Credit Unions nor any other legal regulations authorise the CNB to make specific requirements for the collateralisation of such exposures to a person with a special relation to the bank. These loans are evaluated in the same way as other loans and they are fully subject to the rules for evaluation of receivables from financial transactions and the maintaining of provisions and reserves as well as the credit risk management rules. Capital investments in the institutions, insurance companies, reinsurance companies, mixed-activity insurance holding entities or other financial institutions, should they exceed 10 % of the registered capital of the individual entities, represent items deductible from the capital in accordance with the Decree. If the liable entity maintains the capital adequacy on a consolidated basis and includes the entities, in which it has a capital investment, in a consolidated group by the full or proportional method, then these investments are not classified as deductible items.

In accordance with the wording of the Act on Banks (Article 15) and the Act on Credit Unions (Article 11, paragraph 3), the Prudential Rules Decree (Articles 190 to 193) regulates the rules for the acquisition and financing of assets by a bank and credit union. This part of the Decree limits or prohibits certain transactions between a bank or credit union and legal persons with a qualifying holding or between the bank or credit union with persons that act in concert or have control over it. The issues of acquiring holdings in other legal entities and setting the limits for these holdings are further dealt with in the Act on Banks (Article 17). As to credit unions, this area is regulated in the Act on Credit Unions (Article 1, paragraph 8), which bans credit unions from acquiring holdings in the registered capital of a legal entity, becoming a member, partner or shareholder of a legal entity or acquiring influence in the management of a legal entity in a different way.

6. The supervisor requires banks to have policies and processes to identify individual exposures to related parties as well as the total amount of such exposures, and to monitor and report on them through an independent credit review process. The supervisor confirms that exceptions to policies, processes and limits are reported to the appropriate level of senior management and, if necessary, to the Board, for timely action. The supervisor also confirms that senior management monitors related party transactions on an ongoing basis, and that the Board also provides oversight of these transactions.

COMPLIANT

Regulation:

Requirements are dealt with on a general level in the Prudential Rules Decree. In compliance with this Decree a bank or credit union must have an approved risk management strategy and procedures developing this strategy. Among other things, the risk management strategy has to contain rules for the credit risk management, credit risk management methods, system of credit risk measurement and monitoring as well as the acceptable degree of credit risk. Banks and credit unions are obliged to establish and maintain a set of limits for credit risk management, and procedures used for credit risk measurement and monitoring. The set of limits is subject to the approval and regular review by the board of directors or possibly by a committee, which the board of directors has delegated this power to [Article 16, paragraph 2, subparagraph b) of the Prudential Rules Decree]. Each limit is accompanied with adequate procedures if the limit is exceeded, including information flows [Article 25, paragraph b) of the Prudential Rules Decree]. Furthermore, a bank or credit union is bound to perform

regular analyses of the credit portfolio, including estimates of its future development and stress testing. Subsequently, the results of these analyses should be taken into account when setting and reviewing the reliability of the procedures and the limits for credit risk management.

Supervision:

Within its supervising activities over a bank or a credit union, the CNB reviews internal rules regulating limits and restrictions for approving loans, that is to say it is checked as to whether there is a written list of such valid limits, which limits have been introduced, including restrictions, in which way the limits are set and to which degree they are binding, in which way and how often these are reviewed, whether the limits are in mutual agreement and who checks the compliance with the limits, in which way and how often. Moreover, the CNB examines whether a bank or credit union has procedures in place with respect to providing loans to employees, members of their group, related parties - etc. and whether a bank and credit union have the approved written internal rules regulating the processes in extraordinary cases, for example providing a loan to a good client above the limit.

7. The supervisor obtains and reviews information on aggregate exposures to related parties.

COMPLIANT

Supervision:

The bank or credit union submits to the CNB the exposure report. Should the exposure to the party with a special relation to the bank or credit union exceed 10 % of the capital of the bank or credit union, it is recorded in the monthly exposure report on a solo basis, or in the quarterly exposure report for a consolidated group. The fulfilment of the criteria is checked during the on-site examination (see Essential Criterion No. 6).

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.

Overall assessment of the principle:

COMPLIANT

Essential criteria:

The country risk and transfer risk are regulated in [Decree No. 123/2007 Coll., stipulating the prudential rules for banks, credit unions and investment firms](#) (hereinafter referred to only as the “Prudential Rules Decree”). This Decree sets the requirements for all key aspects of credit risk management. These requirements also fully apply to the country risk and transfer risk, which are specific types of credit risk. Banks and credit unions must have such a system of risk measurement and monitoring in place that is adequate to the nature, scope and complexity of their activities, identify all significant risk sources and enable the evaluation of impacts on the revenue and costs, as well as the value of the assets, liabilities and off-balance sheet items, in a way as to provide an undistorted picture of the degree of the risks undertaken. Furthermore, the Decree specifies requirements for banks and credit unions connected with the restricting and securing of the risks, and imposes on them the obligation to take into consideration factors that influence the results of the evaluation or measurement of the risks undertaken. In addition, the Decree regulates detailed rules for assessing receivables from financial activities as well as maintaining provisions and reserves. Banks submit to the CNB a quarterly report, which shows the overall exposure of selected items of banks. This report is analysed and assessed within the remote supervision. During the on-site examination, risk management of the country is viewed as a part of the credit risk and the system of its management in a bank or credit union. Shortcomings in the functioning of the risk management system with respect to the country risk and transfer risk are considered to be non-prudential conduct.

Analysis of individual criteria

Essential criteria

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

COMPLIANT

Regulation:

The country risk and transfer risk are regulated in the Prudential Rules Decree. This Decree specifies (Articles 24 to 30) the general requirements for risk management and risk management strategy as well as detailed rules for assessing receivables from financial activities and maintaining provisions and reserves. A more detailed specification of certain requirements for managing selected risks, including the credit risk, is given in Annex No. 1 to the Prudential Rules Decree.

The requirements for the country risk and transfer risk are included in the requirements for the credit risk management. Pursuant to the Prudential Rules Decree (Article 26) a bank and a credit union should have a risk management strategy, appropriate to the nature, scope and complexity of their activities. Banks and credit unions should develop specific procedures to implement this strategy. Among other things, the strategy contains credit risk management rules and methods as well as the acceptable degree of credit risk. The credit risk management strategy, new products, a set of limits to restrict the credit risk and requirements for the structure of assets, liabilities and off-balance sheet items are approved and regularly evaluated by the board of directors (Article 16 of the Prudential Rules Decree). The necessary prerequisite for the credit risk management is to ensure the functioning of the information system supplying sufficient support for credit risk management; the information system also has to provide particularly the board of directors, relevant members of the senior management, departments responsible for the risk management and the business departments with information necessary for deciding and managing the credit risk.

Moreover, Annex No. 1 to the Prudential Rules Decree sets out the requirements for the credit risk measurement and monitoring. Further requirements specify that a bank or a credit union shall establish and maintain a set of limits adequate with regard to its size and the management method, the nature, scope and complexity of activities and the stipulated capital adequacy of a bank or a credit union. Depending on these factors a bank or a credit union shall set partial limits, for example for individual counterparties, individual states, geographical areas or for individual activities [Annex No. 1, Part 1, B III, Item 1, subparagraph b) of the Prudential Rules Decree]. All these and other requirements set in the Prudential Rules Decree also apply to the country risk and transfer risk at the full extent.

Supervision:

The CNB has introduced for banks (credit unions do not submit similar reports in view of their minimum exposure) a quarterly report, which monitors the exposure according to countries and the structure of the exposure according to selected types of on-balance sheet and off-balance sheet assets and liabilities; this report is analysed and reviewed within the remote supervision as well as the on-site examination. During the on-site examination, the risk management of the country is viewed as a part of the credit risk and the system of its management in the bank. Shortcomings in the functioning of the risk management system with respect to the country risk or transfer risk are considered to be non-prudential conduct.

2. The supervisor confirms that banks have information systems, risk management systems and internal control systems that accurately monitor and report country exposures and ensure adherence to established country exposure limits.

COMPLIANT

Supervision:

Checked within the scope of the supervision in the form of the on-site examination as a part of the assessment of the credit risk and the system of its management in a bank.

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

- **The supervisor (or some other official authority) decides on appropriate minimum provisioning by setting fixed percentages for exposures to each country.**

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

COMPLIANT

Regulation:

Detailed rules for assessing receivables from financial activities as well as maintaining provisions and reserves are set in the Prudential Rules Decree (Articles 194 to 205). These rules are described and evaluated in connection with Principle No. 9 (problem assets, provisions and reserves). In essence this concerns the procedures specified in the third bullet, however the Czech regulation is based on a higher standard of prudence than is this procedure, because it relates to receivables from financial activities, i.e. a wider scope of items than just loans.

Supervision:

Within the scope of the supervision in the form of the on-site examination the system of provisioning is checked as a part of the credit risk assessment, including a random review of the sufficient amount of the provisions set with respect to receivables from financial activities. The sufficiency of the provisioning is also included in the audit of the annual financial statements of a bank for the relevant year.

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

COMPLIANT

Supervision:

For monitoring the country risk and transfer risk the CNB introduced a bank exposure report in relation to individual countries, which monitors the exposure according to countries and the structure of the exposure according to the types of on-balance sheet and off-balance sheet assets and liabilities; this report is analysed and reviewed within the remote supervision. It is submitted quarterly and at any time upon request. In view of concentrating their activities in the domestic market, credit unions do not submit this report. During the on-site examination, the risk management of the country is viewed as a part of the credit risk and the system of its management in a bank or a credit union.

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.

Overall assessment of the principle:

COMPLIANT

Essential criteria and additional criterion

[Act No. 21/1992 Coll. on Banks, as amended](#) (hereinafter referred to only as the “Act on Banks”) and [Act. No 87/1995 Coll., on Credit Unions and Certain Related Measures and on the Amendment of Czech National Council Act No. 586/1992 Coll., on Income Tax, as amended](#) (hereinafter referred to only as the Act on “Act on Credit Unions”) impose on banks, credit unions and foreign bank branches, which do not enjoy the advantages of the single licence under the EU law , the obligation to set up and maintain an adequate system of governance, including strategies and procedures to accurately identify, measure, monitor and control the market risk. More detailed regulatory requirements for the market risk management are set for banks and credit unions in [Decree No. 123/2007 Coll., stipulating the prudential rules for banks, credit unions and investment firms](#) (hereinafter referred to only as the “Prudential Rules Decree”).

Under the Act on Banks and the Act on Credit Unions, the CNB is authorised to impose on a bank or a credit union specific limits or special capital requirements concerning the market risk exposure, if warranted. In this way the CNB may proceed mainly in the situation when a bank or a credit union lacks efficient arrangement, strategy, procedures or mechanisms for the risk management, in the given case of a market risk, and other remedial actions seem insufficient to achieve rectification within the appropriate period of time. See Principle No. 1 (4), Principle No. 6 and Principle No. 23.

Within the scope of the supervision in the form of the on-site examination the CNB checks whether banks and banking groups have the appropriate strategy for the market risk management, which was approved by the board of directors, whether the board of directors regularly evaluates the strategy and whether it also checks the principles and procedures significant for identification, measurement, monitoring and control of the market risk. Moreover, the stress testing is examined as well as the method of the utilisation of its results.

Analysis of individual criteria

Essential criteria

- 1. The supervisor determines that a bank has suitable policies and processes that clearly articulate roles and responsibilities related to the identification, measuring, monitoring and control of market risk. The supervisor is satisfied that policies and processes are adhered to in practice and are subject to appropriate Board and senior management oversight.**

COMPLIANT

Regulation:

The Act on Banks, and the Act on Credit Unions impose on banks and credit unions the obligation to set up and maintain an adequate system of governance and since the market risk management system is one of the essential components of the 1 system of governance, this obligation also relates to the market risk management, which a bank or credit union may be exposed to.

The said acts specify that the system of governance of banks and credit unions have to be integrated and correspond to the nature, scope and complexity of their activities. A bank, pursuant to the Act on Banks (Article 8b, paragraph 3) and credit unions under the Act on Credit Unions (Article 7b, paragraph 3) must establish and maintain an efficient system of governance on the solo basis, and if it is a member of a financial group or more precisely of a regulated consolidated group, then also on the consolidated basis, and this requirement also fully applies for the strategy and processes to identify, measure, monitor and control the market risk. The last mentioned obligation is specified in greater detail in Article 7, paragraph 2 of the Prudential Rules Decree.

Within the above context the Prudential Rules Decree imposes on banks and credit unions in Article 26, paragraph 4, that their risk management strategy must always include the market risk management strategy, which contains the internal definition of the market risks, rules for determining or more precisely evaluating the significance of the market risks, principles and methods of the market risk management, determination of the acceptable degree of the market risk and policies for defining licensed products, currencies, states, geographical areas, markets and counterparties, through which a bank takes on a market risk.

The Prudential Rules Decree requires that the market risk management strategy covers all material sources of the market risks, and simultaneously the Decree specifies more detailed requirements for the system of market risk measurement and monitoring, the limits for the market risk management and the market risk stress testing. Furthermore, the Decree imposes on a bank or a credit union the obligation to ensure that the relevant bodies, i.e. also the board of directors, have, in their decision-making and when pursuing other laid down activities, access to up-to-date, reliable and comprehensive information. The board of directors of a bank or a credit union is obliged to regularly approve and evaluate:

- the market risk management strategy,
- the set of limits, which a bank or a credit union shall use to restrict the market risk.

Moreover, the Prudential Rules Decree stipulates (Article 18, paragraph 1) that senior management shall be responsible for performing the strategies, rules and targets, approved by the board of directors, including the development of procedures for their implementation and the daily management of the bank or credit union also in the area of the market risk management.

Supervision:

Within the scope of the supervision in the form of the on-site examination in banks and credit unions, the CNB checks whether the reviewed institution has a suitable strategy and processes, which clearly define the tasks and responsibilities connected with ensuring the market risk measurement, monitoring and control. Simultaneously, it is checked whether these processes are adhered to in practice.

- 2. The supervisor determines that the bank has set market risk limits that are commensurate with the institution's size and complexity and that reflect all material market risks. Limits should be approved by the Board or senior management. The supervisor confirms that any limits (either internal or imposed by the supervisor) are adhered to.**

COMPLIANT

Regulation:

The Decree (Article 24, paragraph 2) states that a bank or a credit union shall introduce and maintain a risk management system that corresponds to the nature, scope and complexity of the activities and their associated risks in order to provide a true picture of the degree of the risks undertaken. The provisions of Article 16, paragraph 2, subparagraph b) and Annex No. 1, [Part 2, B. II, Item 2, subparagraph b)] of the Prudential Rules Decree explicitly specify that the set of limits, which a bank or a credit union shall use to restrict the market risk, is subject to the approval and regular review of the board of directors, or the committee to which the board of directors delegated this power. Moreover, it regulates the responsibility of employees, i.e. also of the senior management of banks or credit unions, to re-evaluate the set limits on a regular basis and upon material changes in the market conditions in a way as to match the market conditions and overall strategy of the bank or credit union.

Supervision:

Within the scope of the supervision in the form of the on-site examination in banks and credit unions the CNB checks the system of limits adopted by the reviewed institution from the point of view of adequacy with respect to its risk profile, scope and complexity of activities. In addition, the system of adopting and approving the limits is reviewed along with whether the limits are adhered to.

- 3. The supervisor is satisfied that there are systems and controls in place to ensure that all transactions are captured on a timely basis, and that the banks' marked to market positions are revalued frequently, using reliable and prudent market data (or, in the absence of market prices, internal or industry-accepted models). The supervisor requires banks to establish and maintain policies and processes for considering valuation adjustments/reserves for positions that otherwise cannot be prudently valued, including concentrated, less liquid, and stale positions.**

COMPLIANT

Regulation:

The Prudential Rules Decree (Annex No. 1, Part 2, B. II, 2) stipulates that a bank or a credit union should have such a system for the market risk measurement and monitoring, which shall facilitate capturing all transactions on a timely, accurate and complete basis in a way allowing the identification of all the market risks relating to these transactions. The system of the market risk measurement and monitoring must also value these transactions correctly, whereas the said Decree imposes on a bank and a credit union the obligation to apply a valuation performed independently of business activities (business units). If a bank or a credit union uses models for the re-valuation of their positions, these must comply with the demanding requirements set in the Prudential Rules Decree (Annex No. 21).

Supervision:

Within the scope of the supervision in the form of the on-site examination in banks and credit unions the CNB checks whether the systems of the reviewed institution enable capturing all

transactions. Other areas reviewed are – valuation methods of individual transactions and the system of the provisioning for the positions, which cannot be valued by a market price or generally accepted valuation model.

4. The supervisor determines that banks perform scenario analysis, stress testing and contingency planning, as appropriate, and periodic validation or testing of the systems used to measure market risk. The supervisor confirms that the approaches are integrated into risk management policies and processes, and results are taken into account in the bank's risk-taking strategy.

COMPLIANT

Regulation:

The Prudential Rules Decree (Annex No. 1, Part 2, B. III) imposes on a bank or a credit union the obligation to regularly perform stress testing to evaluate the impacts of extraordinarily adverse market conditions and to integrate the results of the stress testing in procedures for market risk management. The Decree states that a bank or a credit union shall take into consideration the stress test results when stipulating and evaluating the reliability of the procedures and limits for the market risk management so that the losses it suffers as a result of adverse extreme changes in the market conditions do not result in its insolvency or cause its capital adequacy to fall below the level stipulated by the supervisor. Moreover, the Decree imposes (Annex No. 21, Parts VI and VII), the obligation to perform regular back-testing and verification of the market risk measurement internal models, whose employment was approved by the competent supervisor for the calculation of capital requirements concerning the market risk.

Supervision:

Within the scope of the supervision in the form of the on-site examination in banks and credit unions the CNB checks the performance of stress testing, its integration in the strategy and procedures of the risk management as well as the method of utilisation of the test results. Moreover, the CNB reviews whether the banks perform regular back-testing and verification of internal models, whose employment was approved by the competent supervisor for the calculation of capital requirements concerning the market risk.

Additional criterion

1. The supervisor requires that market data used to value trading book positions are verified by a function independent of the lines of business. To the extent that the bank relies on modelling for the purposes of valuation, the bank is required to ensure that the model is independently tested.

COMPLIANT

Regulation:

Article 20, paragraph 2, subparagraph g) of the Prudential Rules Decree ranks the approval of the evaluation systems and models used to measure and monitor the market risk among the activities, which a bank or a credit union must perform independently of business activities. Furthermore, the Decree specifies the requirements for having the model tested by a person who is independent of the development process of the model in question.

Supervision:

While ensuring the supervision in the form of the on-site examination in banks and credit unions the CNB also checks the independence of the market position valuation in business

departments, as well as the approval and testing of models used to value individual positions.

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.

Overall Assessment of the Principle:
COMPLIANT

[Act No. 21/1992 Coll. on Banks, as amended](#) (referred to hereinafter as "Act on Banks" [Act No. 87/1995 Coll., on Credit Unions and Certain Related Measures and on the Amendment of Czech National Council Act No. 586/1992 Coll., on Income Tax, as amended](#) (referred to hereinafter as the "Act on Credit Unions") impose upon banks and credit unions a duty to establish and maintain an adequate system of governance, including liquidity risk management system. The laws referred to, and also [Decree No. 123/2007 Coll., stipulating the prudential rules for banks, credit unions and investment firms](#) (referred to hereinafter as the "Prudential Rules Decree") impose upon credit institutions a duty to introduce and maintain an effective system of governance on a solo basis, and if they are a part of a financial group or regulated consolidated unit, to do so also on a consolidated basis. This requirement also applies in full for the liquidity risk management system.

The more detailed regulatory requirements for the liquidity management system are designated by the Prudential Rules Decree (Annex No 1 part 4 points 16 to 27). This decree instructs banks and credit unions to have principles and processes for identifying, measuring, monitoring and controlling liquidity risk, including liquidity management, on a day to day basis within the context of the risk management strategy agreed by the Board. Senior management is responsible for the implementation of this strategy and the development of processes for its achievement. The decree also requires that banks and credit unions have contingency plans for handling liquidity problems. During supervision in the form of on-site examination the CNB determines whether banks and banking groups have the corresponding strategy and processes for liquidity risk management and contingency plans for dealing with liquidity problems.

Analysis of individual criteria

Essential criteria:

1. The supervisor sets liquidity guidelines for banks. These guidelines take into consideration undrawn commitments and other off-balance sheet liabilities, as well as existing on-balance sheet liabilities.

COMPLIANT

Regulation:

The Prudential Rules Decree lays down the requirements for the system of governance of banks and credit unions, including the liquidity risk management system. In Article 27 paragraph 1a) of this decree amongst other things a duty is imposed on a bank or credit union to manage the liquidity risk on an ongoing basis, and it also designates both the general (annex No 1 part 4.A), and more detailed (annex No 1 part 4.B) requirements for liquidity risk management. These requirements include, amongst other things, a duty for a bank or credit

union to assemble a liquidity management scenario which, in addition to other liabilities and undrawn commitments, must take into account other off-balance sheet liabilities and the existing on-balance sheet liabilities.

The Act on Banks (Article 14) and Act on Credit Unions (Article 11 paragraph 2) designates that a bank and credit union is obliged to maintain on an ongoing basis its solvency and to adhere to the designated rules of liquidity and safe operation, and in addition to other things these rules can also designate the minimum level of liquid funds or group of these funds in relation to the assets or in relation to the liabilities or group of assets or liabilities. For banks the Act on Banks also specifies that the rules may additionally adjust the restrictions and conditions for the currency position. The Act on Banks (Article 15) and Act on Credit Unions (Article 11 paragraph 3) authorise the CNB to designate these liquidity rules. In practice these authorisations remain unused, because the Prudential Rules Decree sufficiently covers all the requirements for liquidity management of banks and credit unions in compliance with the requirements contained in the Basel document "Principles for Sound Liquidity Risk Management and Supervision, September 2008".

Supervision:

In the context of regular reporting, banks, branches of foreign banks and credit unions submit information to the CNB serving for the monitoring of liquidity risk. This mainly consists of an overview of assets and liabilities, including selected off-balance sheet assets and liabilities according to the remaining maturity period broken down into several time bands with a monthly periodicity on a solo basis. There is also regular monitoring of the various liquid ratio indicators providing information for off-site supervision. During on-site examination there is also verification of whether banks and credit unions take into account all on-balance sheet and off-balance sheet assets and liabilities during the measurement and management of liquidity.

2. The supervisor confirms that banks have a liquidity management strategy, as well as policies and processes for managing liquidity risk, which have been approved by the Board. The supervisor also confirms that the Board has an oversight role in ensuring that policies and processes for risk-taking are developed to monitor, control and limit liquidity risk, and that management effectively implements such policies and processes.

COMPLIANT

Regulation:

The Act on Banks and Act on Credit Unions instruct banks and credit unions to develop and maintain an adequate managing and supervisory system, and because liquidity management belongs to the fundamental elements of the managing and supervisory system, this duty also applies to the monitoring, management and limiting of the liquidity risk which the bank or credit union is exposed to.

A bank or credit union which is a part of a financial group or regulated consolidated unit is obliged, pursuant to the Act on Banks (Article 8b paragraph 3) and pursuant to the Act on Credit Unions (Article 7b paragraph 3), to establish and maintain an effective system of governance, not only on a solo basis, but also on a consolidated basis, and this requirement also applies in full for the strategy and processes for the monitoring, management and limiting of liquidity risk. In Article 7 paragraph 2 the Prudential Rules Decree specifies this duty in more detail.

In the above context, Article 26 paragraph 1 of the Prudential Rules Decree imposes upon a bank or credit union a duty to have a risk management strategy commensurate with the nature, scope and complexity of its activities and to prepare concrete processes for the fulfilment of this strategy. Amongst other things the strategy must establish the principles for managing liquidity risk, the methods for managing liquidity risk and the principles for defining permitted products, currencies, states, geographical areas, markets and counter parties. The specified principles have great significance not only for managing credit and market risk, but also for monitoring, managing and limiting liquidity risk. The Prudential Rules Decree also imposes upon a bank or credit union a duty of ongoing management of liquidity risk and other relevant risks.

The Prudential Rules Decree also designates a requirement for the Board of a bank or credit union to supervise the development of such principles and processes as ensure the monitoring, management and limiting of liquidity risk so that the Board approves and regularly updates a risk management strategy which must always also cover liquidity risk. The Board is also obliged on a regular basis to approve a set of limits which the bank or credit union will use for limiting liquidity risk. The Board may also transfer this last mentioned authority to a committee which it appoints.

The Prudential Rules Decree also designates that the senior management of a bank or credit union will supervise the creation of such principles and processes as ensure the monitoring, management and limiting of liquidity risk and approves a risk management strategy which must also always cover liquidity risk.

According to the Prudential Rules Decree, the senior management of a bank or credit union is responsible for the implementation of the strategies, principles and goals approved by the Board, including the development of processes for their implementation and day-to-day management of the bank or credit union. These provisions also apply in full to liquidity risk management.

Supervision:

During supervision in the form of on-site examination, the CNB confirms that the supervised institutions have a liquidity management strategy, as well as policies and processes for managing liquidity risk, which have been approved by the Board. There is also a verification of whether the management of the institution has an oversight role in the creation of such principles and processes for risk-taking which ensure the monitoring, management and limiting of liquidity risk, and that management effectively implements such principles and processes.

3. The supervisor determines that a bank's senior management has defined (or established) appropriate policies and processes to monitor, control and limit liquidity risk; implements effectively such policies and processes; and understands the nature and level of liquidity risk being taken by the bank.

COMPLIANT

Regulation:

The Prudential Rules Decree states that the senior management of a bank or credit union is responsible for the implementation of the strategies, principles and goals approved by the Board, including the development of processes for their implementation and day-to-day management of the bank or credit union. For this reason the strategy referred to must also

always include a strategy for the management of liquidity risk (see basic criterion No 1), and the relevant provisions also apply to senior management during liquidity risk management.

Supervision:

During supervision in the form of on-site examination CNB confirms that banks and credit unions have approved appropriate strategies and processes for the monitoring, management and limiting of liquidity risk, and that it applies this strategy and processes effectively in practice. There is also a verification of whether the management has available information about the nature and level of liquidity risk faced.

4. The supervisor requires banks to establish policies and processes for the ongoing measurement and monitoring of net funding requirements. The policies and processes include considering how other risks (eg credit, market and operational risk) may impact the bank's overall liquidity strategy, and require an analysis of funding requirements under alternative scenarios, diversification of funding sources, a review of concentration limits, stress testing, and a frequent review of underlying assumptions to determine that they continue to be valid.

COMPLIANT

Regulation:

The Prudential Rules Decree designates that a bank or credit union must have adequate processes for measuring and monitoring net cash flow and liquid position in such a way that it is possible to designate the steps of the bank or credit union necessary for liquidity risk management. These steps must enable both a comparison of the flow of funds in and out, and also monitoring of the net cash flows on a daily basis for a period of at least 5 working days in advance (annex No 1 part 4 B. I point 2 of the Prudential Rules Decree), also the compilation of a maturity calendar and finally the calculation of the liquid position. At the same time the decree takes into account the influence of market risk on the liquidity of a bank or credit union by requiring that for the assets included in the band with maturity period shorter than that which corresponds to their true maturity, the given credit institution designates a system of discounts reflecting the market risk in the case of a rapid selloff of the individual assets. The influence of credit risk on the liquidity of a bank or credit union is dealt with in the Prudential Rules Decree by the imposition of a duty on a bank or credit union to stabilise and diversify its financial resources sufficiently. The influence of operational risk on the liquidity of a bank or credit union is chiefly taken into account by virtue of the fact that the decree requires that a bank and credit union have a contingency plan for liquidity risk management under extraordinary crisis circumstances (see also basic criterion No 6). In Article 26 paragraph 4d) the decree expressly orders a bank or credit union to ensure stress tests of the liquidity scenario. Moreover a bank or credit union is obliged to ensure not only contingency planning but also regular verification of the correctness of the assumptions of the liquidity risk management scenario with regard to changing internal or external conditions. Changes of assumptions constitute the basis for an amendment of the scenario (annex No 1 part 4 B IV point 3 of Prudential Rules Decree).

Supervision:

During supervision in the form of on-site examination the CNB confirms that the institution has a created strategy and processes for the ongoing measurement and monitoring of the requirements of net financing and that these also take into account how other risks (for example, loan risk market risk and operational risk) can influence the overall strategy for the institution's liquidity. It also confirms that the requirements for financing are analysed under

the assumption of alternative scenarios and diversification of funding sources, that concentration limits are checked regularly, that stress testing is ensured and that there is frequent review of underlying assumptions to determine that they continue to be valid.

5. The supervisor obtains sufficient information to identify those institutions carrying out significant foreign currency liquidity transformation. Where a bank or banking group's foreign currency business, either directly, or indirectly through lending in foreign exchange to domestic borrowers, is significant, or where a particular currency in which the bank has material exposure is experiencing problems, the supervisor requires the bank to undertake separate analysis of its strategy for each currency individually and, where appropriate, set and regularly review limits on the size of its cash flow mismatches for foreign currencies in aggregate and for each significant individual currency

COMPLIANT

Regulation:

The Prudential Rules Decree imposes upon a bank or credit union (in annex No 1 part 4 B II) the requirements for managing liquidity risk in the individual main currencies and for relevant limits. A bank or credit union is obliged to introduce processes allowing the measuring, monitoring and supervision of liquidity in each of the main currencies with which it works. If it finances assets held in one currency with obligations held in another, it analyses the market conditions which can influence its access to the foreign currency market, possible exchange conditions of one currency for another during various situations and other conditions which could influence its access to sources in the required currency. Depending on the volume of activities in the individual currencies, a bank or credit union will designate limits for managing liquidity risk both collectively for all currencies and individually for each main currency with which it works, and when designating these limits it is obliged to take into account the impact of possible non-standard conditions or extraordinary crisis circumstances with regard to its size, financial situation, nature, scope and complexity of the activities performed.

Supervision:

Banks and credit unions are obliged to send the CNB a notification on liquidity according to the remaining maturity period. This notification gives information about the volume and structure of assets and obligations, including off-balance sheet items, broken down according to individual time bands and broken down into Czech crowns and total foreign currencies. In addition to this the balance sheet and additional information about receivables, payables and securities give information broken down into Czech crowns and foreign currency. Banks also submit to the CNB a return including a summary of assets and liabilities, including off-balance sheet ones, broken down into the individual currencies. The specified information is submitted on a solo basis once a month. Consequently the CNB receives sufficient information for identification of institutions which perform significant transformations of foreign currency liquidity.

During supervision in the form of on-site examination the CNB confirms that the supervised institution has an appropriate strategy and processes for all the significant currencies with which it works.

6. The supervisor determines that banks have contingency plans in place for handling liquidity problems, including informing the supervisor.

COMPLIANT

Regulation:

The Prudential Rules Decree (annex No 1 part 4 B V) instructs a bank or credit union to create and maintain an emergency plan for the eventuality of a liquidity crisis which contains in particular the ensuring of precise and timely information flows in the context of the bank or credit union, clear definition of responsibilities and authorities in the context of the bank or credit union and also possible methods for influencing the development of assets, liabilities and off-balance sheet items and method of communication with significant liability holders, business partners, other persons, clients and the public when implementing this strategy and finally also the specification of emergency financial sources. The decree also instructs a bank or credit union to ensure the regular updating of the emergency plan for the eventuality of a liquidity crisis with regard to changing internal or external conditions. As part of regular reporting banks and credit unions submit to CNB notifications about liquidity according to remaining maturity period.

Supervision:

During supervision in the form of on-site examination the CNB confirms that institutions have introduced a corresponding emergency plan containing the particulars specified by the decree and regularly updates the emergency plan with regard to the changing internal and external conditions.

Additional criteria

1. The supervisor determines that, where a bank conducts its business in multiple currencies, foreign currency liquidity strategy is separately stress-tested, and the results of such tests are a factor in determining the appropriateness of mismatches.

LARGELY COMPLIANT

Regulation:

The Prudential Rules Decree designates that for the purposes of managing liquidity risk in the individual currencies, a bank or credit union has processes allowing the measuring, monitoring and supervision of liquidity in every one of the main currencies with which it works, and that during the management of liquidity in the various currencies and designation of the relevant limits it takes into account the impact of possible non-standard conditions or extraordinary crisis circumstances (see above basic criterion No 5). However, the Prudential Rules Decree does not expressly impose upon a bank or credit union a duty to ensure separate stress testing of liquidity in various currencies and to use the results of this testing for determining the appropriateness of mismatches.

Supervision:

During on-site examination, CNB confirms liquidity management as a whole, including whether foreign currency liquidity management is prudent. The CNB determines in particular whether the institution manages liquidity risk in each of the main currencies, whether it analyses the market risks which can influence its access to the foreign currency market and whether limits are designated for the management of liquidity risk for all currencies together and individually for each main currency with which it works. The CNB also evaluates how the institution takes into account exposure in foreign currencies in their liquidity risk management scenarios.

2. The supervisor confirms that banks periodically review their efforts to establish and maintain relationships with liability holders, maintain the diversification of liabilities, and aim to ensure their capacity to sell assets.

LARGELY COMPLIANT

Supervision:

During bank supervision, the CNB confirms that banks and credit unions regularly evaluate the method of communicating with significant liability holders, business partners, other persons, clients and the public, that they maintain the diversification of their assets, that they evaluate the possible methods of influencing the development of assets, liabilities and off-balance sheet items, including their capacity to sell assets.

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.⁸⁾ These policies and processes should be commensurate with the size and complexity of the bank.

Overall Assessment of the Principle:
COMPLIANT

Essential and additional criteria:

[Act No. 21/1992 Coll. on Banks, as amended](#) (referred to hereinafter as "Act on Banks") [Act No. 87/1995 Coll., on Credit Unions and Certain Related Measures and on the Amendment of Czech National Council Act No. 586/1992 Coll., on Income Tax, as amended, as amended](#), (referred to hereinafter as the "Act on Credit Unions") impose upon banks and credit unions and branches of foreign banks which do not enjoy the advantages of a single licence according to EU law a duty to establish and maintain an adequate system of governance, including operational risk management system. Pursuant to the Act on Banks and Act on Credit Unions, the system of governance of a bank or credit union, including operational risk management system, must be integrated and commensurate with the character, scope and complexity of the bank or credit union. The acts referred to, and also [Decree No. 123/2007 Coll., stipulating the prudential rules for banks, credit unions and investment firms](#) (referred to hereinafter as the "Prudential Rules Decree"), impose upon the aforementioned credit institutions a duty to establish and maintain a functional and effective system of governance on a solo basis, and if it is part of a financial group or regulated consolidated unit, also on a consolidated basis, and this requirement also applies in full for the management of operating risk.

The more detailed regulatory requirements of the operational risk management system are designated for banks and credit unions by the Prudential Rules Decree. The regulatory requirements in the area of operational risk management, including information system risk, have been a part of the regulation of the CNB since February 2004 (requirements for the management of operational risk effective since 1. 1. 2005).

From the regulatory aspect all the relevant criteria are complied with in relation to banks and credit unions. During supervision in the form of on-site examination, the CNB determines whether banks and banking groups have a corresponding strategy and processes for managing operational risk.

Analysis of individual criteria

Essential criteria:

- 1. The supervisor requires individual banks to have in place risk management policies and processes to identify, assess, monitor and mitigate operational risk. These policies and processes are adequate for the size and complexity of the bank's operations, and the supervisor confirms that they are periodically adjusted in the light of the bank's changing risk profile and external market developments.**

⁸⁾ The Basel Committee has defined operational risk as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. The definition includes legal risk but excludes strategic and reputational risk.

COMPLIANT

Regulation:

The Act on Banks and Act on Credit Unions impose upon banks and credit unions a duty to introduce and maintain an adequate system of governance which, amongst other things, includes a risk management system. Because the management of operational risk is one of the fundamental elements of the system of governance, this duty also applies to identifying, assessing, monitoring and mitigating the operational risk to which the bank or credit union is exposed.

The acts referred to above designate that the system of governance of the bank or credit union must be integrated and commensurate with the character, scope and complexity of its activities. A bank or credit union which is a part of a financial group or consolidated unit is, pursuant to the Act on Banks (Article 8b paragraph 3) and pursuant to the Act on Credit Unions (Article 7b paragraph 3), obliged to introduce and maintain an effective system of governance not only on a solo basis, but if it is part of a financial group of consolidated unit, also on a consolidated basis. This requirement also applies in full for strategy and processes for ascertaining, measuring, monitoring and managing market risk. There is a more detailed specification of the last duty referred to in Article 7 paragraph 2 of the Prudential Rules Decree.

In the above context, Article 26 paragraph 1 of the Prudential Rules Decree imposes upon a bank or credit union a duty to have a risk management strategy commensurate with the nature, scope and complexity of its activities and to prepare concrete processes for the fulfilment of this strategy. Pursuant to the Prudential Rules Decree (Article 26 paragraph 4) this strategy must, amongst other things, designate the principles, methods and accepted level of operational risk. In Article 27 paragraph 1 the Prudential Rules Decree imposes upon a bank or credit union a duty of ongoing management of operational risk and other relevant risks. In the Prudential Rules Decree (annex No 1 part 3. B. I.) it is designated that a bank or credit union is obliged to evaluate and if needs be amend the operational risk management system on a regular basis.

Supervision:

During supervision in the form of on-site examination, the CNB determines whether banks and credit unions have introduced effective systems for identifying, assessing, monitoring and mitigating operational risk and evaluates the fulfilment of all the aforementioned regulatory requirements. The CNB has been conducting inspections focussing on the system of operational risk management systematically since 2005. For these purposes a methodology has been created for the management of operational risk and ensuring of ongoing education of employees ensuring supervision in this area. The processes and methodology take into account all the valid regulatory requirements and also reflect many other standards and best practice. The Czech National Bank has sufficient knowledge and experience for an evaluation of the adequacy of the system for the management of operational risk and models used by banks and credit unions for designating the capital requirements for operational risk. During inspections the CNB always takes into account the scope and complexity of activities of the inspected institutions, method used for calculation of capital requirement, and it takes into account the current development of internal and external sources of operational risk. The CNB evaluates the identified shortcomings according to seriousness and communicates with the inspected subjects. Then the CNB issues measures for rectification of the identified shortcomings, the performance of which the inspected subjects report regularly. The CNB

verifies the course of rectification of shortcomings on an ongoing basis. This is performed on an ongoing basis in the form of follow-up specific purpose inspections.

2. The supervisor requires that banks' strategies, policies and processes for the management of operational risk have been approved and are periodically reviewed by the Board. The supervisor also requires that the Board oversees management in ensuring that these policies and processes are implemented effectively.

COMPLIANT

Regulation:

The Prudential Rules Decree [Article 16 paragraph 1c)] designates that the Board approve the strategy of risk management which, pursuant to Article 26 paragraph 4 of this decree, must cover operational risk in addition to other significant risks. Article 16 of the decree imposes the following duties on the Board:

- to oversee that the strategy and principles and processes for the management of operational risk are applied effectively in practice,
- to discuss regularly with senior management matters which concern the system of governance,
- at least once a year to evaluate the overall functionality and effectiveness of the system of governance, including system for management of operational risk, and to ensure any steps for rectification of identified shortcomings,
- to assess in good time the regular reports and extraordinary findings about operational risk and its management which are submitted to it in particular by senior management in the context of the internal audit, by a supervisory body, auditor or audit company or relevant supervisors, and on the basis of these assessments the Board will take adequate steps which are implemented without undue delay.

Supervision:

The subject of CNB on-site examination is a verification of whether the Board has approved and created conditions for the implementation of a strategy for the management of operational risk, strategy for development of information systems and technologies and security principles. In this context the CNB also verifies whether the Board ensures, supervises and evaluates that the strategies are effectively implemented and adhered to. In addition to this, in during on-site examination other facts are evaluated, such as the information level of bodies and the Board concerning operational risk, regular re-evaluation of strategic documents and their updating in reaction to changes of internal and external environment. For the elimination of ascertained shortcomings the CNB imposes upon banks and credit unions remedial measures, and it verifies and checks adherence to them thoroughly.

3. The supervisor is satisfied that the approved strategy and significant policies and processes for operational risk are implemented effectively by management.

COMPLIANT

Regulation:

The Prudential Rules Decree [Article 18 paragraph 1] states that the senior management of a bank or credit union is responsible for the implementation of the strategies, principles and goals approved by the Board, including the development of processes for their implementation and day-to-day management of the bank or credit union. These provisions also apply in full to operational risk management.

Supervision:

During supervision in the form of on-site examination, the CNB determines whether the senior management of the bank thoroughly applies in practice the systems and strategies approved by the Board and whether it has created inspection mechanisms for their effective inspection. For the elimination of ascertained shortcomings the CNB imposes upon banks and credit unions remedial measures, and it verifies and checks adherence to them thoroughly.

- 4. The supervisor reviews the quality and comprehensiveness of the bank's business resumption and contingency plans to satisfy itself that the bank is able to operate as a going concern and minimise losses, including those that may arise from disturbances to payment and settlement systems, in the event of severe business disruption.**

COMPLIANT

Regulation:

The Prudential Rules Decree (annex No 1 part 3. A. 2.) imposes a duty on a bank or credit union to create and maintain contingency plans for extraordinary situations, including emergency and crisis situations and for renewal of activities, for ensuring the capability to perform, on an ongoing basis, activities and limit losses in the case of significant disruption of activities. In addition the Prudential Rules Decree (annex No 1 part 3. B. IV.) designates the more detailed requirements for these plans, which include, amongst other things, minimum requirements for the content of the contingency plan, also a requirement for the relevant staff to be acquainted with the contingency plans and to proceed in compliance with them, and finally for these plans to be subject to regular testing, assessment and, if needs be, updating.

Supervision:

The CNB considers the creation, updating and testing of contingency plans of banks and credit unions and plans for the resumption of their business and systems to be a highly significant area on which it focuses when performing supervision on site and upon which it expends a considerable amount of the time allocated for supervisory activity. The CNB has specialists for this area and ensures their systematic education. During on-site examination it determines the level of ensuring of continuity of automated and non-automated activities necessary for the permanent functioning of the inspected subjects. For the elimination of ascertained shortcomings the CNB imposes upon banks and credit unions remedial measures, and it verifies and checks adherence to them thoroughly.

- 5. The supervisor determines that banks have established appropriate information technology policies and processes that address areas such as information security and system development, and have made investments in information technology commensurate with the size and complexity of operations.**

COMPLIANT

Regulation:

The Prudential Rules Decree (annex No 1 part 3 B.V.) imposes upon a bank or credit union the more detailed requirements for information systems and technology. A bank or credit union is obliged to designate and adhere to security principles for information systems, to perform an analysis of the risks associated with information systems, to perform measures for ensuring security of access to information and security of communication network and for

physical protection of information technologies, information saved in the information system and documentation for this system.

Supervision:

Security and operability of information technologies is one of the key supervision areas of the CNB in the operational risk field. The security principles, in particular in the area of information systems and technologies, must be approved by the Board, and the CNB verifies thoroughly not only the adoption of security principles but also their ensuring in the day-to-day activity of banks and credit unions. The CNB enforces adherence to the internationally acknowledged standards in the given area. The CNB has been performing systematic supervision in this area since 2002 and has advanced methodology for supervision in this area and specialists for this area. These specialists are a part of the team which ensures supervision in the area of operational risk. The CNB considers IS/IT to be a significant sub-item of operational risk. For the elimination of ascertained shortcomings the CNB imposes upon banks and credit unions remedial measures, and it verifies and checks adherence to them thoroughly.

6. The supervisor requires that appropriate reporting mechanisms are in place to keep the supervisor apprised of developments affecting operational risk at banks in their jurisdictions.

COMPLIANT

Regulation:

The CNB derives basic information about development of operational risk mandatorily disclosed information. The Act on Banks (Article 11a paragraph 1) and Act on Credit Unions (Article 7 b paragraph 1) impose upon a bank or credit union a duty to publish, amongst other things, data about its activity and the financial situation, which also includes data about performance of prudential business rules. Pursuant to Article 11a paragraph 3 of the Act on Banks, or Article 7b paragraph 3 of the Act on Credit Unions, a bank or credit union which is a part of a financial group or regulated consolidated unit is obliged to publish data about the performance of the rules of prudential business on a consolidated basis too. The Act on Banks (Article 11 paragraph 10) and Act on Credit Unions (Article 7b paragraph 10) imposes upon a bank or credit union a duty to introduce internal processes and principles for performance of the requirements for the publication of information, including information about performance of prudential business rules, and for evaluation of the adequacy of the published data, including their publication and frequency of publication. The Act on Banks (Article 11a paragraph 9) and Act on Credit Unions (Article 7b paragraph 9) authorises the CNB to determine, by means of an implementing legislative instrument, the content of data intended for publication on a solo and consolidated basis and the content of data published by the auditor. On this basis, the Prudential Rules Decree designates in Article 208 paragraph 1 that a bank or credit union will publish data quarterly about the performance of prudential business rules given in annex No 25 of this decree. Here a duty is imposed on a bank and credit union to publish information about:

- strategy and processes of operational risk management,
- the organisation system for operational risk management,
- the scope and nature of the system for the assessment and measuring of operational risk and
- techniques for reducing operational risk and about the strategy and monitoring of effectiveness of these techniques.

In addition to this, banks submit regularly information about requirements (including information about operational risk) and since 2008 banks have been submitting information in the form of quarterly commentaries about the three greatest events of operational risk separately for electronic banking, information systems and technologies, and for others.

Supervision:

One part of checking the calculation of the capital requirements for operational risk is a verification of the data which the banks and credit unions submit to the CNB. The entire process for the creation of returns is subject to a detailed inspection. In this context there is also an inspection of the linkage of data in the reports to the accounting and operative records of the inspected persons and the overall correctness and accuracy of the reported data. For the elimination of ascertained shortcomings the CNB imposes upon banks and credit unions remedial measures, and it verifies and checks adherence to them thoroughly.

7. The supervisor confirms that legal risk is incorporated into the operational risk management processes of the bank.

COMPLIANT

Regulation:

The Prudential Rules Decree [Article 2 paragraph 3f)] also includes legal risk under the term operational risk. Also in this decree in Article 27 paragraph 1b) it imposes upon a bank or credit union a duty to manage operational risk on an ongoing basis and to report on the more detailed definition of certain requirements for the management of the selected risks shown in annex No 1 of the decree. In this annex (part. 3. B. III. 2.) of the Prudential Rules Decree, in the context of the more detailed requirements for the management of operational risk there is an express requirement for a bank or credit union to manage and maintain the processes for the resolution of operational risk, including legal and compliance risk.

Supervision:

The CNB verifies the processes of banks and credit unions when regulating legal risk. The scope and method of resolving active and passive legal disputes and the generation of reserves for the purposes of resolving the impacts of legal disputes on supervised persons is also verified. For the elimination of ascertained shortcomings the CNB imposes upon banks and credit unions remedial measures, and it verifies and checks adherence to them thoroughly.

8. The supervisor determines that banks have established appropriate policies and processes to assess, manage and monitor outsourced activities. The outsourcing risk management programme should cover:

- **conducting appropriate due diligence for selecting potential service providers;**
- **structuring the outsourcing arrangement;**
- **managing and monitoring the risk associated with the outsourcing arrangement;**
- **ensuring an effective control environment and;**
- **establishing viable contingency planning.**

Outsourcing policies and processes should require the institution to have comprehensive contracts and/or service level agreements with a clear allocation of responsibilities between the outsourcing provider and the bank.

COMPLIANT

Regulation:

Pursuant to the Prudential Rules Decree (Article 11) the fact that a bank or credit union has outsourced a certain activity to another subject does not free the relevant bank or credit union from responsibility for ensuring that this activity is performed in compliance with the requirements of regulatory rules designated by the relevant legal regulations. The bank must ensure the designation of the supervisory activities which are subject to outsourcing, including any inspection of facts concerning outsourcing at its provider. In relation to the specified activities, a bank or credit union is also obliged to ensure the performance of information duties towards the CNB, the performance of supervision from the part of the CNB, including any inspection of facts subject to supervision at the outsourcing provider, and performance of audit of final accounts and other verifications designated by legal regulations. Pursuant to the Prudential Rules Decree (Article 216) a bank or credit union which has arranged outsourcing for ensuring any of its significant activities or in support of them is obliged to inform the CNB of this fact without delay.

Supervision:

The CNB verifies the processes for managing outsourcing relations, their effectiveness and level of risk for the supervised persons. The CNB verifies whether the supervised persons check at outsourcing providers adherence to the rules and processes which banks and credit unions have adopted for the management of their activities and systems, for example in the field of information systems and technologies, risk management, audit and control mechanisms. In the case of cross-border outsourcing the CNB cooperates with the relevant foreign regulators when evaluating this area. For the elimination of ascertained shortcomings the CNB imposes upon banks and credit unions remedial measures, and it verifies and checks adherence to them thoroughly.

Additional criterion

1. The supervisor determines that the risk management policies and processes address the major aspects of operational risk, including an appropriate operational risk framework that is applied on a group-wide basis. The policies and processes should include additional risks prevalent in certain operationally intensive businesses, such as custody and correspondent banking, and should cover periods when operational risk could increase.

COMPLIANT

Regulation:

The performance of this criterion for the financial group or regulated consolidation unit of a bank or credit union is derived from the Act on Banks (Article 8b paragraph 3) and from the Act on Credit Unions (Article 7b paragraph 3), which impose upon a bank or credit union a duty to impose and maintain an effective system of governance, including risk management system which includes the management of operational risk, not only on a solo basis, but also on a consolidated one. The same requirement is also derived from the Prudential Rules Decree (Article 7 paragraph 2).

Supervision:

During on-site examination the CNB looks into the matter of compliance processes of inspected persons with the processes applied in the group of the inspected person, for example in the area of linkage and compliance with the strategy of operational risk management, strategy for development of information systems and technologies, coordination of outsourcing relations, internal regulations etc. For the elimination of ascertained

shortcomings the CNB imposes upon banks and credit unions remedial measures, and it verifies and checks adherence to them thoroughly.

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.

Overall Assessment of the Principle:

COMPLIANT

Essential criteria:

[Act No. 21/1992 Coll., on Banks, as amended](#) (referred to hereinafter as the “Act on Banks”) and [Act No. 87/1995 Coll., on Credit Unions and Certain Related Measures and on the Amendment of Czech National Council Act No. 586/1992 Coll., on Income Tax, as amended, as amended](#) (referred to hereinafter as “Act on Credit Unions“), impose upon banks and branches of foreign banks which do not enjoy the advantages of a single licence according to EU law and credit unions, a duty to establish and maintain an adequate system of governance. The system of governance of banks and credit unions must be integrated and commensurate with the character, scope and complexity of their activities. This duty also applies to the system for management of the interest rate risk in the banking book, which is a significant component of the system of governance of the aforementioned institutions. The system for management of the interest rate risk in the banking book must take into account the risk profile of the given institution.

More detailed requirements of the system for the management of interest rate risk in the banking book is designated for banks and credit unions by [Decree No 123/2007 Coll., stipulating the prudential rules for banks, credit unions and investment firms](#) (referred to hereinafter as the "Prudential Rules Decree"). The Prudential Rules Decree designates that the system of governance of a bank or credit union, including system for managing the interest rate risk in the banking book, must correspond to the size, method of management, number of staff, nature, scope and complexity of activities which the bank or credit union performs or intends to perform, and it also requires that a bank or credit union take into account the development of the environment in which it works. The decree referred to also designates that the Board of a bank or credit union is obliged to approve and regularly evaluate the risk management strategy, including strategy for interest rate risk in the banking book and system of limits which the bank or credit union will use to limit this risk. The Board may also transfer this last mentioned authority to a committee which it appoints. The Prudential Rules Decree also regulates the responsibility of senior management of the bank or credit union for the development and practical application of the strategy, principles and processes for identifying, measuring, monitoring and managing interest rate risks in the banking book, and it also designates the detailed requirements of stress testing for interest rate risk in the banking book.

During supervision in the form of on-site examination, the CNB determines whether banks, bank groups and credit unions have introduced effective systems for identifying, measuring, monitoring and managing interest rate risk in the banking book, whether they have a corresponding and Board approved strategy for managing market risk, including interest rate risk in the banking book, and also whether the senior management of the bank strictly applies the systems and strategy referred to in practice. The CNB also has sufficient knowledge and experience for an evaluation of the adequacy of the models used by banks and credit unions

for managing interest rate risk in the banking book and for designation of capital requirements for interest rate risk in the context of the concept of capital adequacy.

Additional criteria

The CNB also has the right to require information pursuant to the Act on the CNB and other relevant provisions of other special legal regulations, which include, for example, the Act on Banks and Act on Credit Unions. During on-site examination the CNB is also authorised to require all information from subjects which it supervises. On the basis of measures for reporting, every quarter banks submit a report containing the assets and liabilities in a basic structure according to the time of revaluation, type of interest rate and results of standardised shock for the interest rate risk in the banking book. The Prudential Rules Decree requires that a bank or credit union perform regular stress tests for interest rate risk in the banking book. The Prudential Rules Decree requires a bank or credit union to ensure that the responsibilities and authorisations be assigned to bodies, staff, units and committees, if established, at all levels of management and organisation in such a way that no possible conflict of interest arises.

Analysis of individual criteria

Essential criteria:

1. The supervisor determines that a bank's Board approves, and periodically reviews, the interest rate risk strategy and policies and processes for the identification, measuring, monitoring and control of interest rate risk. The supervisor also determines that management ensures that the interest rate risk strategy, policies and processes are developed and implemented.

COMPLIANT

Regulation:

The Act on Banks and Act on Credit Unions imposes on banks and credit unions a duty to introduce and maintain an adequate system of governance, and this duty also applies to the management of interest rate risk in the banking book. The laws referred to designate that the system of governance of a bank or credit union must be integrated and commensurate with the character, scope and complexity of their activities. Pursuant to the Act on Banks (Article 8b paragraph 3) or pursuant to the Act on Credit Unions (Article 7a paragraph 3) a bank or credit union is obliged to introduce and maintain an effective system of governance not only on a solo basis, but also on a consolidated basis if it is part of a regulated consolidation unit, and this requirement also applies in full for management of the interest rate risk in the banking book. The Prudential Rules Decree also imposes this last named duty on banks and credit unions in Article 7 paragraph 2.

The Prudential Rules Decree expressly imposes upon a bank or credit union a duty to create and maintain a system for the management of interest rate risk. The provisions of Article 26 paragraph 4 and Article 16 paragraph 2 of the Prudential Rules Decree also apply to this system as part of the interest rate risk management system, and these provisions state that the Board of a bank or credit union is obliged to approve and assess the following regularly:

- strategy for managing market risk, including interest rate risk,
- system of limits which the bank or credit union will use for limiting market risk, including interest rate risk.

The Prudential Rules Decree [Article 18 paragraph 1] states that the senior management is responsible for the implementation of the strategies, principles and goals approved by the Board, including the development of processes for their implementation and day-to-day management of the bank or credit union. All of these provisions apply for the investment and business portfolio of the bank or credit union.

2. The supervisor determines that banks have in place comprehensive and appropriate interest rate risk measurement systems and that any models and assumptions are validated on a regular basis. It confirms that banks' limits reflect the risk strategy of the institution and are understood by and regularly communicated to relevant staff. The supervisor also confirms that exceptions to established policies, processes and limits should receive the prompt attention of senior management, and the Board where necessary.

COMPLIANT

Regulation:

The Prudential Rules Decree (annex No 1 part 2. A. I.) designates that a bank or credit union is obliged to create and maintain a system for the management of interest rate risk in the banking book (and also the currency, share and commodity risk in this book). In addition to this, from the Prudential Rules Decree (annex No 1 part 2. B) it follows that the system for the management of interest rate risk in the banking book must contain:

- a system allowing the measuring of interest rate risk separately in every currency in which the bank or credit union has an interest rate sensitive position. If the interest rate risk is measured jointly in two or more currencies, it is necessary to justify this process;
- limits for the management of interest rate risk, which are assessed by the relevant staff or units regularly and during significant changes of conditions on the market and which are subject to approval and regular assessment by the Board, and for the eventuality that it is exceeded commensurate processes, including information flows, are established for each limit;
- stress testing of interest rate risk, see essential criterion No 3 below.

Supervision:

During supervision in the form of on-site examination, the CNB determines whether the limits designated by the bank or credit union reflect its strategy for risk management and that the responsible staff are duly acquainted with these limits. There is also a determination of whether the management of the bank or credit union pays due attention to exceptions to an exceeding of these limits.

3. The supervisor requires that banks periodically perform appropriate stress tests to measure their vulnerability to loss under adverse interest rate movements.

COMPLIANT

Regulation:

The Prudential Rules Decree (annex No 1 part 2.A.II.) designates the detailed requirements for stress testing for interest rate risk in the banking book. These requirements include, in particular, the fact that a bank or credit union should ensure the measuring and documenting of interest rate shock impacts on capital at least once every 3 months, and this shall be separately for each currency with a minimum 5% share of the value of assets or liabilities of the banking book. And the Prudential Rules Decree gives two methods for stress testing of

the interest rate risk in the banking book. The first of these methods consists of a parallel shift of the yield curve by 200 base points in both directions, and in the case of a significant increase in the volatility of interest rate changes a bank or credit union will calibrate the value of the yield curve shift. The second method consists of designating the lower and upper value of a one percent fractile of interest rate changes for the period of 1 year (240 days) ascertained on the basis of at least five years of observation of interest rate changes. And in the eventuality that the overall impact of interest rate shock should cause a drop in the economic value of the bank or credit union by more than 20% of the sum of the original (element of tier 1) and additional (element of tier 2) capital, the bank or credit union must promptly take remedial measures and inform the Czech National Bank of these measures.

Supervision:

During supervision in the form of on-site examination, the CNB determines whether a bank or credit union performs adequate stress testing in the area of interest rate risk. The summarised results of a standardised shock are reported to the CNB on a quarterly basis in the context of the bank's interest rate risk reporting.

Additional criteria

1. The supervisor has the power to obtain from banks the results of their internal interest rate risk measurement systems, expressed in terms of the threat to economic value, including using a standardised interest rate shock on the banking book.

COMPLIANT

Regulation:

In order to perform its tasks, the CNB requires the necessary information and documents from banks, branches of foreign banks and savings and credit cooperatives trading on the territory of the Czech Republic. [Act No 6/1993 Sb., on the Czech National Bank, as amended](#) (referred to hereinafter as “Act on the CNB”) designates that the CNB also has the right to require information pursuant to the relevant provisions of other special legal regulations, which include in particular the Act on Banks and Act on Credit Unions. During on-site examination the CNB is also authorised to require all information from subjects which it supervises. The laws of the Czech Republic also regulate the exchange of information between the CNB and foreign bank supervisors. This last mentioned adjustment is implemented by the relevant EU directives. See principle No 1(3), essential criterion No 3.

Supervision:

In the context of regular submission of reports, banks submit to the CNB quarterly the results of the standardised interest rate shock, not only overall but also according to the individual currencies in the commentary. One part of the commentary is a description of the used methods for calculation of the standardised shock. One part of a return consists of an overview of assets and liabilities pursuant to the revaluation bands or residual maturity for a vulnerability analysis of the interest rate risk. During on-site examination the CNB is authorised to require the results of the stress tests performed by a bank or credit union.

2. The supervisor assesses whether the internal capital measurement systems of banks adequately capture the interest rate risk in the banking book.

COMPLIANT

Regulation:

The Prudential Rules Decree requires that a bank or credit union perform regular stress tests for interest rate risk in the banking book and if necessary take the relevant steps promptly and inform the CNB of this. See above essential criterion No 3.

Supervision:

Information about the results of regulatory stress testing for interest rate risk in the banking book is part of regular reporting for the CNB. During supervision in the form of on-site examination, the CNB determines whether internal systems for measuring capital adequately capture the risk, whether there is compliance with the requirements of the decree for the performance of stress testing of the interest rate risk in the banking book and the impact of interest rate risk in the banking book on Pillar I and Pillar II, including its aggregation into overall economic capital.

- 3. The supervisor requires stress tests to be based on reasonable worst case scenarios and to capture all material sources of risk, including a breakdown of critical assumptions. Senior management is required to consider these results when establishing and reviewing a bank's policies, processes and limits for interest rate risk.**

COMPLIANT

Regulation:

See above essential criterion No 3.

Supervision:

During supervision in the form of on-site examination, the CNB determines whether the stress scenarios are based on realistic assumptions and capture all sources of interest rate risk. There is also a verification of whether the results of stress testing are taken into account when creating the plan and strategy of risk management.

- 4. The supervisor requires banks to assign responsibility for interest rate risk management to individuals independent of and with reporting lines separate from those responsible for trading and/or other risk-taking activities. In the absence of an independent risk management function that covers interest rate risk, the supervisor requires the bank to ensure that there is a mechanism in place to mitigate a possible conflict of interest for managers with both risk management and risk-taking responsibilities.**

COMPLIANT

Regulation:

The Prudential Rules Decree (Article 20 paragraph 1) requires a bank or credit union to ensure that the responsibilities and authorisations be assigned to bodies, staff, units and committees, if established, at all levels of management and organisation in such a way that a possible conflict of interest is sufficiently prevented. And areas where there exists the possibility of a conflict of interest arising must be identified in good time, processes must be designated in such a way as to prevent the possibility of a conflict of interests, and the areas of the conflict of interests and its possible occurrence must be subject to ongoing independent monitoring. In Article 20 paragraph 2f) and g) of the Prudential Rules Decree a duty is imposed on a bank or credit union to ensure that the approval of limits for the management of market risk or approval of valuation systems and models used for measuring and

monitoring market risk, including interest rate risk, are performed independently of business activities as a direct result of which the bank or credit union is exposed to interest rate or market risk. These provisions also apply to the management of interest rate risk in the banking book.

Supervision:

During supervision in the form of on-site examination, the CNB determines whether the authorisations and responsibilities for the management of interest rate risk (and preparation of documents) are clearly designated so that there can be no conflict of interest (combination of incompatible functions).

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.

Overall Assessment of the Principle:

COMPLIANT

Essential criteria:

The basic requirements for the system of governance are regulated in [Act No. 21/1992 Coll., on Banks, as amended](#) (referred to hereinafter as the "Act on Banks") and in [Act No. 87/1995 Coll., on Credit Unions and Certain Related Measures and on the Amendment of Czech National Council Act No. 586/1992 Coll., on Income Tax, as amended, as amended](#) (referred to hereinafter as "Act on Credit Unions"). These requirements, including ensuring the separate exercise of incompatible functions, internal audit function and compliance function, are developed further in [Decree No. 123/2007 Coll., stipulating the prudential rules for banks, credit unions and investment firms](#) (referred to hereinafter as the "Prudential Rules Decree"). Banks and saving and credit unions are obliged to fulfil the designated requirements with regard to their size, method of management, number of staff, scope and complexity of activities which they perform or intend to perform and with which risks are associated. When fulfilling the requirements for the system of governance banks and credit unions are also obliged to take into account the development of the environment, including development in the area of corporate governance. The main duties of the Board of joint-stock companies and cooperatives and the duties of supervisory bodies (supervisory board and inspection committee) are designated by Act No. 513/1991 Coll., the Commercial Code, as amended (referred to hereinafter as "the Commercial Code"). The Act on Banks and Act on Credit Unions designate further requirements for the supervisory body, board and their members. The authorisations of the board and supervisory body and the authorisations and responsibilities of the head officers and managing persons must be covered in the articles of incorporation of a bank or credit union. The Prudential Rules Decree also details the requirements for the supervisory body and board in the area of the internal control system of a bank or credit union. The requirements of the law for internal control mechanisms, including separation of incompatible functions and internal audit, are also specified in detail in the context of the Prudential Rules Decree. When conducting supervision, the CNB determines adherence to the requirements designated by legal regulations, including assessment of whether the internal audit unit has an independent status in the bank or credit union, whether it has adequate resources, and whether it has a prepared methodology which reveals key risks in the bank or credit union.

The Prudential Rules Decree also details the particulars and processes for the submission of reports concerning the verification of the system of governance or some of its elements by the external auditor. This verification is performed by an external auditor in compliance with the Act on Banks as a rule once a year (Article 22 paragraph 2 of the Prudential Rules Decree), or in compliance with the Act on Credit Unions once every three years (Article 8b paragraph 1 of Prudential Rules Decree).

Additional criteria

If not precluded by Article 44 paragraph 6 of Act No. 93/2009 Coll., on Auditors, as amended (referred to hereinafter as the “Act on Auditors”), subjects of public interest, i.e., banks and credit unions, must establish an audit committee. Pursuant to the Prudential Rules Decree (Article 33 paragraph 6) the internal auditor gives the reports to the Board and supervisory body. Pursuant to annex No. 2 of point V. 1. of the Prudential Rules Decree, the person managing the performance of internal audit informs the Board, supervisory body and any audit committee of the internal audit findings.

The CNB receives a report of the external auditor concerning the verification of the bank’s system of governance once a year, and in the case of a credit union, once every three years, unless otherwise is decided in compliance with the law. Significant facts ascertained after the submission of the report to the CNB and having a fundamental relationship with its content must be announced without delay to the CNB. Pursuant to the Act on Auditors [Article 21 paragraph 3b)] an external auditor is also obliged to announce to the CNB facts ascertained by it when performing the audit which have a fundamental negative influence on the trading of the regulated subject, i.e., bank or credit union.

Analysis of individual criteria

Essential criteria:

- 1. Laws, regulations or the supervisor establish the responsibilities of the Board and senior management with respect to corporate governance to ensure that there is effective control over a bank’s entire business.**

COMPLIANT

Regulation:

For banks as joint-stock companies, the responsibility of the Board and supervisory board is in general terms regulated primarily in the provisions of Article 191 to 201 of the Commercial Code. Pursuant to the Act on Banks (Article 8) the authorisations of the Board and supervisory board of a bank must be regulated in the bank’s articles of incorporation. The Act on Banks designates that the authorisations which the Commercial Code entrusts to the board of directors of a joint-stock company must not be entrusted to supervisory board of a bank. Members of the Board who have breached their duties from the title of member of the Board of the bank arising for them from legal regulations or the articles of incorporation are responsible jointly and severally for the loss incurred by liability holders of the bank because the bank is incapable of meeting its due liabilities as a result of the breach of duties of these members (Article 8a of the Act on Banks). In the articles of incorporation the bank is also obliged to regulate the authorisation and responsibility of the senior officers of the bank and organisational ensuring of the system of governance (Article 9 paragraph 1 of the Act on Banks).

The Prudential Rules Decree regulates in more detail the duties of the supervisory body, Board and senior management and the requirements for internal audit and function of compliance in the context of organisational ensuring of the system of governance of a bank or credit union. In Article 14 of the Prudential Rules Decree there is an explicit designation of the responsibility of the Board for the creation and assessment of the system of governance and for the sustainable maintenance of its functionality and effectiveness. Pursuant to Article 15 of this decree the Board is also obliged to ensure that all the staff understand their role in the system of governance and get involved actively in this system. Pursuant to Article 18

of the Prudential Rules Decree senior management is responsible for the implementation of the strategies, principles and goals approved by the Board, including the development of processes for their implementation, and for the maintenance of a functional and effective organisational arrangement, including separation of incompatible functions and prevention of the incidence of a possible conflict of interests.

The responsibility of the Board and control committee of a credit union is regulated primarily in Article 243 to 244 of the Commercial Code. The other authorisations of the Board are regulated in Article 6 of the Act on Credit Unions. In the same way as in the case of banks, it applies pursuant to the Act on Credit Unions (Article 6 paragraph 11) that members of the elected bodies of a credit union who have breached their duties from the title of member of an elected body of a credit union arising for them from legal regulations or the articles of incorporation are responsible jointly and severally for the loss incurred by liability holders of the credit union because the credit union is incapable of meeting its due liabilities as a result of the breach of duties of these members of the elected bodies. The requirements for the system of governance of a credit union are designated in the Act on Credit Unions (Article 7a). The other requirements concerning the Board and control committee are designated by the Prudential Rules Decree and are the same as for banks - see above.

- 2. The supervisor determines that banks have in place internal controls that are adequate for the nature and scale of their business. These controls are the responsibility of the Board and/or senior management and deal with organisational structure, accounting policies and processes, checks and balances, and the safeguarding of assets and investments. More specifically, these controls address:**
- **Organisational structure: definitions of duties and responsibilities, including clear delegation of authority (for example, clear loan approval limits), decision-making policies and processes, separation of critical functions (for example, business origination, payments, reconciliation, risk management, accounting, audit and compliance);**
 - **Accounting policies and processes: reconciliation of accounts, control lists, information for management;**
 - **Checks and balances (or “four eyes principle”): segregation of duties, cross-checking, dual control of assets, double signatures;**
 - **Safeguarding assets and investments: including physical control.**

COMPLIANT

Regulation:

The Act on Banks (Article 8b) and Act on Credit Unions (Article 7a) designate a duty for banks and credit unions to have a system of governance, and these laws also designate what such a system includes. The system of governance must be integrated and commensurate with the character, scope and complexity of the activity of the bank or credit union and the risks associated with them. Further requirements concerning the system of governance are regulated in detail in the Prudential Rules Decree in Article 7 to Article 36 and in annexes 1 to 3 of this decree. In Article 8 the Prudential Rules Decree designates that a bank and credit union complies with the requirements designated for the system of governance with regard to its size, method of management, number of staff, nature, scope and complexity of activities which it performs or intends to perform, and at the same time account is taken of the development of the environment, including development in the area of corporate governance.

The organisational structure, or organisational arrangement, of the institution must be configured in such a way that it provides a clear and integrated definition of responsibilities, authorisations and their assignment so that there should arise no conflict of interests. A bank and credit union are obliged to ensure that all approval and decision-making processes and supervisory activities, including responsibilities and associated internal regulations, are traceable. Pursuant to Article 16 paragraph 1b) of the Prudential Rules Decree the Board approves and regularly assesses the organisational arrangement. The organisational arrangement pursuant to Article 19 of this decree clearly and consistently delineates the responsibilities, main information flows and linkages of bodies, staff, units and committees of a bank or credit union, if established, and in the framework of a regulated consolidation unit. Pursuant to Article 20 of the Prudential Rules Decree the bank or credit union will ensure that the responsibilities and authorisations be assigned to bodies, staff, units and committees, if established, in such a way that a possible conflict of interest is sufficiently prevented. The areas where there exists the possibility of the incidence of a conflict of interests must be identified in good time. The processes are designated in such a way as to prevent the possibility of conflict of interests. Areas of conflict of interest and areas of its possible occurrence must be subject to ongoing independent monitoring. The Act on Banks (Article 8) and Act on Credit Unions (Article 7) designate certain restrictions which should prevent a conflict of interests occurring.

Accounting processes are designated by the Act on Accounting and associated regulations. The completeness, evidentiary nature and correctness of bookkeeping and reliability of information provided to the bodies of a bank or credit union is subject to independent verification by internal audit pursuant to Article 33 paragraph 4 of the Prudential Rules Decree. In Article 21 paragraph 1 of the Prudential Rules Decree it is designated that a bank or credit union will ensure that the relevant bodies, including supervisory ones, staff, units and committees, if established, should have current, reliable and comprehensive information for their decision making and further designated activities.

The four eyes principle is incorporated in legal standards as a necessary component of control mechanisms and processes for the control activity which a bank or credit union should introduce and maintain at all managing and organisational levels pursuant to Article 31 of the Prudential Rules Decree. Supervisory activities include in particular supervision along the line of management and commensurate supervisory mechanisms for the individual processes, for example, supervision of adherence to legal and internal regulations and limits, supervision of approval and authorisation of transactions above the designated limits, supervision of course of activities and transactions, verification of transaction details, verification of outputs of the used systems and models of risk management, regular reconciliation.

The securing of assets and investments is also regulated in Article 31 of the Prudential Rules Decree, which deals with physical supervision as a component of supervisory activities. Physical supervision focuses in particular on preventing access to material assets, securities and other financial assets and on regular asset inventories.

Supervision:

During supervision in the form of on-site examination, the system of governance is verified, including the organisational structure and its functionality. The individual elements of the management and inspections systems are subject to verification in the context of the examination of management of the individual risks (as an integral component of the systems for management of these risks). In addition to this there is a verification of the key

summarised assumptions of corporate governance and the internal control system. In the framework of the internal control system this involves, in particular, the area of internal audit, compliance and system for detecting and resolving shortcomings of the system of governance. In the area of assumptions for corporate governance this involves an evaluation of the role of the bodies and committees of credit institutions, overall organisational structure, configuration of information flows and mutual linkages ensuring sufficient reconstruction ability etc.

3. Laws, regulations or the supervisor place the responsibility for the control environment on the Board and senior management of the bank. The supervisor requires that the Board and senior management understand the underlying risks in their business and are committed to a strong control environment.

COMPLIANT

Regulation:

The requirement of the supervisor (the CNB) that the Board of regulated subjects and their senior management have the requisite knowledge of risks associated with the trading of these subjects is reflected in the relevant laws [Article 4 paragraph 5d) of the Act on Banks and Article 2a paragraph 4a) Act on Credit Unions]. In Articles 14 to 18, the Prudential Rules Decree designates the more detailed requirements for the duties and responsibilities of the Board and senior management during the management of the company, including risk management. Amongst other things, these provisions designate that the Board will ensure the creation and assessment of a system of governance one mandatory part of which will be the risk management system, and it is responsible for the ongoing maintenance of its functionality and effectiveness and for the permanent and effective functioning of the internal control system. The Board approves and regularly assesses the risk management strategy and principles of the internal control system. The Board will ensure the designation of principles for human resource management one part of which is also a requirement that qualified staff with corresponding knowledge and skills perform all activities. Senior management is then responsible for the implementation of the strategies, principles and goals approved by the Board, including the development of processes for their implementation.

Supervision:

During supervision in the form of on-site examination, the system of governance is verified, including necessary knowledge of risk management of the relevant senior officers of the bank.

4. The supervisor has the power to require changes in the composition of the Board and senior management to address any prudential concerns related to the satisfaction of these criteria.

COMPLIANT

Regulation:

In the event of the finding of shortcomings in the activity of a regulated institution, including shortcomings in the management of a regulated institution by persons who do not have sufficient expert competence or are not reliable, in compliance with the Act on Banks (Article 26 paragraph 1) and the Act on Credit Unions (Article 28 paragraph 1a) point 3 and 4) the CNB is authorised to require that the bank or branch of a foreign bank or credit union replace the persons in the management or replace members of the Board, control or credit committee. The CNB is also authorised to require the replacement of member of the supervisory board of a bank as a result of an ascertained shortcoming in the activity of the bank.

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

COMPLIANT

Regulation:

The Prudential Rules Decree (Article 20) designates a requirement for the separation of incompatible functions and identification and management of conflicts of interest. Pursuant to this provision a bank or credit union must ensure the separation of responsibility for the management of business activities from responsibility for managing credit and market risk and the concentration and settlement and reconciliation of transactions agreed on financial markets up to the level of senior management. In addition the requirement that a bank or credit union ensure the corresponding independence and prevention of a conflict of interests when ensuring control mechanisms and activities is dealt with here, as is the requirement that the internal audit be conducted independently of all executive activities.

Supervision:

This principle is a part of the verification of risk management and separation of responsibilities performed in the framework of licence proceedings and also in during supervision in the form of on-site examination. The CNB should also be notified of an unsuitable organisational arrangement and separation of responsibilities and authorisations between front and back office by the auditor in the report concerning the system of governance of the bank or credit union.

6. The supervisor determines that banks have a permanent compliance function that assists senior management in managing effectively the compliance risks faced by the bank. The compliance function must be independent of the business activities of the bank. The supervisor determines that the Board exercises oversight of the management of the compliance function.

COMPLIANT

Regulation:

The Prudential Rules Decree (Article 32) imposes upon a bank and credit union the duty to introduce and maintain principles and processes for ensuring compliance which aim in particular to ensure the compliance of internal regulations with legal regulations, mutual compliance of internal regulations and compliance of activities with legal and internal regulations. There is also a requirement that the ensuring of compliance and associated control be configured in such a way that the following is ensured:

- a) informing of senior management about all ascertained deviations and mismatches, and the Board is also informed of significant deviations and mismatches,
- b) informing of senior management of prepared or new legal regulations and acknowledged standards concerning the activities of the bank or credit union,
- c) provision of other useful information concerning compliance to the Board and senior management.

The specified decree also contains a requirement that the principles and processes for compliance should cover all activities of the bank or credit union in an integrated and connected manner. From the definition of requirements for the compliance function in connection with the requirements for the independence of control activities (Article 20 paragraph 5) it follows that this is an activity which is not dependent on the business activities

of the bank. The Board is responsible for the approval and regular assessment of principles for compliance. The Prudential Rules Decree (Article 16 paragraph 5) requires that at least once a year the Board evaluate the overall functionality and effectiveness of the system of governance (one part of which is also compliance) and ensure steps for the rectification of ascertained shortcomings. The Prudential Rules Decree (Article 13 paragraph 1) also requires the supervisory body to participate in the guiding, planning and assessment of activities of the internal audit and assessment of compliance.

Supervision:

During supervision in the form of on-site examination, the CNB focuses on the system of governance. During this examination, the CNB determines the ensuring of the compliance function, i.e., the means for ensuring the compliance function and adjustment of compliance in a bank and credit union, the configuration of the training system and dissemination of awareness about the framework of the compliance function, the system for identifying and reflecting legal and regulatory requirements in the internal regulation base and the system for monitoring soft standards. Other subjects of control include the regulation base of the main units which in the bank ensure the compliance function, the actual performance of activities in the context of the compliance function and passing on information about the ensuring of the compliance function.

7. The supervisor determines that banks have an independent, permanent and effective internal audit function charged with (i) ensuring that policies and processes are complied with and (ii) reviewing whether the existing policies, processes and controls remain sufficient and appropriate for the bank's business.

COMPLIANT

Regulation:

Ensuring of the performance of internal audit is an integral part of the system of governance which according to the law a bank (Article 8b of the Act on Banks) and credit union (Article 7a of the Act on Credit Unions) must have established. The more detailed requirements for internal audit are regulated in the Prudential Rules Decree in Article 33 and also in Annex No. 2 of this decree. The internal audit must be ensured on a permanent and consistent basis by at least one officer or via a third party on a contractual basis or by a combination of these methods. All activities of a bank or credit union are subject to independent verification by internal audit, in particular adherence to prudential trading rules and internally designated principles, goals and processes, the risk management system and internal control system, financial management, accounting, reliability of information and functionality and security of information systems.

8. The supervisor determines that the internal audit function:

- **has sufficient resources, and staff that are suitably trained and have relevant experience to understand and evaluate the business they are auditing;**
- **has appropriate independence, including reporting lines to the Board and status within the bank to ensure that senior management reacts to and acts upon its recommendations;**
- **has full access to and communication with any member of staff as well as full access to records, files or data of the bank and its affiliates, whenever relevant to the performance of its duties;**
- **employs a methodology that identifies the material risks run by the bank;**
- **prepares an audit plan based on its own risk assessment and allocates its resources**

accordingly; and

- **has the authority to assess any outsourced functions.**

COMPLIANT

Regulation:

The requirements for internal audit are regulated by the Prudential Rules Decree (Article 33 and Annex No. 2 of this decree). The exercise of internal audit is independent of all executive activities of the bank or credit union. The requirements for internal audit consist in particular of the fact that

- for the performance of internal audit the bank or credit union has or gains such capacities as are essential for performing the designated requirements;
- the persons conducting internal audit in the bank or credit union or for the bank or credit union conduct independent, objective, safeguarding and, if needs be, consultation activities when performing their duties. They provide their outputs to the bodies of the bank or credit union or other persons in good time, and they must always be up to date, reliable and comprehensive. A person conducting internal audit must be subject to such an organisational degree as allows it the performance of the internal audit function;
- a person performing internal audit must have access to all relevant documents of the bank or credit union during the performance of their activities; It must be ensured that the person managing the performance of internal audit must have the possibility to participate in the meetings of all advisory and decision-making bodies and committees of the bank or credit union unless this right is restricted on an individual basis by a justified decision of the Board;
- the person managing the performance of internal audit must inform the Board of the bank or credit union, the supervisory body and, as appropriate, the audit committee of discovered facts; in the case of findings which could in some significant manner negatively impact the financial situation of the bank or credit union, it is obliged to suggest an extraordinary meeting of the supervisory body;
- the activity of internal audit is based on a risk analysis which assesses the level of risk associated with the individual activities of the bank or credit union and takes into account the probability of failure of the system of governance in the individual areas and the extent of possible loss arising from this failure;
- on the basis of the risk analysis the person managing the performance of internal audit puts together a proposal for a strategic and periodic internal audit plan. When preparing it he also takes into account the suggestions of the supervisory body, Board and senior management and the requirements of the individual regulations for verification by internal audit. During the preparation of the plan he also takes into account other significant relevant information and facts and takes into account the activity and requirements of internal audit of other persons which are a member of the same consolidation unit and external auditor. Before approval by the Board the plan for activities of internal audit is submitted for discussion to the supervisory body or, if established, the audit committee. The strategic plan is assembled for a period of three to five years, and the periodic internal audit plan is put together for a period of one year;
- all activities of a bank or credit union are subject to independent verification by internal audit, and so consequently activities which are subject to outsourcing are also subject to independent verification by internal audit. In Article 11 the Prudential Rules Decree designates that if some activity which would otherwise be performed by a bank or credit union is ensured for the bank or credit union on a contractual basis by another person, the bank or credit union does not thereby free itself of any of its responsibilities towards

the relevant supervisors and third parties for the activities which are the subject of outsourcing.

Supervision:

The requirements for internal audit are verified during supervision in the form of on-site examination. The internal audit system is also described in the risk management report. During this examination there is a full-range verification of internal audit and an assessment of the internal control system as a whole.

Additional criteria

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

Irrelevant.

2. The supervisor requires the internal audit function to report to an audit committee, or an equivalent structure.

COMPLIANT

If not precluded by Article 44 paragraph 6 of the Act on Auditors, subjects of public interest, i.e., banks and credit unions, must establish an audit committee. Pursuant to Article 33 paragraph 6 of the Prudential Rules Decree the internal auditor gives the reports to the Board and supervisory body. Pursuant to Annex No 2 point V. 1. of the Prudential Rules Decree, the person entrusted with managing the performance of internal audit informs the Board, supervisory body and, if applicable, the audit committee of the findings of internal audit.

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

Irrelevant.

4. Laws or regulations provide, or the supervisor ensures, that banks must notify the supervisor as soon as they become aware of any material information which may negatively affect the fitness and propriety of a Board member or a member of the senior management.

LARGELY COMPLIANT

Regulation:

Pursuant to the Act on Credit Unions (Article 6 paragraph 10) the members of the elected bodies of a credit union and managing persons are obliged to inform the CNB without delay and in full of all facts which could result in a threat to the trading of the credit union or the application of a process in the case of the finding of a shortcoming in an activity and of the loss of professional fitness or propriety of members of the elected bodies of a credit union and managing persons. There is no comparable provision in the Act on Banks, but in the context of communication between the CNB and regulated subjects the CNB is informed informally of such facts. The degree of evaluation was reduced for this reason. In Article 22 of the Prudential Rules Decree it is designated that a bank or credit union publishes information about its current situation and the anticipated development in good time, in an accessible form, sufficiently and in a balanced manner. There is also a requirement in Article 23 of the Prudential Rules Decree that the system for creation, control and transfer of information to the

relevant supervisory bodies is created and maintained in such a way as it provides information up to date, reliably and comprehensively.

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.

Overall Assessment of the Principle:

LARGELY COMPLIANT

Essential criteria:

The area of the legitimisation of the proceeds of criminal activity and financing of terrorism (“money laundering”) is [regulated by Act No. 253/2008 Coll., on Certain Measures Against the Legitimation of the Proceeds of Criminal Activity and Financing of Terrorism](#) (referred to hereinafter as the “Act on Money Laundering”). Pursuant to this act the CNB is the supervisor for the liable persons which it supervises for administrative supervision of the performance of duties designated by this act. The Act on Money Laundering authorises the CNB to issue an implementing legislative instrument designating certain requirements for the establishment and application of a system of internal principles by certain liable persons which the CNB oversees. The Act on Money Laundering contains a requirement that the liable persons should announce suspicious transactions to the [Ministry of Finance \(referred to hereinafter as the “MF”\)](#), and this shall be via the analytical unit (referred to hereinafter as “FAU”; version of FIU abroad).), which is a part of it. The CNB is not a notification place (it is not a body to which notifications are sent).

When performing on-site examination in particular the CNB verifies performance of the duties designated by the Act on Money Laundering and the requirements for performance of these duties designated by [Decree No. 281/2008 Coll., on Certain Requirements for the System of Internal Principles, Processes and Control Measures against the Legitimation of the Proceeds of Criminal Activity and Financing of Terrorism](#) (referred to hereinafter as “Decree on Prevention of Money laundering“).

The reason for the reduction in degree of compliance of this principle is the fact that the relevant laws regulating the duties associated with the issue of money laundering prevention do not contain a requirement that when adhering to legal duties, the liable persons should ensure corresponding protection of their employees who report suspicious activity in good faith. Another reason for reducing the level of performance of the principle is that bank and credit unions are obliged to announce to the CNB facts which could threaten the safety of the bank or credit union or their financial stability, but not committed acts of a criminal nature according to the criminal law.

Additional criteria

The criminal aspects of money laundering come within the competence of the Ministry of the Interior (investigation) and Ministry of Justice (punishment). The CNB has neither the competencies nor the experts to cover the criminal aspects of the area of money laundering. If the MF (FAU) discovers facts indicating that a criminal offence has been committed, it makes a notification according to the Criminal Code and at the same time gives all associated information from the results of its own investigation to investigative bodies (Article 32 paragraph 1 of the Act on Money Laundering). If the CNB discovers facts indicating

a suspicious transaction in the sense of the Act on Money Laundering, it informs the MF (FAU) of this without delay.

Analysis of individual criteria

Essential criteria:

- 1. Laws or regulations clarify the duties, responsibilities and powers of the banking supervisor and other competent authorities, if any, related to the supervision of banks' internal controls and enforcement of the relevant laws and regulations regarding criminal activities.**

COMPLIANT

Regulation:

The area of prevention of money laundering and terrorism finance is regulated by a separate Act on Money Laundering. Pursuant to Article 35 of this Act the CNB is the supervisor for legal oversight of the performance of duties designated by this law for liable persons which the CNB oversees, which are banks, saving and credit cooperatives (referred to hereinafter as “credit unions”), branches of foreign banks, electronic money institutions, payment institutions, small-scale issuers of electronic money, providers of small-scale payment services and also securities traders, insurers, reinsurance companies etc. In relation to these persons, pursuant to the Act on Money Laundering (Article 56) the CNB is authorised to issue a decree designating the requirements for the introduction and application of a system of internal principles, processes of control measures by certain credit and financial institutions for the fulfilment of certain duties designated by the Act on Money Laundering. And pursuant to Article 15 paragraph 2 [of Act No. 69/2006 Coll., on the Enacting of International Sanctions](#), the CNB is entrusted with supervising adherence to this act, which designates certain natural and legal persons during the enacting of international sanctions with the aim of maintaining or restoring international peace and security, protection of basic human rights and the fight against terrorism, and is for banks, branches of international banks and persons to whom permits are granted under the Foreign Exchange Act (Act No. 219/1995 Coll.).

When conducting its activities, the CNB works closely with the FAU, to whom the liable persons announce suspicious transactions (Article 18 of the Act on Money Laundering). In the case of a breach of duties designated by the Act on Money Laundering, the FAU is authorised to impose fines for such a violation. If the MF discovers that a legal or natural person having revenues from entrepreneurial or other independent gainful activity has grossly or repeatedly breached any of the duties designated in the Act on Money Laundering or imposed by a decision issued pursuant to this act, pursuant to the Act on Money Laundering (Article 36) the MF may submit a suggestion for the cancellation or revocation of authorisation for entrepreneurial or other independent gainful activity on the revocation of which the MF is authorised to decide according to another legal regulation (if it involves subjects coming under the competence of the CNB, this body is the CNB). The CNB is then obliged within 30 days from the delivery of the suggestion to inform the MF of its steps and about the method of dealing with the suggestion. The FAU provides other supervisors with information from its own activity necessary for the exercise of administrative oversight. The Czech Banking Association organises an event called “Prevention of Financial Crime”, which is held every year at Police Headquarters.

Pursuant to the Act on Money Laundering the CNB is obliged to inform the FAU if during the exercise of oversight it discovers facts which could be associated with money laundering or

terrorism financing. Before on-site examination at the place of a specific institution, the CNB will ask the FAU to provide information concerning the supervised person. The CNB provides conclusions from on-site examination which concerns the matter of money laundering on the basis of an agreement concluded with the MF (FAU).

Within the framework of the legislative process the CNB participates in the comment procedure for bills in compliance with Governmental Legislative Rules, i.e., specifically for the Act on Money Laundering.

- 2. The supervisor must be satisfied that banks have in place adequate policies and processes that promote high ethical and professional standards and prevent the bank from being used, intentionally or unintentionally, for criminal activities. This includes the prevention and detection of criminal activity, and reporting of such suspected activities to the appropriate authorities.**

COMPLIANT

Regulation:

The Act on Money Laundering (Article 21) imposes upon a bank and credit union a duty to introduce and apply corresponding internal control and communication processes with the aim of complying with the duties designated by this law (this duty also applies to branches of foreign banks). In this Article the law also imposes a duty to prepare, in writing and in the scope of the valid permits or authorisations for activities subject to the applicability of the Act on Money Laundering, a written system of internal principles, processes and control measures for meeting the duties designated by this act (referred to hereinafter as “system of internal principles”). This law also specifies (Article 21 paragraph 5) what the system of internal principles must contain. The relevant institution is obliged to deliver the system of internal principles, including notification of changes to it, to the FAU and CNB at the latest 30 days from the day when it became a person subject to the Act on Money Laundering or from the adoption of a change in the system of internal principles.

Supervision:

Checking of the system of internal principles and supervision of performance of duties designated by the Act on Money Laundering and Decree on Prevention of Money laundering is in particular a subject of the performance of CNB supervision in the form of on-site examination. The CNB requires that banks and credit unions ensure that the designation of authorisations and responsibilities of individual officers of the bank or credit union in the system of internal principles is sufficiently directed and specific, i.e., it must be evident where and for what area they are responsible. It is expected that the system of internal principles will not merely copy the provisions of the law at the general level, but that it will be prepared in greater detail. All staff of the relevant institution who could come up against suspicious transactions when performing their duties should be acquainted with this internal regulation and should be sufficiently trained. The non-preparation of a system of internal principles constitutes an administrative delict pursuant to the Act on Money Laundering for which a fine of up to CZK 1 million is imposed.

- 3. In addition to reporting to the financial intelligence unit or other designated authorities, banks report to the banking supervisor suspicious activities and incidents of fraud when they are material to the safety, soundness or reputation of the bank.**

LARGELY COMPLIANT

Regulation:

Banks and credit unions are obliged to announce to the CNB facts which could threaten the safety of the bank or credit union or their financial stability. But they do not announce to the CNB criminal acts committed pursuant to the Criminal Code, and for this reason the assessment degree was reduced to “largely compliant”. Liable persons perform this obligation to notify the FAU. However, banks and credit unions have a quarterly obligation to disclose to the CNB information about the largest loss events of operational risk for the past period. One part is reporting of any suspected frauds with a heavy loss if they are amongst the largest loss events of the bank or credit union, and the CNB is authorised to request additional information for the loss events of operational risk thus announced.

4. The supervisor is satisfied that banks establish “know-your-customer” (KYC) policies and processes which are well documented and communicated to all relevant staff. Such policies and processes must also be integrated into the bank’s overall risk management. The KYC management programme, on a group-wide basis, has as its essential elements:

- **a customer acceptance policy that identifies business relationships that the bank will not accept;**
- **a customer identification, verification and due diligence programme; this encompasses verification of beneficial ownership and includes risk-based reviews to ensure that records are updated and relevant;**
- **policies and processes to monitor and recognise unusual or potentially suspicious transactions, particularly of high-risk accounts;**
- **escalation to the senior management level of decisions on entering into business relationships with high-risk accounts, such as those for politically exposed persons, or maintaining such relationships when an existing relationship becomes high-risk;**
- **clear rules on what records must be kept on consumer identification and individual transactions and their retention period. Such records should have at least a five year retention period.**

COMPLIANT

Supervision:

When performing oversight the CNB verifies the fulfilling of Article 21 paragraph 5 and Article 25 paragraph 5 of the Act on Money Laundering, i.e., whether the system of internal principles of a liable person contains the prescribed particulars and how this system works in practice. This involves in particular

- a) a detailed demonstrative listing of traits of a suspicious transaction which could be present for the activity of a specific liable person,
- b) method of identifying a client, including measures for identifying politically exposed persons and subjects against which the Czech Republic is enforcing international sanctions pursuant to the Act on the Enacting of International Sanctions,
- c) processes for performing a check on a client and designating the scope of checking of a client corresponding to the risk of money laundering and terrorism financing depending on the type of client, business relationship, product or transaction,
- d) commensurate and appropriate methods and processes for risk assessment, risk management, internal control and ensuring control of adherence to duties designated by the Act on Money Laundering,
- e) process for making available to the relevant bodies data kept pursuant to part two of Chapter II (archiving information) of the Act on Money Laundering,
- f) process of liable person from ascertainment of suspicious transaction up to the moment

of delivery of notification to the MF in such a way that the period designated in Article 18 paragraph 1 is adhered to, as are the rules for processing of a suspicious transaction and designation of persons who assess the suspicious transaction,

- g) the rules and processes by which third parties acting on behalf of or to the account of a liable person abide when offering the services or products of the liable person,
- h) measures which preclude or fundamentally frustrate the securing of proceeds from crime, by immediate performance of client's instruction,
- i) technical and personnel measures which ensure the making of a delay in the performance of a client's instruction pursuant to Article 20, and in the designated period for performance of information duty pursuant to Article 24,
- j) in cases given in the Act on Money Laundering (Article 25 paragraph 4), description of additional measures for effective handling of the risk of money laundering or terrorism financing.

The system of internal principles of a bank or credit union is approved by its Board.

As the administrative body, the CNB determines whether the bank, credit union or branch of a foreign bank adheres to the provisions of the Decree on Prevention of Money laundering. This involves in particular performance of duties when identifying a client, suspicious transaction, introduction and application of system of internal principles.

When performing oversight the CNB also checks compliance with the provision of Article 16 of the Act on Money Laundering concerning the archiving of information gained when performing client identification. Pursuant to this provision of the act, the liable person keeps data and documents about transactions associated with identification duty for at least 10 years from the end of the relationship with the client.

5. The supervisor is satisfied that banks have enhanced due diligence policies and processes regarding correspondent banking. Such policies and processes encompass:

- **gathering sufficient information about their respondent banks to understand fully the nature of their business and customer base, and how they are supervised; and**
- **not establishing or continuing correspondent relationships with foreign banks that do not have adequate controls against criminal activities or that are not effectively supervised by the relevant authorities, or with those banks that are considered to be shell banks.**

COMPLIANT

Regulation:

The Act on Money Laundering (Article 25) forbids a bank, credit union or branch of a foreign bank operating on the territory of the Czech Republic from establishing a correspondent banking relationship with a foreign credit or similar institution,

- a) recorded in a commercial or similar register in a country in which neither it nor its real management is physically present and which is not affiliated to any regulated financial group,
- b) about which it is known that it allows the use of its accounts by the institutions shown in a), or
- c) which does not apply measures against money laundering and terrorism financing at least equal to the requirements of EC law.

If a bank, credit union, branch of a foreign bank operating on the territory of the Czech Republic has already established such a relationship, it must end it as soon as possible.

Before establishing a correspondent banking relationship with a correspondent institution, a bank or credit union is obliged to gather sufficient information about the correspondent institution and the nature of its trading, to ascertain the quality of oversight which the correspondent institution is subject to, and to assess the measures performed by the correspondent institution against money laundering and terrorism financing.

The Board of a credit institution or head of branch of a foreign credit institution operating on the territory of the Czech Republic must issue consent for the establishment of a correspondent banking relationship.

6. The supervisor periodically confirms that banks have sufficient controls and systems in place for preventing, identifying and reporting potential abuses of financial services, including money laundering.

COMPLIANT

Supervision:

The abuse of a bank or credit union for money laundering may threaten the reputation and consequently the stability of these financial subjects. On-site examination in particular play a decisive role in the involvement of the CNB in the fight against money laundering. During an examination the CNB abides by the legal regulations of the Czech Republic, and it also takes into account the recommendations and standards issued by various international organisations, such as the International Monetary Fund, the World Bank and the Bank for International Settlements. The CNB also proceeds from the recommendations of the Financial Action Task Force (FAT) issued in 2003 (Forty Recommendations) and its addenda and revisions concerning the fight against terrorism financing.

For ensuring the fulfilment of supervisory and oversight functions arising from the Act on Money Laundering, from [Act No. 21/1992 Coll., on Banks, as amended](#) (referred to hereinafter as the “Act on Banks”) and from [Act No. 87/1995 Coll., on Credit Unions and Certain Related Measures and on the Amendment of Czech National Council Act No. 586/1992 Coll., on Income Tax, as amended, as amended](#) (referred to hereinafter as “Act on Credit Unions“) the CNB has processed an internal methodology containing a highly detailed CNB process for verifying the identification of clients by banks and credit unions, assertion of the KYC principles, archiving of identification data about clients and transaction records, ensuring, assessing and reporting suspicious transactions, system of internal principles, processes and control measures for the prevention of money laundering and terrorism financing, training of staff in the area of money laundering, internal control mechanisms.

7. The supervisor has adequate enforcement powers (regulatory and/or criminal prosecution) to take action against a bank that does not comply with its obligations related to criminal activities.

COMPLIANT

Regulation:

The Act on Money Laundering designates that the supervisor of performance of duties designated by this act is

- a) the FAU, which at the same time checks to ensure that there is no money laundering or terrorism financing by liable persons, and
- b) the CNB for liable persons which it oversees.

The acts qualified as administrative delicts associated with non-performance of duties pursuant to this act are defined in the Act on Money Laundering, as are the sanctions for such violations (fines). The FAU imposes these fines. If the FAU discovers that a liable person has grossly or repeatedly breached any of the duties designated in this act or imposed by a decision issued pursuant to this act, it will submit a suggestion for the cancellation or revocation of authorisation for entrepreneurial or other independent gainful activity to the body which is authorised to decide on its revocation pursuant to another legal regulation. This body is obliged within 30 days from the delivery of the suggestion to inform the MF of its steps and about the method of dealing with the suggestion.

The Act on Banks [Article 26 paragraph 3b)] and Act on Credit Unions [Article 28 paragraph 4b)] describe a breach of special acts (which in this case is the Act on Money Laundering), other legal regulations for example [Decree No. 123/2007 Coll., stipulating the prudential rules for banks, credit unions and investment firms](#) (referred to hereinafter as the “Prudential Rules Decree”), and Decree on Prevention of Money laundering as a shortcoming in activities. If the Czech National Bank discovers that a bank or credit union is in breach of the Act on Money Laundering or relevant decree, it is obliged to take remedial or sanction steps against the given subject.

If when exercising oversight the CNB discovers that criminal activity is occurring in the bank or credit union, the general obligation to notify given by the criminal law applies to the CNB.

8. The supervisor must be satisfied that banks have:

- **requirements for internal audit and/or external experts to independently evaluate the relevant risk management policies, processes and controls. The supervisor must have access to their reports;**
- **established policies and processes to designate compliance staff at the management level, and appointed a relevant dedicated officer to whom potential abuses of the bank’s financial services (including suspicious transactions) shall be reported;**
- **adequate screening policies and processes to ensure high ethical and professional standards when hiring staff; and**
- **ongoing training programmes for their staff on KYC and methods to detect criminal and suspicious activities.**

COMPLIANT

Regulation:

The Prudential Rules Decree requires that a bank or credit union establish and maintain principles and processes for ensuring the risk management function, internal audit function and compliance function. The subject of performance of oversight is a verification that in practice a bank or credit union fulfils the designated requirements associated with ensuring risk management function, internal audit function and the compliance function. This involves verification that a bank or credit union has a comprehensive document concerning the approach to risk management, internal audit and compliance ensuring, how risk management, internal audit and compliance ensuring is organised, how the systematic education of staff dealing with ensuring risk management, internal audit and compliance is ensured, how the access of compliance officers to the relevant information is ensured in internal regulations, how the management is informed of the findings revealed when ensuring the performance of the risk management function, the internal audit function and the compliance function etc. From the title of exercise of supervision the CNB has access to the reports concerning internal audit, risk management and compliance function. The CNB determines whether, in

compliance with the Act on Money Laundering, a bank or credit union has designated staff for ensuring ongoing contact and exchange of information with the FAU and performance of obligation to notify pursuant to the Act on Money Laundering, whether this officer submits to the Board and supervisory body of the bank or credit union a report at least once a year assessing the activity of the credit institution in the area of prevention of money laundering and terrorism finance, and whether the other requirements designated by the Prudential Rules Decree and Decree No 281/2008 Coll. are met. In the context of the exercise of oversight, the CNB also determines whether a bank or credit union has an internal regulation prepared which includes the process for identifying and describing transactions which could serve for money laundering.

In General terms and also in the context of ensuring prevention of money laundering, CNB determines whether a bank or credit union has prepared and designated principles for human resource management for the selection of staff, including principles to ensure that all activities are performed by qualified staff with corresponding knowledge and skills and how these principles are complied with and checked in practice. The CNB determines whether in a bank or credit union there is designation and application of rules clearly formulating the ethical fundamentals and anticipated models of behaviour and action of staff in compliance with these principles. The CNB also determines whether a regulated subject has designated principles and internal processes regulating internal reporting of a suspicious transaction.

Supervision:

In the context of the performed inspections, the CNB also examines whether there is compliance with the requirements of the Act on Money Laundering concerning the duty to regularly train staff in the area of money laundering prevention, i.e., to check whether in the bank or credit union a person has been designated who is responsible for ensuring training programmes and whether such a person truly fulfils his duties. This person is responsible for assembling a training plan which should contain both training intended for specialists in the area of money laundering and for selected staff who may come into contact with suspicious transactions or for other staff where training has a primarily preventative significance. The CNB determines whether the liable person has ensured training for prevention of money laundering in compliance with the Act on Money Laundering and Decree on Prevention of Money Laundering, whether all persons who may come into contact with suspicious transactions are trained before being appointed to positions where they may come into contact with suspicious transactions, whether records of participants (an attendance register) is kept, whether the training is augmented with new findings, and whether the knowledge of persons is checked.

When exercising oversight the CNB regularly determines whether banks and credit unions have implemented the requirements for internal audit designated by the Prudential Rules Decree. The correct configuration of the system of activities for internal audit is an essential requirement for the reliability of outputs from the internal audit, the aim of which is an independent verification of all activities of the regulated subject in connection with their risk level. From the title of exercise of supervision the CNB has access to the reports of internal audit or other person, for example, external auditor if the bank or credit union has outsourced a certain act of the internal audit to an external auditor or third party.

9. The supervisor determines that banks have clear policies and processes for staff to report any problems related to the abuse of the banks' financial services to either local management or the relevant dedicated officer or to both. The supervisor also

confirms that banks have adequate management information systems to provide managers and the dedicated officers with timely information on such activities.

COMPLIANT

Regulation:

The basic requirements are designated by the Act on Money Laundering in Article 18, Article 21, Article 22 and Article 25.

The Decree on Prevention of Money Laundering specifies further the requirements of the specified act. Specifically it states that if during the assessment of a transaction a liable person ascertains facts indicating that a client is performing a suspicious transaction,

- a) it will prepare a suspicious transaction notification (referred to hereinafter as “notification”) and send it to the contact person for further assessment within the period designated by the system of internal principles,
- b) in the notification propose deferral of enacting the client’s instruction if by immediate performance of the client’s instruction the securing of proceeds from crime would be precluded or fundamentally frustrated.

The notification must also contain such data about the client or its transactions as would allow the contact person to assess whether it is a suspicious transaction. The responsible persons must have access to the information contained in the information system which allows effective searching, monitoring and assessment of information necessary for realising the intent of the act and complying with the requirements designated by the Decree on Prevention of Money Laundering.

The Prudential Rules Decree contains requirements for risk management which include requirements concerning information systems. Pursuant to this decree (Article 21 paragraph 1) the information system must be configured in such a way as to provide current, reliable and effective information for the performance of the designated activities and thus enable the management of the bank or credit union to perform its function effectively, including the area of preventing money laundering.

Supervision:

For the conducting of supervision concerning money laundering the CNB has prepared an internal methodology. One part of on-site examination is an evaluation of the method for archiving records of internal reports of suspicious transactions sent by an officer of a bank or credit union to the entrusted person of this institution for further assessment, and whether the information system of a bank or credit union is configured in such a way as to allow the management of the bank or credit union or entrusted staff to gain timely and full information about cases where there may be abuse of the financial institution for money laundering or terrorism financing. The requirement of the ability to reconstruct decision-making activities also applies for this process (Prudential Rules Decree).

10. Laws and regulations ensure that a member of a bank’s staff who reports suspicious activity in good faith either internally or directly to the relevant authority cannot be held liable.

LARGELY NON-COMPLIANT

Regulation:

The criterion requiring protection of an officer who reports suspicious activity in good faith is

not expressly covered by laws. The Act on Money Laundering imposes a duty on a person to announce to the FAU suspicious transactions which the liable person discovered in connection with its activity. The announcement should be made without undue delay, at the latest within five working days from the discovery of the transaction. Should the circumstances of the case require it, in particular if there is a danger in delay, the liable person will announce a suspicious transaction immediately after discovering it. By not reporting a suspicious transaction the liable person commits an administrative delict and may be fined up to CZK 5 million by the FAU (Article 46). If by non-performance of the notification obligation the securing or drawing of the yields of crime was prevented or hampered or terrorism financing was permitted, the law allows the imposition of a fine of up to CZK 50 million.

In Article 38 of the Act on Banks it is stated that giving data about a client and its transactions in the case of the submission of a criminal complaint or when discharging the obligation to notify pursuant to the Act on Money Laundering or Act on International Transactions does not constitute a breach of duty to maintain banking secrecy. Pursuant to Article 25b of the Act on Credit Unions a credit union is obliged to maintain the confidentiality of and protect from abuse data about its member and about its transactions with the credit union. The announcing of data about a member of a credit union and its transactions in the case of the submission of a criminal complaint or when discharging the obligation to notify pursuant to a special act against money laundering does not constitute a breach of duty to maintain banking secrecy.

The Prudential Rules Decree requires (Article 15 paragraph 2) that the Board ensures the designation of rules which clearly formulate the ethical principles and expected models of behaviour and action of staff in compliance with these principles and that it enforces these rules. The incorporation of the general duty to point out the shortcomings in the activity of an institution or dubious transactions and operations should be a part of the internal control system. If within the internal control system a bank or credit union establishes a whistle-blowing mechanism, pursuant to Article 34 paragraph 2 of the decree it is obliged to ensure that this mechanism is available to all staff and to preserve the confidentiality of the officer who uses whistle blowing in order to announce concerns about the functionality or effectiveness of the system of governance or its component, i.e., including the system of internal principles and processes against money laundering.

The cited laws regulate the duties associated with the prevention of money laundering, but they do not ensure that when discharging their legal duties the liable persons ensure corresponding protection for staff who report suspicious activity in good faith. For this reason the assessment degree was designated as “largely non-compliant”.

Supervision:

During supervision in banks and credit unions the CNB determines how the duty to report suspicious transactions in the relevant institution is dealt with by the internal regulations or how the Act on Money Laundering is implemented in the institution. An institution should prove that it has an internal regulation the content of which is the ensuring of the duty of each officer to report a suspicious transaction if he discovers one during the performance of his activity and the method by which the officer should proceed when reporting a detected suspicious transaction.

11. The supervisor is able to inform the financial intelligence unit and, if applicable, other designated authority of any suspicious transactions. In addition, it is able,

directly or indirectly, to share with relevant judicial authorities information related to suspected or actual criminal activities.

COMPLIANT

Pursuant to Article 25a of the Act on Banks all persons performing banking supervision are obliged to preserve the confidentiality of all data gained in connection with the performance of their profession, employment or function. But the provision of information gained during banking supervision whilst adhering to legal conditions to the following parties does not constitute a breach of confidentiality duty:

- a) public bodies in connection with the fight against money laundering or the enacting of international sanctions with the aim of maintaining international peace and security,
- b) body responsible for criminal proceedings.

A similar regulation for credit unions concerning the breaking of confidentiality duty is contained in Article 25a of the Act on Credit Unions.

12. The supervisor is able, directly or indirectly, to cooperate with the relevant domestic and foreign financial sector supervisory authorities or share with them information related to suspected or actual criminal activities where this information is for supervisory purposes.

COMPLIANT

Regulation:

Pursuant to the Act on Banks (Article 25a) all persons performing banking supervision are obliged to preserve the confidentiality of all data gained in connection with the performance of their profession, employment or function. The provision of information gained during banking supervision whilst adhering to legal conditions to public bodies and other persons in EU member states in connection with the fight against money laundering or the enacting of international sanctions with the aim of maintaining international peace and security, protection of basic human rights and the fight against terrorism does not constitute a breach of confidentiality duty. Information gained in connection with the performance of banking supervision may also be provided to international organisations operating in the area of the fight against crime and also to bodies of foreign states responsible for criminal proceedings for the fulfilment of their functions.

A similar regulation concerning the breaking of confidentiality duty is contained in Article 25a of the Act on Credit Unions.

Pursuant to the Act on Banks (Article 38) and Act on Credit Unions (Article 25 paragraph 3), information about a client and its transactions in the case of the submission of a criminal complaint or when discharging the obligation to notify pursuant to a special legal regulation about the fight against money laundering or special legal regulation on the enacting of international sanctions with the aim of maintaining international peace and security, protection of basic human rights and the fight against terrorism is not considered a breach of banking secrecy or breach of duty of confidentiality.

Additional criterion

1. If not done by another authority, the supervisor has in-house resources with specialist expertise for addressing criminal activities.

Irrelevant.

The area of the fight against crime comes under the competence of the Ministry of the Interior (investigation) and Ministry of Justice (punishment).

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.

Overall Assessment of the Principle:

COMPLIANT

Essential criteria:

In compliance with [Act. No. 6/1993 Coll., on the Czech National Bank, as amended](#) (referred to hereinafter as “Act on Czech National Bank”), the CNB should care for the secure functioning and development of the financial market in the Czech Republic and contribute to the stability of its financial system as a whole. In order to secure these tasks a corresponding comprehensive complex of tools must be created to ensure the acquisition of sufficient information and data about the supervised subjects. For this reason one essential precondition is that banking supervision has sufficient and qualified human resources for methodological, analytical and control activity and that these employees be capable of grasping and comprehending the latest trends in the activities of the banks and credit unions and their groups, including risks associated with these activities which may, if not duly dealt with and regulated if necessary, threaten the security, financial health and stability of the subject itself and the sector as a whole. In order to ensure the effective activity of banking supervision an entire range of methodological principles and processes have been created for recording and assessing all activities of regulated subjects and processes for the adopting of measures if the results were to signal a danger threatening a regulated subject.

Additional criterion:

In support of the designation of an institution’s risk profile, the CNB has at its disposal an automated information system allowing a calculation of the institution’s assessment from the aspect of quantitative and qualitative aspects. The CNB does not have a prepared methodology with automated support which would wholly enable the complex assessment of the future development of the risk profile of banks and credit unions and forecast and actively resolve any serious threat to the banking sector’s stability arising from existing and emerging risks. But the CNB does have an automated Risk Assessment System (RAS), it regularly performs analyses of the financial situation of the individual banks and credit unions and prospective stress tests of the individual banks and the banking sector as a whole making it possible to reveal, to the greatest possible extent and in good time, potential weaknesses and to prepare suitable remedial measures.

Analysis of individual criteria

Essential criteria:

- 1. The supervisor has policies and processes in place to develop and maintain a thorough understanding of the risk profile of individual banks and banking groups.**

COMPLIANT

Regulation:

Pursuant to the Act on the CNB, the CNB is the central bank of the Czech Republic and is also the body supervising the Czech Republic's financial market. When conducting banking supervision, the CNB, pursuant to Article 25 paragraph 3 [Act No. 21/1992 Coll., on Banks, as amended](#) (referred to hereinafter as the "Act on Banks") and pursuant to Article 28 paragraph 1g) [of Act No. 87/1995 Coll. on Credit Unions and Certain Related Measures and on the Amendment of Czech National Council Act No. 586/1992 Coll., on Income Tax, as amended, as amended](#) (referred to hereinafter as "Act on Credit Unions) examines and assesses whether the arrangement, strategy, processes and mechanisms introduced by a bank or credit union and the capital of the bank or credit union ensure their safe and reliable operation and the coverage of risk to which they are or might be exposed. For more detail see Principle No. 1 and its performance.

Supervision:

For each credit institution a separate analysis of its financial situation and the risks it faces is prepared once a quarter. This analysis contains an evaluation on a solo and consolidated basis. Should shortcomings or risks in the development of the institution be identified, remedial measures are proposed. In the case of building societies analyses are only prepared separately at the end of the calendar year, and in the course of the year brief, summarised quarterly analyses of the development of this sub-sector are prepared.

In support of the designation of a bank's risk profile, there is also available an automated information system allowing a calculation of the institution's assessment from the aspect of quantitative and qualitative aspects. The system assesses the bank's exposure to individual risks (primarily via quantitative indicators based on regular reporting and augmented if needs be with qualitative assessment of exposure - for example in the case of risk to reputation) and the standard of the managing and control environment in the bank (via qualitative questions generally based on the content of supervision performed during on-site examination). There are four degrees for the assessment of the individual elements (A-B-C-D), and these elements are then weighted for the final assessment. One of the outputs of the system is the institution's rating, on the basis of which institutions are divided up into five groups characterised by a similar extent of problems. Bank ratings are submitted to the CNB board for discussion half yearly.

2. The supervisor monitors and assesses trends, developments and risks for the banking system as a whole. The supervisor also takes into account developments in non-bank financial institutions through frequent contact with their regulators.

COMPLIANT

Regulation:

Pursuant to the Act on the CNB, the CNB is the integrated body supervising the Czech Republic's financial market as a whole. For more detail see Principle No. 1 and its performance.

Supervision:

In the context of performing banking supervision, the CNB also evaluates on an ongoing basis the banking sector as a whole from the aspect of its financial situation, the risks faced and development of trends. A report on the development of the banking sector and the most significant banks is prepared once a quarter for the banking board of the CNB.

Once a year a report on the performance of financial sector supervision is prepared, which is intended for legislative and executive bodies of state administration and the professional and general public. This report also contains a description of the individual sectors of the financial market and the risks faced. The basic indicators of development of the banking sector and sector of credit unions are published every quarter on the web pages of the CNB.

During its evaluation of the banking sector's development, supervision cooperates with the other CNB units, in particular with the financial stability unit, which processes its own analyses from the aspect of the mutual interaction of the individual sectors of the financial market and real economy, including performance of parallel testing on the resilience of the sector of banks and insurance companies. The so-called macrofinancial stability panel, which was established in the CNB in 2009 as a forum for the exchange of current information amongst the relevant CNB sections (financial stability, currency policy, bank transactions, risk management, financial market supervision), also participates in the quarterly discussions.

Another significant element during the assessment of the banking sector's development is cooperation at an international level, either bilateral cooperation with foreign partner supervisors or within the structures of various international organisations or institutions. One example is the active involvement of banking supervision staff in the activities of the European Central Bank's (ECB) working groups or the European Banking Authority (EBA) concerning development trends in banking and its regulation and supervision from the aspect of the single European market for financial services. Banking supervision also communicates with ratings agencies and monitors the assessments they issue for the development of individual banks and the banking sector as a whole.

3. The supervisor uses a methodology for determining and assessing on an ongoing basis the nature, importance and scope of the risks to which individual banks or banking groups are exposed. The methodology should cover, inter alia, the business focus, the risk profile and the internal control environment, and should permit relevant comparisons between banks. Supervisory work is prioritised based on the results of these assessments.

COMPLIANT

Regulation:

Pursuant to the Act on Banks (Article 25 paragraph 3) and pursuant to the Act on Credit Unions [Article 28 paragraph 1g)] the CNB examines and assesses whether the arrangement, strategy, processes and mechanisms introduced by a bank or credit union and the capital of bank or credit union ensure their safe and reliable operation and the coverage of risks to which they are or may be exposed, and the examination and evaluation is performed in a scope and periodicity commensurate with the size, significance and status of the bank or credit union, on the market and character, scope and complexity of its activities, at least once a year. See also Principle No. 1 and its performance.

Supervision:

The practical supervision of banks and credit unions is to a large extent formalised. The methodology for defining and assessing the essence, importance and scope of risks to which the individual banks are exposed is contained in the following CNB internal documents:

- off-site supervision manual,
- administrative proceedings manual, which contains the processes for licensing and imposing remedial measures,

- methodology for checking credit risk during on-site examination,
- methodology for checking market risks during on-site examination,
- methodology for checking internal control system and internal audit during on-site examination,
- methodology for checking operational risk management, including information systems and technologies during on-site examination,
- methodology for reflecting ensuring in compliance with the relevant Basel agreement, currently Basel II,
- RAS methodology

There is a progressive processing of processes and benchmarks for stress testing, compliance, money laundering, assessment of banks in the area of the individual risks and internal audit. These internal documents define the standard processes which are applied during the conducting of supervision. They are updated as needs be and on the basis of experience from the performance of supervision.

The basic analyses of a bank or credit union, which are prepared on a quarterly, half-yearly and annual basis, constitute a significant input used for designating priorities for the conducting of supervision. These analyses contain an assessment of all areas of the activities of a bank or credit union, including assessment of significant facts influencing the development of the bank or credit union, and they differ only in the degree of detail

4. The supervisor confirms banks' and banking groups' compliance with prudential regulations and other legal requirements.

COMPLIANT

Regulation:

Pursuant to the Act on the CNB, the CNB performs banking supervision on a solo and consolidated basis, and this supervision also covers adherence to the relevant laws and checking adherence to decrees and measures issued by the CNB. For more detail see Principle No 1 and its performance.

Supervision:

Pursuant to the Act on the CNB, the CNB is the body supervising the financial market. In Article 44 of this Act the persons whom the CNB supervises and what this supervision includes are given. This includes, inter alia, adherence to laws if it is authorised for this supervision and by this law or special legal regulation, and the checking of adherence to decrees or measures issued by the CNB, the gaining of information necessary for performing supervision according to special legal regulations and their enforcement, verification of their truthfulness, completeness and current validity, imposition of remedial measures and sanctions pursuant to this act or special legal regulations, proceedings concerning administrative delicts and offences. The CNB also supervises the persons shown in Article 44 paragraph 1 of the Act on the CNB on a consolidated basis or in a group, and it performs additional supervision of these persons in financial conglomerates in the scope designated by special legal regulations. The CNB verifies adherence to prudential trading rules and other duties of banks and credit unions as part of off-site supervision (in particular on the basis of checking announcements and returns whilst utilising the banking supervision information system) and during on-site examination as part of supervision.

5. The supervisor requires banks to notify it of any substantive changes in their activities, structure and overall condition, or as soon as they become aware of any

material adverse developments, including breach of legal or prudential requirements.

COMPLIANT

Regulation:

In general terms it applies that banks and branches of foreign banks are obliged to submit to the CNB, on the basis of its requirement, all information necessary to conduct supervision on a solo and consolidated basis (Article 24 of Act on Banks).

Pursuant to the Act on Banks (Article 1 paragraph 4) a bank must not conduct business activities other than those permitted for it in the licence. If the bank intends to conduct activities beyond the scope of the licence, it is obliged to apply for a change of licence in compliance with legal regulation. But the group of potential activities which a bank can perform is limited by laws. As a rule banks announce changes in activities which are performed in compliance with the issued licence, for example introduction of a new product within the framework of the permitted activities, and this is during discussions of CNB with the bank's senior management about bank strategy or in the annual reports which banks are obliged to submit to the CNB pursuant to Article 23 paragraph 1 of the Act on Banks.

Pursuant to the Act on Banks (Article 9 paragraph 2) a bank is also obliged to file with the CNB a verified copy of the articles of association and amendments thereto, and a bank is obliged to inform the CNB in advance of proposals for amendments to certain obligatory provisions of the articles of association (Article 16 paragraph 2a) of the Act on Banks). Pursuant to the Act on Banks (Article 16 paragraph 2) proposals for personnel changes in the Board of the bank and positions of senior officers of the bank and intention to establish a legal person abroad or take a property stake in it are also subject to the information duty. In defined cases the new persons are assessed by the CNB. Pursuant to the Act on Banks (Article 16a) a bank is also obliged to inform the CNB in writing of an intention to open a branch or representation abroad, of the intention to provide services abroad without establishing a branch and of any discriminatory measures of the state on the territory of which the branch or representation abroad operates or should operate or on the territory of which the services are or should be provided without the establishment of a branch.

The Act on Banks (Article 26b) imposes upon banks a duty to inform the CNB without delay if the Board or supervisory board discovers that the bank is or will become insolvent or that the bank has suffered or will probably suffer losses which cause or could cause a drop in the capital of the bank on a solo basis to a point below two thirds of the sum of individual capital requirements in the sense of the law. But no further explicit requirement which would impose upon a bank or its bodies a duty to announce automatically any deterioration in activity, including breach of laws and rules of prudential trading, is designated (but this does not affect the duty to submit the requisite information and source documents pursuant to Article 41 paragraph 2 and 3 of the Act on the CNB and annual written report containing qualitative and quantitative information about the reliable, effective and full strategies and processes for determining, assessing on an ongoing basis and maintaining the designated capital at such a level and in such a structure and configuration as to cover adequately the risks to which the bank or credit union is or could be exposed; a bank and credit union is obliged to establish and maintain this system of internally designated capital pursuant to Article 12c of the Act on Banks, or pursuant to Article 8a of the Act on Credit Unions, and information about fundamental change compared with the preceding period constitutes a statutory component of the annual information). Pursuant to the Act on Banks (Article 24 paragraph 1) and the Act

on Credit Unions (Article 27 paragraph 3), the CNB also has the right to require information, documents and other materials necessary for the exercise of supervision. Breaches of designated limits and certain other information characterising the bank's situation are also evident from the content of the regularly submitted returns.

The Act on Credit Unions incorporates certain information duties or requirements associated with changes in significant areas of a credit union's activity. Pursuant to the Act on Credit Unions [Article 1 paragraph 5a)] a credit union is authorised to perform only those activities designated by this act, and this only in the scope of the permit to operate as a credit union. Any changes in the scope of the issued permit are subject to approval by the CNB. In the case of personnel changes on the Board, control and credit committee and managers, a credit union submits a request to the CNB for the assessment of conditions for performance of function, including documents certifying the meeting of these conditions (Article 7 paragraph 7 of the Act on Credit Unions). The Act on Credit Unions (Article 28a) also imposes on the Board or control committee a duty to inform the CNB without delay if the credit union is or will become insolvent or credit union has suffered or will probably suffer losses which cause or could cause a drop in the capital of the credit union to the assets below the ratio designated by the CNB.

When performing supervision the CNB actively utilises the contacts with representatives of the supervised credit institutions and conducts a dialogue with the management of all credit institutions concerning the current situation in the individual subjects. In the event of negative information discussions are instigated immediately with the representatives of the relevant credit institution, where the matter is discussed in detail. The discussions serve as the basis for a decision on the further procedure.

6. The supervisor has an adequate information system which facilitates the processing, monitoring and analysis of prudential information. The system aids the identification of areas requiring follow-up action.

COMPLIANT

Supervision:

For the purpose of banking supervision banks and branches of foreign banks submit in particular information in the framework of regular reporting. Banks submit basic accounting returns, i.e., the profit and loss return and additional information for these returns where there is a detailed specification of, for example, receivables, payables, securities, depreciation of receivables, derivatives, repo-operations, reconciliation of provisions and reserves etc., and also returns and notifications concerning capital adequacy, commitment, categorisation of receivables, interest rate risk in banking book, residual maturity of assets and liabilities, concentration according to countries and individual products, mortgage bonds and mortgage loans, electronic banking, organisational structure of bank etc. Notifications (a smaller number of them) are also required on a consolidated basis. The ICD (Supervision Information Centre) is used to analyse the information, and this centre enables effective work with data from regular returns and announcements saved in the primary database. This system allows the flexible selection of data for individual subjects on the financial market (banks, insurance companies, credit unions etc.) and for individual sectors and defined groups of subjects. It also enables the consistent creation and use of derived calculation indicators, and the creation of standard output arrays allowing uniform evaluation of subjects (for example, so-called signalling information focussing on prompt assessment of monthly development in the individual banks, and it warns of negative development which must be checked promptly,

uniform tables for regular quarterly assessments of a bank, bank rating etc.). The announcements on a solo basis are primarily monthly, and banks submit consolidated returns quarterly.

Credit unions submit a similar set of information, but its scope is narrower in certain cases in view of the limited nature of activity.

Additional criterion

- 1. The supervisor employs a well defined methodology designed to establish a forward-looking view on the risk profile of banks, positioning the supervisor better to address proactively any serious threat to the stability of the banking system from any current or emerging risks.**

COMPLIANT

Supervision:

See in part essential criterion 1. The CNB does not have a methodology with automated information support for complex assessment of further development of banks' risk profile, and it is not considering its preparation. But the CNB does regularly perform analyses of the financial situation of banks and credit unions and stress tests of the individual banks and the banking sector as a whole making it possible to reveal in good time potential weaknesses and to prepare suitable remedial measures.

The stress tests are performed on the one hand by the CNB itself on the basis of data available from regular regulatory reporting of the supervised subjects (so-called top-down stress-test) for all banks operating in the Czech Republic, and in 2009 the CNB also introduced bottom-up stress tests in cooperation with significant selected banks representing more than 70% of all the assets in the banking sector in the Czech Republic. Banks count the impacts of credit risk arising from macroeconomic scenarios designated by the CNB in the capital requirements of the individual portfolios on a one-year horizon which count the impacts of macroeconomic scenarios designated by the CNB (so-called bottom-up stress-test).

Principle 20: Supervisory techniques

An effective banking supervisory system should consist of on-site and off-site supervision and regular contacts with bank management.

Overall Assessment of the Principle:

COMPLIANT

Essential criteria:

The CNB system of banking supervision is based on a combination of on-site examination and off-site supervision. Within the framework of banking supervision great emphasis is placed on direct contact of banking supervision staff with the senior management of banks and credit unions. Banking supervision also utilises the reports of external auditors concerning the verification of final accounts and verification of the system of governance, which represents an additional supervision tool. The key factor for the meeting of this criterion is the potential for the knowledge and abilities of CNB staff working in the banking supervision area. In order to perform supervision, the CNB uses a set of methods and tools which it expands and improves on an ongoing basis.

Additional criterion:

Discussions are held with the senior management of banks and credit unions on a regular basis, as a rule at least once a year, and the discussions are more frequent in the case of subjects which are more significant for the stability of the sector. The discussions with the management of a bank or credit union generally focus most on the development of its financial situation (economic results) and risks faced, on changes in strategy and on the financial-trading plan for the period to come. Nevertheless, one element is a discussion of any specific current problems faced by the bank or credit union.

Analysis of individual criteria

Essential criteria:

1. The supervisor employs an appropriate mix of on-site and off-site supervision to evaluate the condition of banks, their inherent risks, and the corrective measures necessary to address supervisory concerns. The specific mix may be determined by the particular conditions and circumstances of the country. The supervisor has policies and processes in place to assess the quality, effectiveness and integration of on-site and off-site functions, and to address any weaknesses that are identified.

COMPLIANT

Supervision:

When exercising banking supervision the CNB attempts to ensure that it understands in the greatest possible depth the activities and risk profile of the individual banks and credit unions.

To attain this goal it employs:

- off-site supervision,
- supervision performed in the form of on-site examination directly in banks and credit unions,
- the output from auditors.

The designation of methods, focus and forms of supervision of the individual banks and credit unions are contained in the programme of activity of the section for supervision of the

financial market for the relevant year. Checks in banks and credit unions are proposed in this activity programme on the basis of the findings and needs of off-site supervision, and there is also a detailing of the requirement for verification of the system of governance, including risk management system, by external auditors. There is an internal manual for the creation of a control plan in banks and credit unions performed in the context of performing supervision and its change.

During their work inspectors also use the findings gained in the course of the performance of off-site supervision, and the findings gained during off-site supervision are used for the preparation of on-site examination in the relevant bank or credit union. The reports on the verification of final accounts and verification of the system of governance, including risk management, prepared by external auditors constitute an additional source of information for banking supervision. The requirements for the verification of the system of governance of a bank and credit union, including risk management system, are contained in [Decree No. 123/2007 Coll., stipulating the prudential rules for banks, credit unions and investment firms](#) (referred to hereinafter as the "Prudential Rules Decree"). Pursuant to Article 22 paragraph 3 of the [Act No. 21/1992 Coll., on Banks, as amended](#) (referred to hereinafter as the "Act on Banks") and pursuant to Article 8b paragraph 2 of [Act No. 87/1995 Coll., on Credit Unions and Certain Related Measures and on the Amendment of Czech National Council Act No. 586/1992 Coll., on Income Tax, as amended, as amended](#) (referred to hereinafter as "Act on Credit Unions"), the CNB is authorised to excuse the verification of the system of governance of a bank or credit union, including risk management system, or restrict the requirement to only certain parts of it.

The information gained during supervision (both off-site supervision and on-site examination) is combined within the context of the automated risk assessment system (RAS), which contains both quantitative data and, in particular, data from regular reporting, and qualitative information from the results of on-site examination.

Within the context of RAS, on the basis of the assessment of all the aforementioned sources there is a designation of the assessment of the individual risk areas of the relevant bank or credit union and its overall rating.

- 2. The supervisor has in place a coherent process for planning and executing on-site and off-site activities. There are policies and processes in place to ensure that such activities are conducted on a thorough and consistent basis with clear responsibilities, objectives and outputs, and that there is effective coordination and information sharing between the on-site and off-site functions.**

COMPLIANT

Supervision:

Activities within the context of performance of banking supervision constitute a part of the programme of the financial market supervision section assembled for the relevant year. The CNB has prepared internal manuals regulating the creation of the plan of examinations performed in the context of ensuring on-site examination and any changes to it, detailed processes for these examinations and processes designating the main tasks of the inspector when performing off-site supervision.

The control plan in banks and credit unions is assembled for the following year in such a way that it is available on the first working day of December in the ongoing year. Any changes to

the control plan generally react to the current needs for verification of the situation of the supervised subject, for example, in the case of adverse development in the supervised subject. The actual on-site examination is performed in compliance with the control plan and internal manual regulating the aims and focus of the examinations for the relevant risk, responsibilities and authorisations, the control process, verification, processing of control protocol and proposal of remedial measures on the basis of ascertained shortcomings etc.

Off-site supervision is a constant activity, but the basic time interval is one month or quarter (especially in the case of consolidation units) as a result of the periodicity of submission of most returns which are essential for an analysis of a bank and credit union. But if necessary it is possible to require the submission of source data with a shorter periodicity (deterioration in financial situation of relevant institution or adverse external influence with potential impact on relevant institution). The more detailed requirements associated with the performance of off-site supervision are regulated in the internal manual, which contains the basic tasks of the inspector when performing off-site supervision. One part of this manual is a regulation of cooperation with inspectors who perform examination in banks and credit unions.

In addition to the aforementioned internal manuals regulating process-performance of off-site supervision, banking supervision has an internal methodology for designating and assessing the essence, importance and scope of risks which the individual banks and credit unions are exposed to, including focus of activities, risk profile and internal control system. These internal documents define the standard processes which are applied during the conducting of supervision. They are updated as needs be and on the basis of experience from the performance of supervision.

With the aim of better transfer between on-site examination and off-site supervision, off-site supervision staff who perform off-site supervision on the examined subject generally also participate in on-site examination. This lets them get to know the supervised subjects better and gives them a more detailed knowledge of the shortcomings ascertained by the control team.

3. On-site work, conducted either by the supervisor's own staff or through the work of external experts is used as a tool to:

- **provide independent verification that adequate corporate governance (including risk management and internal control systems) exists at individual banks;**
- **determine that information provided by banks is reliable;**
- **obtain additional information on the bank and its related companies needed for the assessment of the condition of the bank, the evaluation of material risks, and the identification of necessary remedial actions and supervisory actions, including enhanced off-site monitoring; and**
- **monitor the bank's follow-up on supervisory concerns.**

COMPLIANT

Supervision:

Inspections performed in banks and credit unions in the framework of performance of the CNB supervision may be complex, i.e., focussing on all activity of the bank or credit union, or specialised, which focuses on individual areas of risks faced by the bank or credit union (credit risk, market risk including liquidity, operational risk, system of governance including prevention of money laundering etc.).

As part of supervision conducted in the form of on-site examination, there is a verification of

the means by which banks and credit unions identify measure, monitor and limit the individual risks faced. Subjects of assessment are the risk management strategies, methods used for the measurement, assessment and monitoring of risks, the completeness, reliability and up-to-date nature of the information used during risk management, clear definition and assignment of authorisations to relevant units and staff, including separation of incompatible functions, and sufficient base of regulations.

Verification of the functionality and effectiveness of the internal system of governance is performed within the framework of the systems for managing the individual risks and as a separate area of supervision. The following components of this system will then be verified:

- application of principles of corporate governance from the aspect of evaluation of organisational structure, functioning of supervisory board and its advisory bodies, effectiveness of control environment, including configuration of control mechanisms,
- ensuring compliance function, in particular system for monitoring development of legislation and incorporation of changes in the regulations base, completeness and comprehensibility of regulations and adherence thereto, enforcement of code of conduct etc.,
- functioning of internal audit, in particular organisational, methodological and personnel ensuring, process of planning and focus of activity, quality of outputs and system for eliminating ascertained shortcomings,

A verification of the material correctness of information submitted to banking supervision in the form of returns and notifications constitutes a standard part of the on-site examination. The main attention focuses on verifying the processes associated with the aggregation of primary data and preservation of its integrity and material accuracy when putting together the individual returns. The verification does not apply to the correctness of primary accounting data performed by external auditors as part of the verification of final accounts.

When evaluating the reliability of the submitted information and verification of the system of governance, banking supervision proceeds not only from its own finding, but it also utilises the outputs of the external auditor. Pursuant to the Act on Banks (Article 22 paragraph 1) and the Act on Credit Unions (Article 8b paragraph 1) a bank and credit union is obliged to ensure that a legal person or natural person conducting audit activity according to a special legal regulation performs a verification of the system of governance, including risk management and verification of final accounts. The report on the verification of the system of governance, including risk management system and report on verification of final accounts is submitted to the CNB at the designated times. According to the law the CNB may excuse the verification of the system of governance of a bank or credit union or limit the requirements to only some of its components.

One essential component of the exercise of supervision is an evaluation of the examined subject's follow-up to the shortcomings ascertained by the CNB, including the performance of remedial measures which the CNB imposed on the subject. Banks and credit unions generally submit a timetable of the steps leading to the rectification of shortcomings, and the ticking off of their performance in regular intervals, which banking supervision assesses.

The verification of how a bank or credit union fulfils the remedial measures imposed on the basis of the findings from previous examinations is a standard part of on-site examination. In the case of the discovery of serious shortcomings, in addition to regular monitoring their rectification also constitutes a subject of on-site examination, which is conducted especially

with the aim of checking performance of remedial measures.

4. Off-site work is used as a tool to:

- **regularly review and analyse the financial condition of individual banks using prudential reports, statistical returns and other appropriate information, including publicly available information;**
- **follow up on matters requiring further attention, evaluate developing risks and help identify the priorities and scope of further work; and**
- **help determine the priorities and scope of on-site work.**

COMPLIANT

Supervision:

Off-site supervision ensures the regular monitoring of activities of the individual banks and credit unions, groups of banks and the entire sector. The basis for it is the ongoing assessment of all available information about the activity of banks and credit unions. This consists primarily of regular returns and notifications on a solo and consolidated basis, final accounts and annual report, audit reports, bank presentations, publically accessible reports and information gained during discussions with representatives of banks and credit unions. Regular complex analyses for the assessment of the financial situation whilst taking into account the faced risks constitute the basic tool. For the timely noting of any negative tendencies there is a regular assessment of the monthly “signalling information” about the development of individual banks for the management of banking supervision with proposals for the process and rectification measures for banks with negative development. Reports on the development of the sector of banks and sector of credit unions, including bank ratings, are also prepared on a half yearly basis. Moreover information about the state and development of system-relevant banks is processed on a quarterly basis.

During its activities, off-site supervision uses the automated Supervision Information Centre (ICD) which combines the data from all returns and notifications and provides standard output arrays and the possibility of creating individual arrays for analytical evaluation. This system affords a quick overview of development of the basic indicators characterising the financial situation and adherence to prudential trading rules. Another information system is the RAS, which serves for an evaluation of an institution’s risk profile on the basis of unified criteria for individual groups of subjects based on qualitative and quantitative information. This system also assists the creation of the on-site examination plan.

The designation of the priorities and scope of on-site examination constitutes a part of the creation of the supervision plan.

- 5. Based on the risk profile of individual banks, the supervisor maintains sufficiently frequent contacts as appropriate with the bank’s Board, non-executive directors, Audit Committee and senior and middle management (including heads of individual business units and control functions) to develop an understanding of and assess such matters as strategy, group structure, corporate governance, performance, capital adequacy, liquidity, asset quality and risk management systems.**

COMPLIANT

Supervision:

The principle is implemented in the context of exercise supervision in the form of on-site examination, which also includes discussions at all levels of the bank’s management structure,

including the supervisory board as the bank's control body. During these examinations there is a verification of all the significant areas, i.e., bank strategy, risk management systems (including assessment of quality of assets and liquidity), and bank administration and management.

During off-site supervision discussions are held with the senior management of individual banks and credit unions on a regular basis, as a rule at least once a year, and the discussions are more frequent in the case of subjects which are more significant for the stability of the sector. Discussions focus primarily on the trading results of the given institution for the relevant period and its future intentions. Discussions with the management of a bank or credit union are used, for example, in cases where it is necessary to clarify a specific problem for the ascertainment or verification of relevant information, explanation of the strategy and business plan of a bank or credit union, evaluation of their corporate governance system and for going through other issues which are of mutual interest. The matter of their capitalisation is another regular theme of the discussions with the supervised subjects. In this context, in addition to standard reporting on capital adequacy according to pillar 1 of the Basel II regulation, banks are also required to submit annual information about the system of internally designated capital adequacy according to pillar 2 (ICAAP). This information is subject to detailed assessment, and feedback is then provided to the individual banks about the shortcomings ascertained and the opinion of CNB on their capital adequacy (Note: For banks which are a part of a European financial group this process has been performed in coordination and cooperation with other regulators within the framework of supervision collegia since 2011).

Information visits in a bank or credit union are also used as needs be. Information visits can be classified as an intermediate stage between off-site supervision and on-site examination. From the legal aspect information visits differ fundamentally from examination in a bank or credit union in the framework of on-site examination in that they do not depend on authorisation on the basis of the Act on State Inspection. The aim of informative visits is to gain a detailed knowledge of the key aspects of bank activities, and this is via discussions conducted at various levels of the bank's senior management and with rank and file bank staff if necessary.

6. On an ongoing basis during on-site and off-site supervisory activities, the supervisor considers the quality of the Board and management.

COMPLIANT

Supervision:

The Act on Banks and Act on Credit Unions require that the persons proposed for senior positions and the Board of a bank and the managing officers in the management of a credit union be persons with expert competence, propriety and experience. The quality of the proposed senior management is evaluated in the context of licence proceedings (i.e., when a bank or credit union is established) and in the case of personnel changes in the management of the supervised subjects, i.e., during the ensuring of the ongoing supervision of the supervised subjects. The detailed requirements for persons proposed for the management of banks and credit unions are described in Principle 3.

The quality of senior management and management at a lower level is also evaluated during on-site examination (for more detail see point 3).

Pursuant to the Act on Banks [Article 26 paragraph 1a)] and Act on Credit Unions [Article 28 paragraph 1a) point 3 and 4] if the CNB discovers shortcomings in the activity of a bank or branch of a foreign bank, it is authorised to require a change of personnel. Specifically these are people in the management of a bank or branch of a foreign bank (these are branches of a foreign bank from third countries) or in the management of a credit union or on the Board, control or credit committee of a credit union.

7. The supervisor evaluates the work of the bank's internal audit function, and determines whether, and to what extent, it may rely on the internal auditors' work to identify areas of potential risk.

COMPLIANT

Supervision:

The Prudential Rules Decree regulates the requirements for banks and credit unions concerning the performance of internal audit (Article 33 and annex No. 2 and 3). During on-site examination in these institutions there is a verification of the performance of the designated requirements for the performance of internal audit, including its functionality and reliability as one of the key elements of the internal control system (see point 3 – verification of functionality and effectiveness of system of governance). Reports on the verification of the system of governance processed by an external auditor on the basis of the requirement designated in the Act on Banks and Act on Credit Unions constitute an important source of information about activities of internal audit and its outputs. The findings of the internal audit are used when conducting supervision because they are considered a significant source of information primarily for the preparation of supervision in a bank or credit union as part of on-site examination.

8. The supervisor communicates to the bank the findings of its on- and off-site supervisory analyses by means of written reports or through discussions or meetings with management.

COMPLIANT

Supervision:

The CNB informs the management of a bank or credit union of the conclusions from the analyses performed in the context of supervision. The CNB uses both forms of communication, i.e., written form and personal discussion, for these notifications. In the case of on-site examination, the control team informs the Board of the bank or credit union of its conclusions after the end of the examination. If shortcomings are discovered, the CNB announces the assessment of their seriousness and assesses their proportionality. Then a protocol is made out based on the examination which contains the main findings, and the bank or credit union receives it in order that it can raise any objections that it may have. If objections to the examination protocol are received, after assessing them the CNB will prepare a decision on the objections in which it either accepts the objections and amends the protocol, or it rejects the objections.

Additional criterion

1. The supervisor meets periodically with senior management and the Board to discuss the results of supervisory examinations and the external audit. The supervisor should also meet separately with the independent Board members, as necessary.

COMPLIANT

Supervision:

On the basis of the external audit's outputs the supervisor will also initiate ad hoc proceedings (on the basis of the audit of final accounts or verification of the risk management system). Representatives of the supervised subject and the external auditor generally participate in these discussions. For more information see the basic criteria No 5 and 8.

Principle 21: Supervisory reporting

Supervisors must have a means of collecting, reviewing and analysing 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.

Overall Assessment of the Principle:
COMPLIANT

Essential criteria:

[Act No. 6/1993 Coll., on the Czech National Bank, as amended](#) (referred to hereinafter as the “Act on the CNB”) gives the CNB the right to require information from banks and credit unions. Banks and credit unions regularly send many returns which, amongst other things, give information about the financial situation of a bank or credit union, and they submit returns in relation to the prudential business rules, both on a solo and consolidated basis. These returns are assessed and constitute the basis for regular announcements and analyses in the context of off-site supervision. Branches of foreign banks submit returns and announcements in a scope comparable to that of banks, with the exception of returns based on capital monitoring, which they are not obliged to hold. In connection with the incorporation of the new concept of capital adequacy (referred to hereinafter as “Basel II”) into the legal regulations of the Czech Republic, the relevant returns concerning the prudential trading of banks and credit unions have been amended in such a way that they cover the requirements associated with the designation of new capital requirements. For the purposes of fulfilment of capital adequacy and commitment, the CNB requires the recording of tools in compliance with international accounting standards. In the same way as for consolidation of data it prescribes a full and proportionate method for consolidation in compliance with international accounting standards. The basic financial returns and returns for Basel II are based on the uniform reporting frameworks recommended by the CEBS (now the EBA). The CNB also verifies the returns and other announcements submitted by banks and credit unions in the context of off-site supervision and on-site examination. It also verifies the activity of internal audit, which includes verification of the reliability of accounting, statistical and operational information, reliability of information provided to bodies of the bank or credit union, verification of reliability of the system for assembling and submitting returns to the CNB, and the functionality and security of information systems. Another independent source for the verification of data are the auditors’ reports which verify for a bank or credit union the final accounts of these institutions and their systems of governance and which have an obligation to inform the CNB if they discover serious facts which could threaten the trading of the given subject.

Analysis of individual criteria

Essential criteria:

- 1. The supervisor has the power to require banks to submit information, on both a solo and a consolidated basis, on their financial condition, performance, and risks, at regular intervals. These reports provide information on such matters as on- and off-balance sheet assets and liabilities, profit and loss, capital adequacy, liquidity, large exposures, asset concentrations (including by economic sector, geography and currency), asset quality, loan loss provisioning, related party transactions, interest rate risk and market risk.**

COMPLIANT

Regulation:

Pursuant to the Act on the CNB (Article 41), in order to ensure its tasks the CNB requires the necessary information and documents from banks, branches of foreign banks, credit unions and other persons subject to its supervision. Via measures announced in the CNB Gazette, the CNB designates the content, form, deadlines and means of assembling and submitting information and documents required from banks and branches of foreign banks and from credit unions, including organisational and communication conditions of their handover to the CNB. In compliance with the Act on the CNB, the CNB is authorised to require a corresponding detailing or explanation if the submitted information and documents do not correspond to the designated requirements or should there arise reasonable doubts as to the correctness or completeness of the submitted information and documents. The CNB verifies the returns in the context of performing off-site supervision and on-site examination. The returns concerning the meeting of prudential trading rules were prepared in compliance with the COREP (**C**ommon solvency ratio **R**eporting) recommendation. In a comparable manner financial returns were prepared in compliance with the FINREP (**F**inancial **R**eporting) recommendation. The system of returns and notifications contains information corresponding to the requirements given in the principle. The returns on a solo basis are generally submitted once a month, and returns on a consolidated basis are submitted once a quarter.

- 2. The supervisor provides report instructions that clearly describe the accounting standards to be used in preparing supervisory reports. Such standards are based on accounting principles and rules that are widely accepted internationally.**

COMPLIANT

The structure of financial returns corresponds to the FINREP recommendations and is based on international accounting standards (referred to hereinafter as “IFRS”) regulated by European Community law (referred to hereinafter as “EC law”). The data contained in the financial returns of a bank or credit union are taken from their accounts. Banks which are issuers of listed securities keep their accounts according to the IFRS. Other banks and credit unions proceed pursuant to the decree and standards of the Ministry of Finance (referred to hereinafter as “MF”), and the designated accounting methods are comparable with the methods according to the IFRS. Consolidated announcements are assembled using the consolidation methods pursuant to the IFRS. For the purposes of capital adequacy and commitment, the CNB requires the recording of tools in compliance with the IFRS. In the same way as for consolidation of data it prescribes a full and proportionate method for consolidation in compliance with the IFRS.

- 3. The supervisor requires banks to utilise valuation rules that are consistent, realistic and prudent, taking account of current values where relevant.**

COMPLIANT

Regulation:

[Decree No. 123/2007 Coll., stipulating the prudential rules for banks, credit unions and investment firms](#) (referred to hereinafter as the "Prudential Rules Decree") instructs banks and credit unions to assess whether there has been a reduction in the book value of the individual receivables or portfolio of receivables with similar characteristics in view of their credit risk. A bank or credit union uses a solo or portfolio approach for this assessment. The conditions for the use of these methods are designated by decree.

Supervision:

Adherence to the aforementioned provisions of the decree is ensured in the context of the CNB on-site examination. The control system which credit institutions use for the preparation of notifications and returns for the CNB is a standard and important part of on-site examination because the gained information serves as fundamental indicators for the health of the individual institutions. Attention focuses on verifying the processes associated with the aggregation of primary data and preservation of its integrity and material accuracy when putting together the individual returns. Specialised staff performs the examination, usually as part of the examination of the system of the individual relevant risks.

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

COMPLIANT

Regulation:

Pursuant to the Act on the CNB (Article 41 paragraph 2 and 3) the following returns are sent to the CNB for banks and branches of foreign banks (with the exception of returns concerning capital and commitment)

a) returns and notifications on a solo basis

- monthly – balance sheet, profit and loss statement, notifications with additional information for financial returns, notifications about capital adequacy, about commitment, about the categorisation of receivables, about liquidity according to remaining maturity period, overview of individual securities held by the bank,
- quarterly – notifications about the concentration of loans and deposits, about the interest rate risk in the banking book, about mortgage bonds and mortgage loans, about commitment towards individual countries, about electronic banking and bank accounts, about the organisational structure and qualified participations,
- annually – additional information for designation of capital requirement for operational risk (values of relevant indicator), allocation of profit

b) returns and notifications on a consolidated basis

- quarterly – balance sheet, profit and loss account, notifications with additional information for financial returns, about capital adequacy, about commitment, about operations within a group of a mixed holding person,
- annually – additional data for designation of capital requirement for operational risk (values of relevant indicator), notification about structure of consolidation unit (update during change).

Should the CNB require it for the purposes of performing supervision, it may use other information submitted to the CNB in the context of currency and banking statistics (for example structure of loans and deposits according to sectors, branch, original maturity period, purpose, interest rate from loans and deposits, information about securities etc.).

Pursuant to the Act on the CNB (Article 41 paragraph 2 and 3), credit unions submit these notifications to the CNB:

a) returns and notifications on a solo basis

- monthly – balance sheet, profit and loss statement, notifications with additional information for financial returns, notifications about capital adequacy, about

commitment, about the categorisation of receivables, about liquidity according to remaining maturity period,

- quarterly – notifications about concentration of loans and deposits, about organisational structure,
- annually – additional information for designation of capital requirement for operational risk (values of relevant indicator),

b) returns and notifications on a consolidated basis

- quarterly – balance sheet, profit and loss account, notifications with additional information for financial returns, about capital adequacy, about commitment, about operations within a group of a mixed holding person,
- annually – additional data for designation of capital requirement for operational risk (values of relevant indicator), notification about structure of consolidation unit (update during change).

Supervision:

Logical and material control of submitted returns and notifications, identification of unusual movements and performance of analyses on the basis of gained information are some of the standard activities of off-site supervision inspectors. There is a monthly assessment of signalling information about the development of the banks, standard analyses are prepared every quarter, and annual comprehensive analyses of the individual banks are prepared.

5. In order to make meaningful comparisons between banks and banking groups, the supervisor collects data from all banks and all relevant entities covered by consolidated supervision on a comparable basis and related to the same dates (stock data) and periods (flow data).

COMPLIANT

Regulation:

Regular returns and notifications are required of all banks, branches of foreign banks and credit unions and consolidated units, and they are submitted in standardised form and as of firmly fixed dates. Pursuant to the Act on the CNB (Article 41 paragraph 2), the CNB has the right to require information and documents from banks, branches of foreign banks, credit unions and other persons subject to its supervision. Pursuant to Article 26f paragraph 2 of [Act No. 21/1992 Coll., on Banks, as amended](#) (referred to hereinafter as the “Act on Banks”) persons included in a consolidated unit are obliged upon request to announce to the CNB directly or via a bank which is a part of this consolidation unit and is designated by CNB, all information necessary for the performance of supervision on a consolidated basis. The same duty is also dealt with in Article 25f paragraph 2 [in Act. No. 87/1995 Coll., on Credit Unions and Certain Related Measures and on the Amendment of Czech National Council Act No. 586/1992 Coll., on Income Tax, as amended, as amended](#) (referred to hereinafter as “Act on Credit Unions”). Persons included in a consolidated unit must also create corresponding control mechanisms ensuring the correctness of provided information for the purposes of supervision on a consolidated basis.

6. The supervisor has the power to request and receive any relevant information from banks, as well as any of their related companies, irrespective of their activities, where the supervisor believes that it is material to the financial situation of the bank or banking group, or to the assessment of the risks of the bank or banking group. This includes internal management information.

COMPLIANT

Supervision:

See essential criterion No 5 - When performing supervision duties on the basis of a performed analysis or when assessing incoming information, should the CNB adjudge that further information is necessary, it will require this information with reference to the relevant provisions of the laws (Article 24 and Article 26f paragraph 2 of the Act on Banks and Article 25f paragraph 2 and Article 27 of the Act on Credit Unions) which state that persons included in a consolidated unit are regularly or upon request obliged to announce to the CNB, directly or via a bank or credit union which is part of the consolidated unit, all information necessary for performing supervision on a consolidated basis. This information may also include information concerning management.

7. The supervisor has the power of full access to all bank records for the furtherance of supervisory work. The supervisor also has similar access to the bank's Board, management and staff, when required.

COMPLIANT

Regulation:

When performing supervision, the CNB acts pursuant to Act No. 552/1991 Coll., on State Control, as amended (referred to hereinafter as "Act on State Control"), which designates the rights and duties of control staff and supervised persons in Article 11 to 14. In compliance with the Act on State Control (Article 11) the supervisor's staff are authorised to require of the supervised persons that by the designated deadlines they submit original documents and other written materials, data records on IT memory media, their print outs from master codes of programs, to acquaint them with confidential information if they present certification for the relevant degree of concealment of this information issued pursuant to special legal regulation, to require of the supervised persons the provision of truthful and full information about ascertained and associated facts, in justified cases to secure documents; they must confirm their receipt in writing for the supervised person, and they must let the supervised person have copies of the received documents, require that the supervised persons submit a written report on the rectification of ascertained shortcomings by a designated deadline. Pursuant to Article 12 of the Act on State Control it is the duty of the control staff to ascertain the true state of matters during an inspection.

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

COMPLIANT

Regulation:

Pursuant to Article 41 paragraph 5 of the Act on the CNB, the CNB is authorised to require a corresponding detailing or explanation if the submitted information and documents do not correspond to the requirements designated in implementing legislative instruments for the submission of returns or should there arise reasonable doubts as to the correctness or completeness of the submitted information and documents. Incorrect reporting constitutes a breach of the relevant measures of the CNB and thus a shortcoming in activity in the sense of the Act on Banks [Article 26 paragraph 3b)] or Act on Credit Unions [Article 28 paragraph 4b)]. For this shortcoming the CNB may impose a fine or some other remedial measure pursuant to the Act on Banks or Act on Credit Unions.

9. The supervisor utilises policies and processes to confirm the validity and integrity of supervisory information. This includes a programme for the periodic verification of supervisory returns by means either of the supervisor's own staff or of external experts.

COMPLIANT

Supervision:

Returns and notifications are submitted via an automated information system which allows the configuration of control mechanisms verifying the correctness of sent data and also allows the refusal of rejection of a return which does not conform to the configured inspections which can be automated. The system also makes it possible to check whether the submitted returns have been submitted, including adherence to deadlines, and it issues automatic reminders for the submission of returns etc.

The CNB has created internal manuals (the main tasks of the inspector when performing off-site supervision and processes for on-site examination) containing the requirement for an inspector of off-site supervision to perform logical and material supervision, and supervision of the completeness of submitted information, and it uses these manuals during its supervision activities.

A verification of the material correctness of information submitted to banking supervision in the form of returns and notifications constitutes a standard part of the performance of on-site examination. The main attention focuses on verifying the processes associated with the aggregation of primary data and preservation of its integrity and material accuracy when putting together the individual returns. The verification does not apply to the correctness of primary accounting data performed by external auditors as part of the verification of final accounts.

Also in the context of supervision performance there is a verification of the activity of internal audit, the duties of which include a verification of the reliability of the system for assembling and submitting returns to the CNB. The reports of external auditors and audit companies focusing on verification of the system of governance of the bank and credit union constitutes another source of independent assessment of correctness and completeness of information for banking supervision. In view of the fact that the information in the returns and notifications is based primarily on the accounting of the bank, they are also verified indirectly by the external auditor who performs the audit of the final accounts.

10. The supervisor clearly defines and documents the roles and responsibilities of external experts, including the scope of the work, when they are appointed to conduct supervisory tasks and monitors the quality of the work. External experts may be utilised for routine validation or to examine specific aspects of banks' operations.

COMPLIANT

Regulation:

External auditors are involved in the performance of supervision in particular on the basis of the Act on Banks (Article 22) and Act on Credit Unions (Article 8b), pursuant to which a bank and credit union are obliged to ensure that the auditor performs a verification of the final accounts, verification of the system of governance, including risk management, and processing of reports on the verification of the final accounts and system of governance,

including risks. A bank and credit union is obliged to announce the selection of the auditor to the CNB. The CNB has 30 days to comment on this auditor, who it may reject. The Act on Banks and Act on Credit Unions designates that an audit company which has a special relationship established with a bank or credit union must not perform the specified verifications in the bank or credit union. Pursuant to the Act on Banks and Act on Credit Unions, the CNB may excuse the verification of the system of governance or limit the requirements to only some activities.

11. The supervisor requires that external experts bring to its attention promptly any material shortcomings identified during the course of any work undertaken by them for supervisory purposes.

COMPLIANT

Regulation:

Pursuant to Article 21 of Act No. 93/2009 Coll., on Auditors, as amended (referred to hereinafter as the “Act on Auditors”) if during the performance of audit activity in an accounting unit the activity of which is subject to state supervision or CNB oversight pursuant to other legal regulations the auditor discovers facts which

- a) indicate that there has been a breach of other legal regulations regulating the conditions of its activity,
- b) have a fundamental negative impact on its trading,
- c) may threaten its time unlimited duration, or
- d) may lead to the expression of an opinion with reservations, negative opinion or refusal to express an opinion,

without delay and in writing it is obliged to inform the relevant body of state supervision, or the CNB if it is an accounting unit which it supervises.

An auditor also has the specified information duty if it ascertains the above facts in an accounting unit where an accounting unit whose activity is subject to state supervision or CNB oversight has 20% or more of the voting rights or a business interest of 20% or more of the registered capital, or if it is a controlling or controlled person.

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 .

Overall assessment of the principle:

COMPLIANT

Essential criteria

According to Act No. 513/1991 Coll., Commercial Code, as amended (hereinafter the “Commercial Code”), the business management of the joint-stock company including the adequate drawing up of accounting records is ensured by the company’s board of directors. The financial statements of banks, foreign bank branches and credit units are verified by external auditors on a regular basis. The CNB publishes measures and follow-up detailed methods published in the CNB website, respectively submitted to reporting entities through the automated reporting system, which contains a definition of all the required items, indexes, control links for all required statements and reports needed for supervision and statistics. Banks that issue quoted securities draw up records according to international financial reporting standards (hereinafter the “IFRS”) regulated by EU law. Other banks and credit unions proceed according to the decrees and standards of the Ministry of Finance (hereinafter the “MF”), whereas the stipulated accounting methods are comparable to IFRS methods. Banks and credit unions are obliged to publish information about themselves, about the shareholder structure or about their members with qualified participation in the credit union, about the structure of the consolidated group which they are a part of, about their activities and financial standing. Banks and credit unions also publish information about fulfilment of the rules of cautious business and risk management.

Additional criteria

The CNB’s dealings with auditors are conducted irregularly as required, generally after receiving a report on verification of the banks’ financial statements or reports on verification of the banks’ system of governance. If during the audit of an accounting unit, whose activities are subject to state supervision or supervision by the CNB according to other legal regulations, the auditor determines facts which

- a) suggest that there has been a violation of other legal regulations governing the conditions of its activity,
- b) have a fundamental negative impact on its financial management,
- c) may threaten its unlimited duration, or
- d) may lead to the expression of a statement with objections, a negative statement or refusal to express a statement,

the auditor is obliged to inform the respective state supervising authority or the CNB immediately, if this is an accounting unit under its supervision. Auditors have no explicitly stipulated obligation to grant the CNB access to their working documentation; the rotation of auditors after a certain period of time is not stipulated. According to the Act on Bank and Act on Credit Unions, the bank or credit union is obliged to draw up internal procedures and principles for the fulfilment of the disclosure requirements stipulated by these Acts or by the executive decree.

Analysis of individual criteria

Essential criteria

- 1. The supervisor has the power to hold bank management and the bank's Board responsible for ensuring that financial record-keeping systems and the data they produce are reliable.**

COMPLIANT

Regulation:

Generally binding legal regulations stipulate the liability of the management of the bank, foreign bank branch and credit union for the reliability of accounting data (Act on Accounting, Act on Banks, Commercial Code). If the CNB finds flaws in the activity of these entities (e.g. information is not disclosed on time or in the appropriate form), these entities may be prosecuted as a legal entity. However, the CNB may require the replacement of an individual in the management of the bank, foreign bank branch or credit union or replacement of an individual on the supervisory board Article 26, paragraph 1 subparagraph a) points (3) and (4) [of Act No. 21/1992 Coll., Act on Banks, as amended](#) (hereinafter the "Act on Banks") and Article 28, paragraph 1 subparagraph a) points (3) and (4) [of Act No. 87/1995 Coll., on Credit Unions and Certain Related Measures and on the Amendment of Czech National Council Act No. 586/1992 Coll., on Income Tax, as amended](#) (hereinafter the "Act on Credit Unions"). Sanctions are permitted only by the Act on Credit Unions, where according to Article 27a, paragraph 3 a member of the elected body of the credit union or manager commits a misdemeanour by not informing the CNB immediately about certain facts, about application of the procedure stipulated by the CNB in connection to the found deficiencies in the activity of the credit union and about the loss of professional qualification or reliability of the members of elected bodies of the credit union and managers. According to the Act on Credit Unions, a penalty of up to CZK 1 million may be imposed for this misdemeanour.

Banks, foreign bank branches and credit unions are obliged to keep accounts according to Act No. 563/1991 Coll., Act on Accounting, as amended (hereinafter the "Act on Accounting"). Requirements for information designated for the performance of banking supervision are regulated by [Decree No. 123/2007 Coll., stipulating the prudential rules for banks, credit unions and investment firms](#) (hereinafter the "Prudential Rules Decree").

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

COMPLIANT

Regulation:

Based on the Act on Banks (Article 22) and the Act on Credit Unions (Article 8b), the bank and credit union is obliged to ensure that the auditor verifies the financial statements of the bank or credit union, the system of governance of the bank or credit union and elaborate a report on this audit. The audit report is a part of the published annual report, the requirements of which are regulated by the Act on Accounting.

- 3. The supervisor requires banks to utilise valuation rules that are consistent, realistic and prudent, taking account of current values where relevant, and to show profits**

net of appropriate provisions.

COMPLIANT

Regulation:

Banks which are issuers of quoted securities are obliged to keep accounts according to IFRS; other banks and credit unions keep accounts according to national regulations, the valuation methods of which are comparable to the IFRS. The Prudential Rules Decree stipulates that in the event of devaluation of a receivable, the bank or credit union will adjust its appraisal valuation [Article 200, paragraph 1]. If the bank or credit union does not write off the receivable or its amount correspond to the loss from evaluation, it will create an adjustment for this loss to the receivable, which constitutes a cost item within the profit and loss statement. In Article 200, paragraphs 2 and 3, this Decree also stipulates that the bank or credit union assesses the adequacy and justification of the created adjustments to receivables and modifies their value at least once per quarter. The Prudential Rules Decree in Article 201 to Article 204 also regulates the methods for stipulating the value of losses from devaluation, which may be stipulated using the discounting of future expected cash flow, coefficients or statistical models.

4. Laws or regulations set, or the supervisor has the power, in appropriate circumstances, to establish, the scope of external audits of individual banks and the standards to be followed in performing such audits.

COMPLIANT

Regulation:

The audit is governed by Act No. 93/2009 Coll., Act on Auditors, as amended (hereinafter the “Act on Auditors”) and the guidelines of the Chamber of Auditors of the Czech Republic. According to the provisions of Article 22 of the Act on Banks and Article 8b of the Act on Credit Unions, the bank and credit union is obliged to ensure that the auditor verifies:

- the bank’s financial statements,
- the banks system of governance including the risk management system (hereinafter the “system audit”),
- information disclosure in the scope stipulated by the decree.

The bank and credit union are obliged to ensure that the auditor compiles reports on verification of the financial statements and system audit, and submits these to the CNB. The CNB may excuse the system audit or limit the requirements to only some parts thereof. The specific requirements of the report on the system audit are stipulated by the Prudential Rules Decree. According to Article 9, paragraph 3 of the Prudential Rules Decree, the CNB publishes an overview of selected acknowledged standards and an overview of publishers of acknowledged standards as well as benchmarks in the CNB Bulletin, the contents of constitute the CNB's expectations during fulfilment of the requirements stipulated by the decree. The report on verification of the system of governance by the auditor according to the Prudential Rules Decree (Article 35) is the result of verification, which fulfils the following requirements:

- a) verification was performed according to the status as at 31 December of the given year,
- b) he system was compared to legal regulations and standards according to Article 9 as follows:
 1. a basic part of the system audit was a comparison and evaluation of system compliance with regulatory requirements arising from legal regulations,

2. in the auditor's view, the chosen standards according to Article 9, which were used to verify the system, best reflected the size, organisation, nature, scope and complexity of activities carried out by the bank or credit union; the auditor may also use acknowledged standards not listed in the overview published by the CNB,
- c) the functionality and efficiency of control mechanisms is evaluated and specified missing internal control mechanisms are identified,
- d) a statement is issued as to the risk posed by the found deficiencies for the system of governance, and
- e) the functionality and efficiency of the system of governance in the given areas as a whole is evaluated.

The Prudential Rules Decree in annex no. 3 contains a detailed definition of the requirements for the report on the audit of the system of governance by the auditor.

The content of information about the fulfilment of prudential rules on an individual or consolidated basis as at 31 December of the given year designated for publication, which is verified by the auditor, is included in annex no. 30 to the Prudential Rules Decree. This information verified by the auditor is disclosed by the bank or credit union in its annual report.

5. Supervisory guidelines or local auditing standards determine that audits cover such areas as the loan portfolio, loan loss reserves, non-performing assets, asset valuations, trading and other securities activities, derivatives, asset securitisations, and the adequacy of internal controls over financial reporting.

COMPLIANT

See basic criterion 3.

6. The supervisor has the power to reject and rescind the appointment of an external auditor that is deemed to have inadequate expertise or independence, or not to be subject to or not to follow established professional standards .

COMPLIANT

Regulation:

According to the law (Article 22 of the Act on Banks and Article 8b of the Act on Credit Unions), the bank or credit union is obliged to report the chosen auditor to the CNB. The CNB does not appoint the auditor directly, but may reject their appointment within 30 days from notification from the bank or credit union. In practice, the CNB uses this right. The law stipulates that auditors cannot be entities with a special relation to the bank or credit union. Relations between the banking supervisor and auditors are regulated by the Chamber of Auditors direction no. 51, which is binding only for auditors, not for the CNB. The said laws do not regulate the option of cancelling appointment of the auditor.

Supervision:

The CNB compares the results of the auditor's work with its own findings in the course of and within inspections onsite. This comparison is performed not only for the reporting audit but also for the statutory audit, i.e. in terms of assessing the overall financial standing of the bank or credit union, in particular the quality of assets (value of provisions). The findings of the CNB obtained from onsite inspections are also compared with the auditor's findings within

the framework of verifying the risk management system (if the obligation to have such verification performed by an auditor was imposed on the bank in the past). If significant discrepancies are found, the CNB discusses these with the auditors.

7. The supervisor requires banks to produce annual audited financial statements based on accounting principles and rules that are widely accepted internationally and have been audited in accordance with internationally accepted auditing practices and standards.

COMPLIANT

Regulation:

Banks and credit unions are obliged to compile financial statements according to the Act on Accounting. This act stipulates an obligation for accounting units, which are commercial companies and issuers of securities registered on the regulated securities market in EU member states, to use the IFRS for accounting and compiling their financial statements. The Act on Accounting also enables the use of the IFRS for compiling the consolidated financial statements. The accounting unit may also decide to use the IFRS, provided it may be assumed that as of the balance date it will be obliged to undergo the compiling of consolidated financial statements using IFRS, or an accounting unit that compiles consolidated financial statements using IFRS. In both cases, the application of the IFRS is subject to approval by the superior body of this organisation unit. Other organisations units are governed by the accounting decrees and standards issued by the MF of the Czech Republic, whereas the stipulated accounting methods are comparable to IFRS methods. According to the Act on Banks (Article 22) and the Act on Credit Unions (Article 8b), these financial statements are verified by an auditor. The auditor that the bank or credit union chooses and reports to the CNB should verify the financial statements according to internationally acknowledged auditing standards and according to internationally acknowledged auditing procedures.

8. Laws, regulations or the supervisor require periodic public disclosures of information by banks that adequately reflect the bank's true financial condition. The requirements imposed should promote the comparability, relevance, reliability and timeliness of the information disclosed.

COMPLIANT

Regulation:

Banks (Article 11a, paragraph 1 of the Act on Banks) and credit unions (Article 7b, paragraph 1 of the Act on Credit Unions) are obliged to publish information about themselves, the structure of shareholders or members with qualified participation in the credit union and about members with other membership contributions, about the structure of the consolidated whole which they are a part of, and about their activity and financial standing. The bank and credit union publishes information about fulfilment of the prudential rules of business and risk management on an individual basis, unless this information is published on a consolidated basis. The Prudential Rules Decree stipulates in Articles 206 to 213, including the related annexes, the content of information designated for publication, the periodicity, deadlines and manner of its publication and the structure and content of data verified by an auditor. The Prudential Rules Decree in Article 22 contains a requirement for banks and credit unions to publish information about their current situation and expected development on time, in accessible form, in an adequate and balanced manner. The aggregate information which the bank or credit union must disclose follows up in methodical terms on the statements and reports submitted to the CNB, thereby guaranteeing the comparability of published

information among the individual banks or credit unions.

- 9. The required disclosures include both qualitative and quantitative information on a bank's financial performance, financial position, risk management strategies and practices, risk exposures, transactions with related parties, accounting policies, and basic business, management and governance. The scope and content of information provided and the level of disaggregation and detail should be commensurate with the size and complexity of a bank's operations.**

COMPLIANT

Regulation:

Information published by the bank, foreign bank branch that does not enjoy the benefits of a single license and credit union according to the Act on Banks and Act on Credit Unions - see above – must reflect the size, management method, number of employees, nature, scope and complexity of activities performed by the bank or credit union. A detailed list of all the published information is defined in the Prudential Rules Decree (annexes no. 24 to 28).

- 10. Laws, regulations or the supervisor provide effective review and enforcement mechanisms designed to confirm compliance with disclosure standards.**

COMPLIANT

Regulation:

The law stipulates the information disclosure obligation of banks, foreign bank branches which does not enjoy the benefits of a single license and credit unions. The violation or evasion of this law is assessed as a deficiency in activity. In this case, the CNB may undertake corrective measures and sanctions (penalties) according to the Act on Banks and Act on Credit Unions.

Supervision:

The bank is obliged to ensure that the accuracy of selected mandatory disclosed information as at 31 December of the respective calendar year is verified by its auditor. Within the framework of ongoing supervision over banks, the CNB in the course of the year compares the information published by the bank with the data obtained from periodical reporting by the bank sent to the CNB.

- 11. The supervisor or other relevant bodies publish aggregate information on the banking system to facilitate public understanding of the banking system and the exercise of market discipline. Such information includes aggregate data on balance sheet indicators and statistical parameters that reflect the principal aspects of banks' operations (balance sheet structure, capital ratios, income earning capacity, and risk profiles).**

COMPLIANT

Regulation:

See CP 1 (1) criterion 4 and CP 19 essential criterion 2.

Periodically every quarter, the CNB publishes, by means enabling remote access, aggregate information about the banking sector and bank groups and about the credit unions sector, which essentially corresponds to the structure of aggregate information which the individual banks or credit unions are obliged to publish. Additional information is available to the public

in the annual publication about performance of financial market supervision. Additionally, on its website the CNB publishes an updated list of links to the websites of individual banks and credit unions, which publish the information according to the Prudential Rules Decree (see criterion 8).

Additional criteria

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

COMPLIANT

Supervision:

Discussions between the CNB, respectively supervision employees and external auditors take place irregularly as needed, generally after receiving the auditor's report on verification of the bank's financial statements or a report on verification of the bank's system of governance.

2. External auditors, whether or not utilised by the supervisor for supervisory purposes, have the duty to report to the supervisor matters of material significance, for example failure to comply with the licensing criteria or breaches of banking or other laws, or other matters which they believe are likely to be of material significance to the functions of the supervisor. Laws or regulations ensure that auditors who make any such reports in good faith cannot be held liable for breach of a duty of confidentiality.

COMPLIANT

Regulation:

Based on the Act on Auditors [Article 21, paragraph 3], the auditor is obliged to inform the CNB in writing of any serious facts, which indicate there has been any violation of special legal regulations governing the conditions of activity of banks or credit unions and other serious facts which have a fundamental negative impact on its management, may threaten its unlimited duration or may lead to the rejection of a statement, a negative statement or a statement with objections.

3. Laws, regulations or the supervisor require banks to rotate their external auditors (either the firm or individuals within the firm) from time to time.

LARGELY COMPLIANT

Regulation:

Neither the Act on Banks nor the Act on Credit Unions stipulate a requirement for banks or credit unions to change auditors after a certain period. This explicit requirement is not contained in the Prudential Rules Decree. Nevertheless, the CNB, which according to the Act on Banks (Article 22) and the Act on Credit Unions (Article 8b) has the right to comment on the proposed auditor within 30 days from their proposition, may reject this auditor, whereas the law does not stipulate the reasons for rejection. A reason for rejection of the auditor may therefore be the loss of impartiality and the building of overly close personal ties that would affect the final output. Moreover, banks and credit unions should project established practice in choosing an auditor, according to which the rotation of auditors should be ensured, whereas the maximum period for an auditor to conduct audits for one company should be between 5 to 7 years.

4. The supervisor requires banks to have a formal disclosure policy.

COMPLIANT

Regulation:

According to the Act on Banks [Article 11a, paragraph 10] and the Act on Credit Unions [Article 7b, paragraph 10], the bank or credit union is obliged to implement internal procedures and principles for fulfilment of the information disclosure requirements stipulated by these laws or by the Prudential Rules Decree, and for evaluation of the adequacy of disclosed information, including its verification and disclosure frequency.

Supervision:

Within the framework of supervision, the CNB ascertains whether procedures for disclosure including control of these procedures were created at the bank or credit union.

5. The supervisor has the power to access external auditors' working papers, where necessary.

COMPLIANT

Regulation:

According to Article 21 of the Act on Auditors, the CNB has the right to be informed immediately about facts of a fundamental character – see additional criterion 2. The auditor is also obliged to provide information and explanations concerning the course of the mandatory audit and findings acquired on the basis of the mandatory audit at the bank or credit union to the CNB upon its request for the purpose of carrying out supervision.

Principle 23: 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 licence or to recommend its revocation.

Overall assessment of the principle:

LARGELY COMPLIANT

Essential criteria:

Based on [Act No. 21/1992 Coll., Act on Banks, as amended](#) (hereinafter the “Act on Banks”) and [Act No. 87/1995 Coll., on Credit Unions and Certain Related Measures and on the Amendment of Czech National Council Act No. 586/1992 Coll., on Income Tax, as amended](#) (hereinafter the “Act on Credit Unions”), the CNB has at its disposal a wide range of corrective actions and sanctions. These particularly include requirements to remedy deficiencies in activity within the stipulated deadline (e.g. restriction of activities, replacement of managers and the supervisory board, amendment of strategies, procedures and mechanisms, creation of provisions and reserves and use of profit to supplement reserve funds or increase capital). Another level consists of sanctions, which include not only the imposition of a financial penalty, restriction of the license, prohibition to perform certain operations, imposition of an extraordinary audit or the obligation to maintain capital above the stipulated minimal level, but also revocation of the license or permit. In the case of banks, the CNB may also use the institute of imposing receivership. The CNB uses these authorities in practice. Application of corrective actions and sanctions depends on the structure of deficiencies defined by law and their gravity in terms of the impact on the activities and financial situation of the banks and credit unions.

The CNB has reduced the evaluation level of the principle because the CNB cannot prohibit certain individuals from acting in the banking sector or credit union sector. However, when assessing the qualifications of individuals proposed for management positions at banks or credit unions during licensing proceedings and changes in the management of the bank or credit union, the CNB may take into account the previous activities of these individuals. Furthermore, the CNB cannot apply sanctions against the individual in the bank’s top management. A change in legislation is not being prepared at present.

Additional criteria:

The Act on Banks and Act on Credit Unions create conditions so that the CNB does not defer remedial actions, respectively they allow the CNB to impose remedial actions immediately, once it identifies deficiencies in the activities of the bank or credit union. If the bank’s capital declines to less than two thirds of the stipulated value, the CNB by law is obliged to apply one or more of the stipulated measures. If the capital of the bank or credit union declines to less than one third, the CNB is obliged to revoke the license, respectively permit. If the security or stability of the bank or credit union may be threatened, the CNB is authorised to prohibit or restrict operations of the respective regulated activity or prohibit or restrict operations with entities in the same consolidated whole.

Analysis of individual criteria

Essential criteria

1. The supervisor raises supervisory concerns with management or, where appropriate,

the Board, at an early stage, and requires that these concerns are addressed in a timely manner. Where the supervisor requires the bank to take significant remedial actions, these are addressed in a written document to the Board. The supervisor requires the bank to submit regular written progress reports and checks that remedial actions are completed satisfactorily.

COMPLIANT

Regulation:

The Act on Banks, Act on Credit Unions, [Decree No. 123/2007 Coll., stipulating the prudential rules for banks, credit unions and investment firms](#), as amended (hereinafter the “Prudential Rules Decree”) and other legal regulations stipulate or further specify the obligations that banks and credit unions must fulfil in performing their activities. The CNB supervises the fulfilment of these obligations on an ongoing basis, general within the framework of remote supervision. However, some of them may be verified only within the framework of supervision performed through on-site examinations.

Supervision:

During supervision, the CNB must identify and react to negative tendencies, which may not yet mean a direct violation of obligations, but may lead to their violation if developed further. If during supervision the CNB has doubts as to the fulfilment of the stipulated obligations or requirements or that the development of certain facts may lead to the worsening of the financial situation or stability of the regulated entity, in particular in terms of affecting the future development of the bank or credit union and the impact on its overall financial management, the CNB uses its lawful right to adopt the adequate actions. The specific chosen instrument corresponds to the gravity of the situation, whereas differentiation of the gravity of situations is important for applying specific remedial actions or actions.

Generally, the CNB first warns the bank or credit union of the deficiencies while simultaneously requirement an explanation; depending on the nature of the deficiency, it may stipulate a deadline by which the bank or credit union is obliged to inform the CNB about the adopted internal measures aimed at eliminating this deficiency. The CNB may discuss the identified deficiency, including the ability of the bank or credit union to analyse and solve the given problem, directly with the top management of the bank or credit union and stipulate specific steps to improve the situation. The CNB may also require that the bank or credit union process and submit in writing the measures and timeframe for elimination of the deficiencies, including the obligation periodically to inform the CNB in writing about the results of adopted measures. Subsequently, the CNB controls whether the measures for elimination of deficiencies were truly adopted by the bank or credit union.

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

COMPLIANT

Supervision:

If the bank or credit union finds itself in a problematic situation, the CNB requires that the bank or credit union propose remedial actions, including specific deadlines for elimination of the undesirable situation. If the situation is so grave and the steps taken by the management of the bank or credit union and shareholders or members of the credit union to date have proven ineffective and have not led to a remedy, there are other legal means which give the

CNB a more active role. This particularly involves the termination of certain activities, the requirement to increase capital, but also the imposition of receivership or the revocation of the license or permit.

3. The supervisor has available an adequate range of supervisory tools for use when, in the supervisor's judgment, a bank is not complying with laws, regulations or supervisory decisions, or is engaged in unsafe or unsound practices, or when the interests of depositors are otherwise threatened. These tools include the ability to require a bank to take prompt remedial action and to impose penalties. In practice, the range of tools is applied in accordance with the gravity of a situation.

COMPLIANT

Regulation:

The Act on Banks authorises the CNB to apply a number of remedial actions and sanctions, depending on the gravity of the deficiencies identified in the activities of the bank or foreign bank branch. According to the Act on Banks [Article 26, paragraph 3], a deficiency in the bank's activity refers to:

- a) violation of the conditions stipulated in the license or non-fulfilment of the conditions under which the license was granted,
- b) violation or evasion of the Act on Banks, special laws and legal regulations and measures issued by the CNB,
- c) violation or evasion of the obligations or conditions stipulated in CNB decisions or measures of a general nature (threatening the stability of the banking or financial system),
- d) performance or decision on performance of a trade or trades, transfer or transfer of funds or other transaction or transactions by the bank or foreign bank branch in a manner that damages the interests of its depositors or threatens the safety and stability of the bank or foreign bank branch,
- e) management of the bank or foreign bank branch by individual who do not have sufficient professional qualifications or are unreliable,
- f) if the sum of reserves and provisions created by the bank does not suffice to cover the risks arising from the volume of classified assets reported by the bank,
- g) violation of the internal regulations of the state in which the bank has a branch while conducting business on the territory of this state,
- h) decline of the capital ratio to less than the minimum (value corresponding to the sum of individual capital requirements, whereas the capital must not simultaneously decline to below the minimal registered capital stipulated by law, i.e. below CZK 500 million),
- i) violation of the obligations stipulated in the special legal regulation for concluding contracts on financial services concluded remotely,
- j) use of the credit evaluation to calculate capital requirements in a manner contrary to this law.

1. If the aforementioned deficiencies are identified, the CNB is authorised to require that the bank or foreign bank branch implement a remedy within the stipulated deadline, in particular that it

- a) restrict certain permitted activities, terminate prohibited activities or refrain from certain trades, transfer of funds or other transactions,
- b) limit the distribution network, including a reduction of the number of points of sale,
- c) replace the bank's managers or individuals in the management of the foreign bank branch,

- d) replace the members of the supervisory board,
- e) bring the organisation, strategy, procedures and mechanisms in line with the Act on Banks,
- f) adopt stricter rules for liquidity, stricter rules for creation of provisions to the bank's assets and reserves or for stipulation of capital requirements,
- g) create the adequate value of provisions and reserves,
- h) maintain the capital above the minimal level stipulated by law,
- i) reduce the registered capital in the stipulated scope, or
- j) use profit after tax preferentially to supplement the reserve funds or increase the registered capital, or
- k) reduce the value of its share in a different entity or transfer its share in this entity to a different entity or otherwise limit the risks arising from the bank's share in this entity.

2. If the requirement of the CNB (see clause 1 above) is not fulfilled or if required by the nature of the identified deficiency, particularly if the matter does not bear delay, the Act on Banks authorises the CNB to apply one or more of the following sanctions:

- a) change the license by eliminating or restricting certain activities contained therein,
- b) order an extraordinary audit at the expense of the bank or foreign bank branch,
- c) impose receivership (cannot be applied against a foreign bank branch) – the CNB may impose receivership in situations when the deficiencies in the bank's activity threaten the stability of the banking system and the shareholders have not taken the necessary steps to eliminate these deficiencies,
- d) impose a penalty of up to CZK 50 million,
- e) reduce the bank's capital for the purpose of paying losses by the amount corresponding to the loss after offsetting reserves and other funds, assuming the loss exceeds 20% of the bank's equity,
- f) prohibit or restrict the performance of operations with entities that are closely related to the bank or are part of the same consolidated whole as the bank or have a special relation to the bank (cannot be applied against a foreign bank branch),
- g) require an increase of capital above the level stipulated in the Act on Banks (Article 12a), particularly if the bank has ineffective organisation, strategies, procedures or mechanisms, and the imposition of measures according to the previous clauses is deemed inadequate to attain a remedy within reasonable time,
- h) require an increase of the liquid resources of the bank or foreign bank branch at least in the amount stipulated by the CNB.

3. If the bank's capital on an individual basis declines to less than two thirds of the sum of its individual capital requirements, the CNB is obliged to apply one or more of the following remedial actions: increase of capital, acquisition only of assets with a risk weight of less than 100%, prohibition of acquiring a share in another legal entity, prohibition of providing loans to entities with a special relation, prohibition of providing interest rates from deposits increasing the current standard interest rate - see essential criterion no. 5. At the same time, the remedial action according to Article 26, paragraph 1 of the Act on Banks may be applied.

4. The CNB may revoke the license according to Article 34, paragraph 1 of the Act on Banks if serious deficiencies in the activities of the bank or foreign bank branch persists. Furthermore, the license may be revoked according to Article 34, paragraph 2 subparagraph a of the Act on Banks, if the bank or foreign bank branch did not commence activities within 12 months from granting the license or if it does not receive deposits from

the public for a period of 6 months or if the license was acquired based on false information in the application. The CNB is obliged to revoke the license according to Article 34, paragraph 3 of the Act on Banks if the bank's capital on an individual basis declines to less than one third of the sum of the individual capital requirements.

The Act on Credit Unions also authorises the CNB to apply corrective actions and sanctions, depending on the gravity of the identified deficiency in the activity of the credit union. According to Article 28, paragraph 4 of this act, a deficiency in the activity of a credit union refers to:

- a) violation of the conditions stipulated in the permit or conditions for granting consent,
- b) violation or evaluation of this act, special laws, supplementary regulations issued according to this act and special regulations and CNB measures issued according to this act, as well as decision issued by the CNB,
- c) performance of trades by the credit union in a manner that damages or may damage the interests of its contributors or members or threatens the security and stability of the credit union,
- d) business and financial management of the credit union by individuals who do not have sufficient professional qualifications or are unreliable,
- e) if the credit union has not created the adequate value of provisions and reserves according to special legal regulations,
- f) if the elected body of the credit union does not perform its functions for more than 60 days,
- g) withholding of the requested information and documents or delay in their handover or refusal to allow access to premises or delay in allowing access during control,
- h) violation of the rules and indicators set out in Article 11 of the Act on Credit Unions (rules of exposure, payment capacity),
- i) failure to approve the ordinary financial statements of the credit union within 6 months from the last day of the accounting period,
- j) failure to fulfil disclosure obligations by the credit union (Article 27).

Authorisation to adopt remedial measures is regulated in Article 28, paragraph 1, subparagraphs a) to g) of the Act on Credit Unions. Their scope is essentially the same as for banks, whereas the specific features of the legal form of credit unions are taken into account.

4. The supervisor has available a broad range of possible measures to address such scenarios as described in EC 3 above and provides clear prudential objectives or sets out the actions to be taken, which may include restricting the current activities of the bank, withholding approval of new activities or acquisitions, restricting or suspending payments to shareholders or share repurchases, restricting asset transfers, barring individuals from banking, replacing or restricting the powers of managers, Board directors or controlling owners, facilitating a takeover by or merger with a healthier institution, providing for the interim management of the bank, and revoking or recommending the revocation of the banking licence.

LARGELY COMPLIANT

Regulation:

According to the Act on Banks (Article 26) and the Act on Credit Unions (Article 28), the CNB is authorised to require that the bank or credit union limit certain permitted activities, terminate prohibited activities or refrain from certain trades and operations. Furthermore,

according to the said provisions the CNB is authorised to change the license or permit by eliminating or restricting certain activities contained in the license or permit. The Act on Banks [Article 26, paragraph 1 subparagraph g)] authorises the CNB to prohibit or restrict the performance of operations by entities which are closely related to the bank or are a part of the same consolidated whole as the bank or have a special relation to the bank. A similar authorisation is included in the Act on Credit Unions [Article 27f, paragraph 2], which authorises the CNB to prohibit or restrict the performance of operations with entities that are a part of the same consolidated whole, should the CNB find deficiencies in the activities of an entity included in the consolidated whole in relation to the controlling entity, depending on the nature of the found deficiency.

According to the Act on Banks (Article 26), if the CNB finds a deficiency in the bank's activity, it may require the bank to use its profit after tax preferentially to supplement the reserve funds or increase the registered capital, i.e. limit the option of dividing the profit among shareholders in the form of dividends.

The CNB may suspend the voting rights of shareholders or credit union members (Article 20a, paragraph 1 of the Act on Banks and Article 2c, paragraph 1 of the Act on Credit Unions), who acquired a share in the bank or credit union without prior consent from the CNB or if their activity would be detrimental to the due and prudent operation of the bank or credit union, or if such consequences of their activity may be justly expected; this suspension of rights includes the right to participate and vote at the general meeting, respectively the members' meeting and to request the convening of a general meeting, respectively members' meeting.

Within the framework of imposing corrective actions [Article 26, paragraph 1 subparagraph a) point (1) of the Act on Banks, or Article 28, paragraph 1 subparagraph a) point (1) of the Act on Credit Unions], it is possible to require that the bank or credit union restrict certain permitted activities or terminate prohibited activities, i.e. the transfer of assets.

Within the framework of corrective actions, the CNB has the right to request the replacement of the bank's management and supervisory board, replacement of a member of the board of directors, controlling or loan committee of a credit union or replacement of an individual in the credit union's management. However, the CNB cannot prohibit the activity of certain individuals in the banking or credit union sector, therefore the evaluation is decreased. However, within the framework of assessing the qualifications of individual proposed for management positions at banks or credit unions during licensing proceedings and changes in the management of banks or credit unions, the CNB may take into account the previous activities of such individuals.

The replacement or limitation of authority of the top management, members of the board of directors or owners with controlling influence, enabling the takeover or merger with a healthier institution, ensuring the temporary management of the bank is possible by imposing receivership in situations when deficiencies in the bank's activity threaten the stability of the banking system and shareholders have not undertaken the necessary steps to eliminate these deficiencies. The receiver appointed by the CNB has the position of a statutory body and decides also about matters in the competence of the general meeting, as the general meeting is not convened during the term of receivership.

The Act on Banks (Article 34) and Act on Credit Unions (Article 28g) stipulate the cases in which the CNB revokes the license, respectively permit.

5. The supervisor has the power to take measures should a bank fall below the minimum capital ratio, and seeks to intervene at an early stage to prevent capital from falling below the minimum. The supervisor has a range of options to address such scenarios.

COMPLIANT

Regulation:

If the bank's capital ratio falls below the minimal stipulated limit of CZK 500 million, this constitutes a deficiency in activity according to the Act on Banks and the CNB is authorised to apply remedial actions and sanctions in these cases – see essential criterion no. 3.

The Act on Banks (Article 26a, paragraph 1 stipulates that if the CNB determines that the bank's capital ratio on an individual basis is less than two thirds of the sum of individual capital requirements stipulated by law, the CNB will impose one or more of the following corrective actions in administration proceedings:

- a) to increase the registered capital so that the bank's capital on an individual basis is equal to at least the value corresponding to the sum of the individual capital requirements stipulated in Article 12a, paragraph 1 of the Act on Banks,
- b) to acquire only assets which have a risk value of less than 100% according to the Prudential Rules Decree,
- c) to not obtain any shares in the registered capital and voting rights of any legal entity, with the exception of contracts concluded before the imposition of this measure, to not dispose of or acquire any other legal entity or an organisation unit thereof,
- d) to not provide loans to any entity with a special relation to the bank,
- e) to not provide interest rates from deposits exceeding the current interest rate from deposits of comparable amounts and with comparable maturity, as determined by the CNB.

Concurrently with these actions, the CNB may also impose corrective measures according to Article 26, paragraph 1 of the Act on Banks.

The Act on Banks [Article 34, paragraph 3] stipulates the CNB's obligation to revoke the license if the bank's capital adequacy on an individual basis is less than one third of the sum of its individual capital requirements.

According to the Act on Credit Unions [Article 8, paragraph 2], the credit union is obliged to maintain ongoing capital on an individual basis in an amount corresponding to the sum of the individual capital requirements. The capital ratio of the credit union must not drop below the minimal capital ratio stipulated in the act (CZK 35 million). Should the credit union fail to fulfil the said legal requirement, this may be considered a deficiency in the credit union's business activity according to the Act on Credit Unions [Article 28, paragraph 3 subparagraph b]. In this case, the CNB is authorised [Article 28, paragraph 1 subparagraph a) point (9)] to require a remedy within the stipulated deadline, whereas the credit union will maintain its capital ratio above the minimum stipulated by law. If the CNB determines that the credit union has an ineffective strategy or procedures concerning the system of governance or that the credit union does not accept and apply reliable, effective and complete strategies for stipulating, periodically assessing and maintaining the internally stipulated capital in an amount, structure and distribution so as sufficiently to cover the risks to which the credit union is exposed, the CNB is authorised [Article 28, paragraph 1 subparagraph g)] to require

an increase of the capital above CZK 35 million. The CNB may also impose a fine of up to CZK 20 million according to Article 27b, paragraph 3 of this Act.

According to the Act on Credit Unions (Article 28g), the CNB shall revoke the permit if the credit union's capital adequacy is less than one third of the sum of its individual capital requirements.

6. The supervisor applies penalties and sanctions not only to the bank but, when and if necessary, also to management and/or the Board, or individuals therein.

LARGELY COMPLIANT

Regulation:

The CNB may apply sanctions against the bank, but not against individual in the bank's top management, therefore the assessment level was reduced. According to the Act on Banks [Article 26, paragraph 1 subparagraph a) point (3)], however, the CNB may require that the bank or foreign bank branch replace the bank's manager or individual on the foreign bank branch's management. The option of personal penalties is possible only insomuch as the respective individuals do not provide cooperation. Moreover, a clear link (causal nexus) must be proven between the deficiency and personal responsibility; functional liability cannot be applied in these cases. Full compliance with this criterion would require a major intervention in legislation. Such change is not being prepared at present.

The Act on Credit Unions [Article 28, paragraph 1 subparagraph a) points (3) and (4)] contains the right of the CNB to require the replacement of members of the board of directors, control or loan committee of the credit union and replacement of individuals in the credit union's management. The Act on Credit Unions also defines when an employee of the credit union, member of an elected credit union body or member of the loan committee commits a misdemeanour. These misdemeanours may be subject to a penalty. The maximal value of these penalties according to the individual misdemeanours is between 200,000 to 1 million CZK.

Supervision:

The CNB applies sanctions in the scope allowed by valid legislation.

Additional criteria

1. Laws or regulations guard against the supervisor unduly delaying appropriate corrective actions.

COMPLIANT

Regulation and supervision:

Corrective actions are imposed in accordance with the law, i.e. depending on the nature of the found deficiency and within the shortest possible term after the CNB determines this deficiency. The bank or credit union is obliged to fulfil the imposed actions within the required deadline. The law also stipulated cases when the CNB is obliged to adopt remedial actions (capital ratio declines to less than two thirds, respectively one third of the minimum according to capital requirements).

2. The supervisor has the power to take remedial actions, including ring-fencing of the bank from the actions of parent companies, subsidiaries, parallel-owned banking structures and other related companies in matters that could impair the safety and

soundness of the bank.

COMPLIANT

Regulation:

According to Article 26h, paragraph 2 subparagraph d) and Article 26, paragraph 1 subparagraph g) of the Act on Banks, the CNB may prohibit or restrict the (controlling and controlled) bank's or financial holding company's performance of operations with entities that are a part of the same consolidated whole (in the case of banks, also entities that are closely linked or have special relations to the bank). With respect to shareholders with qualified participation in the bank who acquired it without the CNB's prior consent or didn't fulfil their notification duty the CNB is authorised based on Article 20a of the Act on Banks to suspend the execution of certain shareholder rights (participation and voting at the general meeting and requesting the convening of a general meeting) for a shareholder that, itself or by acting in consort with another entity, holds a qualified participation in the bank. Likewise, according to the Act on Credit Unions [Article 27f, paragraph 2 subparagraph c)], the CNB is authorised to prohibit or restrict the credit union's performance of operations with entities that are a part of the same consolidated whole, or according to Article 28, paragraph 1 subparagraph a) to demand that it not perform certain trades and operations. In the case of entities with qualified participation, the CNB is also authorised to decide on the suspension of the right to participate in the members meeting and vote at it, should the conditions stipulated by law be fulfilled.

If the bank is part of a consolidated whole with the status of a subsidiary, the CNB has adequate corrective actions at its disposal, including actions aimed at protecting this bank's assets.

3. When taking formal remedial action in relation to a bank, the supervisor ensures that the regulators of non-bank related financial entities are aware of its actions and, where appropriate, coordinates its actions with them.

COMPLIANT

Since 1 April 2006, supervision over the financial market in the Czech Republic is integrated in the CNB – see CP 2.

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.

Overall Assessment of the Principle:

COMPLIANT

Essential criteria

A general mandate to exercise consolidated supervision and to exercise supplementary supervision is provided [in Act No. 6/1993 Coll., on the Czech National Bank](#) (hereinafter the "Act on the CNB"). The scope of consolidated and supplementary supervision is detailed [in Act No. 21/1992 Coll., on Banks, as amended](#) (hereinafter the "Act on Banks"), [Act No. 87/1995 Coll., on Credit Unions and Certain Related Measures and on the Amendment of Czech National Council Act No. 586/1992 Coll., on Income Taxes, as amended, as amended](#) (hereinafter the "Act on Credit Unions"), in Act No. [377/2005 Coll. on Financial Conglomerates, as amended](#) (hereinafter the "Act on Financial Conglomerates") and [in Decree No. 347/2006 Coll., which implements certain provisions of the Act on Financial Conglomerates](#). A detailed specification of the scope of consolidated supervision is contained in [Decree No. 123/2007 Coll., stipulating the prudential rules for banks, credit unions and investment firms](#) (hereinafter the "Prudential Rules Decree"). The Act on Banks and the Act on Credit Unions specify the cases when it is possible to waive the exercise of consolidated supervision.

Under the Act on Banks, the Act on Credit Unions and the Prudential Rules Decree, the CNB shall obtain information on all members of a consolidated group and on their mutual relationships. Controlling banks and financial holding entities are obligated to maintain capital adequacy and comply with the exposure rules on a consolidated basis. Consolidated reports (statements) for regulated consolidated groups are submitted to the CNB on a quarterly basis.

For the purposes of consolidated supervision, the CNB may supervise the activities performed by a bank's branches and subsidiaries, its controlling entities or other entities belonging to a consolidated group. The same applies to credit unions. For the purposes of consolidated supervision, the CNB may carry out an on-site examination at any entity belonging to a consolidated group (including a bank's subsidiaries) or to ask the competent supervisory body for carrying out this examination.

Under the Act on Banks and the Act on Credit Unions, the CNB may issue prudential rules. The Prudential Rules Decree sets out the requirements associated with the exercise of individual and consolidated supervision, including the requirements arising from the Directive of the European Parliament and of the Council 2006/48/EC of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast), hereinafter "Directive 2006/48/EC"

For the purposes of consolidated supervision, the CNB is authorised by law to cooperate and exchange information with foreign regulators. This cooperation in the exchange of information is usually based on a Memorandum of Understanding. Nevertheless, the CNB also cooperates with these authorities on an informal basis.

When exercising supervision, the CNB verifies whether a bank or credit union complies with all the requirements set out by laws or other legal regulations. Internal procedures must cover all activities, including foreign activities. To assess a consolidated group's compliance with prudential limits and to assess a consolidated group's financial situation, the CNB uses mainly the data obtained from the regular quarterly reports submitted to the CNB.

The CNB is authorised by law, if it detects any shortcomings in the activities of a bank, a credit union or an entity that is not a bank and belongs to a consolidated group to demand that the relevant bank, credit union or entity remedy the situation within a specified period, including the restriction or termination of activities of the relevant bank, credit union or entity.

Additional criteria

The CNB is authorised to inspect the activities of parent companies and enterprises that are linked to parent companies. The CNB may prohibit or restrict a bank (whether controlling or controlled), a credit union (a responsible credit union) and a financial holding entity from the execution of transactions with entities that belong to the same consolidated group (in the case of a bank, this also applies to transactions with entities that have close links with the bank or have a special relation to the bank). The CNB has a mandate to evaluate members of the top management of a financial holding entity and individuals serving as top executives of companies that are to acquire a qualifying holding in a bank or credit union in terms of their integrity and professional competence, i.e. whether they are "fit and proper."

Analysis of individual criteria

Essential criteria

- 1. The supervisor is familiar with the overall structure of banking groups and has an understanding of the activities of all material parts of these groups, domestic and cross-border.**

COMPLIANT

Supervision:

Under Article 26f, paragraph 2 of the Act on Banks, under Article 25f, paragraph 2 of the Act on Credit Unions and under the Prudential Rules Decree (Article 214 et seq.), 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, at least once a year, but always without undue delay after any change in the information provided. The main part of the data is required via a standard form and on an automated basis, which facilitates further processing of the data. To some degree, the necessary information can be also obtained and, in particular, verified from foreign regulators.

- 2. The supervisor has the power to review the overall activities of a banking group, both domestic and cross-border. The supervisor has the power to supervise the foreign activities of banks incorporated within its jurisdiction.**

COMPLIANT

Regulation:

Under Article 2, paragraph 2 subparagraph d) and Article 44, paragraph 1 subparagraph a) of the Act on the CNB, the CNB shall perform banking supervision of banks, foreign bank branches, credit unions, and of the sound operation of the banking system.

Under the Act on Banks (Article 25, paragraph 1), the activities of banks, including their branches carrying on activities within the territory of a foreign country, shall be subject to banking supervision by the CNB, including on-site examinations. The activities of consolidated groups containing a bank are subject to banking supervision on a consolidated basis by the CNB, including on-site examinations, unless the law provides otherwise. The Act on Banks (Article 26e, paragraphs 1 and 2) specifies the cases when an entity is not subject to banking supervision on a consolidated basis by the CNB.

Act on Credit Unions (Article 22, paragraph 1) stipulates that the activities of credit unions shall be performed by the CNB. Under Article 25e, paragraphs 1, 2 and 4 of this Act, the CNB shall perform consolidated supervision of a controlling credit institution group the members of which include a responsible credit union in a controlling credit institution group and of a financial holding entity group the members of which include a responsible credit union in a financial holding entity group and of a mixed-activity holding entity group.

The Act on Banks and the Act on Credit Unions also specify the cases when it is possible to waive the exercise of consolidated supervision of a consolidated group.

Supervision:

Consolidated supervision is implemented in practice. The CNB has compiled an internal manual on the exercise of consolidated supervision which contains, among other, practical experience and data gained under the information duty. As part of regular quarterly analyses of individual banks, the CNB evaluates data on financial situation and on the compliance with prudential limits both on individual and consolidated basis.

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

COMPLIANT

The Act on Banks and the Act on Credit Unions places certain general limitations on risks arising from non-banking activities. A bank or a credit union may not carry on activities other than those permitted in its licence. Nevertheless, a bank may carry on business activities that are associated with safeguarding its operation or the operation of another entity controlled by the bank. However, there are limitations on the acquisition of holdings in non-bank and non-financial entities (Article 12, paragraph 1 and Article 17 of the Act on Banks). A credit union is generally forbidden by law to acquire holdings in other legal entities or otherwise gain influence in the management of other legal entities (Article 1, paragraph 8 of the Act on Credit Unions) – see Principle 5. 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. A controlling bank, a responsible credit union and a financial holding entity are obligated to maintain capital adequacy and comply with the exposure rules on a consolidated basis, i.e. actually when taking account of the activities of the relevant subsidiaries and jointly managed companies.

Supervision:

The CNB has compiled an internal manual on consolidated supervision which reflects practical experience with the implementation of the relevant capital adequacy framework (Basel II), etc.

- 4. The supervisor has the power to impose prudential standards on a consolidated basis for the banking group. The supervisor uses its power to establish prudential standards on a consolidated basis to cover such areas as capital adequacy, large exposures, exposures to related parties and lending limits. The supervisor collects consolidated financial information for each banking group.**

COMPLIANT

Regulation:

Under Article 26f of the Act on Banks, a controlling bank, a responsible bank in a financial holding entity group and a bank in a mixed-activity holding entity group that are members of a consolidated group subject to banking supervision by the CNB, shall comply, on a consolidated basis, with the requirements for the man system of governance, the rules for disclosure of information, the rules for determination of capital, the rules for determination of capital requirements and capital adequacy, the strategies and processes for assessing and changing capital, the exposure rules, the restrictions on qualifying holdings and the requirements for operations within a consolidated group. A similar duty is imposed on a responsible credit union in Article 25f, paragraph 1 of the Act on Credit Unions.

More detailed prudential rules on a consolidated basis concerning capital adequacy, including determination of capital on a consolidated basis and exposure, are set out in the Prudential Rules Decree. The information and data that entities belonging to a consolidated group are required by law to send to the CNB are sent electronically through reports and additional graphical or other information according to the provisions for reporting. The CNB gathers this information and uses it for the purposes of consolidated supervision.

- 5. The supervisor has arrangements with other relevant supervisors, domestic and cross-border, to receive information on the financial condition and adequacy of risk management and controls of the different entities of the banking group.**

COMPLIANT

The CNB takes active part in the activities of a total of seven colleges of supervisors and, in this context, it has committed itself to mutual cooperation by signing a multilateral agreement which uses the European Banking Authority's sample agreement on cooperation and coordination in the supervision of cross-border banking groups. This involves cooperation in the exercise of banking supervision with foreign supervisors of the following groups: Erste Bank, Volksbank, Raiffeisenbank, Société Générale, UniCredit, KBC and ING. The agreements provide, among other, for the banking supervision of controlled banks and branches, including the exchange of information and on-site examinations according to agreed terms. For more details see Principle 25.

- 6. The supervisor has the power to limit the range of activities the consolidated group may conduct and the locations in which activities can be conducted; the supervisor uses this power to determine that the activities are properly supervised and that the safety and soundness of the bank are not compromised.**

COMPLIANT

Regulation:

In the event that the CNB detects any shortcomings in the activities of a bank, the law provides it with a relatively wide range of options, including, among other, the right to require the restriction of some permitted activities or the termination of unpermitted activities [Article 26, paragraph 1 subparagraph a) of the Act on Banks]. Also, the CNB is authorised by law to restrict activities, or to prohibit or restrict the execution of transactions with entities that belong to the same consolidated group, if the CNB detects any shortcomings in the activities of an entity that belongs to a consolidated group and if these shortcomings might adversely affect the performance of a bank that belongs to the consolidated group (Article 26h, paragraph 2 of the Act on Banks). Similarly, the Act on Credit Unions gives the CNB a mandate to require a credit union to remedy the situation by restricting or terminating a permitted activity in order to remove the identified deficiency in the credit union's activities [Article 28, paragraph 1 subparagraph a)]. However, these are sanction or remedial measures, but not preventive measures. It is not possible in advance to restrict territorially the activities of a bank, credit union or an entity belonging to a consolidated group. Such business regulation would be contrary to the legal culture principles on which the Czech legal system is based. Nevertheless, for instance the legal obligation to inform the CNB about the establishment of a foreign branch or subsidiary can be regarded as a preventive measure.

The determination that the activities are properly supervised and that the safety and soundness of the bank or the credit union are not compromised is given by the nature of supervision and consolidated supervision, which is defined in the Act on Banks (Article 26c, paragraph 1) and in the Act on Credit Unions (Article 25d, paragraph 1) as 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. One of the ways of exercising this power is the Prudential Rules Decree.

- 7. The supervisor determines that management is maintaining proper oversight of the bank's foreign operations, including branches, joint ventures and subsidiaries. The supervisor also determines that banks' policies and processes ensure that the local management of any cross-border operations has the necessary expertise to manage those operations in a safe and sound manner and in compliance with supervisory and regulatory requirements.**

COMPLIANT

Supervision:

Under the Commercial Code, the board of directors of a bank or a credit union shall manage the company and, therefore, shall have the ultimate responsibility for the company. Any and all procedures and principles adopted by a bank or a credit union must be formalised. These procedures must be based on the requirements set out in the applicable laws or in the Prudential Rules Decree. The board of directors must ensure that all activities are carried out by qualified employees with adequate knowledge and experience. Under the Prudential Rules Decree, the board of directors is responsible for defining the overall strategy, including the policies and targets for its fulfilment, and the ongoing and effective operation of internal controls. These internal controls also cover any foreign activities performed through branches, joint ventures and subsidiaries. The system of governance of the foreign branches of a bank or a credit union is subject to on-site examinations. The reports and statements submitted to the CNB must always be inclusive of the foreign activities of bank or credit union branches. The reports and statements for a consolidated group or a regulated consolidated group must also provide data on all subsidiaries, affiliates and jointly managed companies.

- 8. The supervisor determines that oversight of a bank's foreign operations by management (of the parent bank or head office and, where relevant, the holding company) includes: (i) information reporting on its foreign operations that is adequate in scope and frequency to manage their overall risk profile and is periodically verified, (ii) assessing in an appropriate manner compliance with internal controls; and (iii) ensuring effective local oversight of foreign operations.**

For the purposes of consolidated risk management and supervision, there should be no hindrance in host countries for the parent bank to have access to all the material information from their foreign branches and subsidiaries. Transmission of such information is on the understanding that the parent bank itself undertakes to maintain the confidentiality of the data submitted and to make them available only to the parent supervisory authority.

COMPLIANT

Regulation:

The CNB has information concerning a bank's foreign operations on an individual basis and obtains this information as part of remote and on-site supervision (see Principles Nos. 19 and 20). The same applies to information within a consolidated group to which a bank or a credit union belongs. The effectiveness of a bank's or a credit union's internal control system is evaluated during on-site examinations, which also check the quality of internal control over any transactions exercised via the bank's or credit union's foreign branches. The option to carry out an on-site examination at the foreign branches of local banks is provided by agreements concluded with foreign regulators (see Principle 25).

The conditions that must be fulfilled to be able to provide information acquired in the context of exercising banking supervision to authorities responsible for banking supervision abroad and to authorities responsible for the supervision of financial institutions and financial markets in the Czech Republic and abroad are set forth in Act on Banks Article (25a) and the Act on Credit Unions (Article 25a). 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. The above-mentioned statutory provisions stipulate that the disclosure of information acquired in the context of exercising supervision to the persons specified by law for the purposes of the performance of their tasks, e.g. to a law enforcement authority operating in the Czech Republic, to an authority that exercises supervision of banks, financial institutions or financial markets in another state or to EU authorities, shall not be deemed as a breach of the confidentiality obligation. The provision that sets forth the obligation to respect confidentiality of information obtained as part of cooperation with a foreign banking supervision authority is embedded in each of the agreements concluded by the CNB with foreign banking supervision authorities.

Supervision:

The CNB exercises consolidated supervision of banks' consolidated groups. As part of on-site examinations the CNB inspects any information that the bank received from its foreign branch.

- 9. The home supervisor authority has the power to require the closing of foreign offices, or to impose limitations on their activities, if:**
- **it determines that oversight by the bank and/or supervision by the host supervisor**

is not adequate relative to the risks the office presents; and/or

- **it cannot gain access to the information required for the exercise of supervision on a consolidated basis.**

COMPLIANT

Regulation:

In the event that the activities of a domestic bank's foreign branch endanger the activities of the parent bank in the Czech Republic or in the event that the information submitted by a domestic bank fails to sufficiently cover the activities of this domestic bank's foreign branch, the CNB is authorised by law to demand that the situation be remedied, including an option to impose a penalty (Article 26, paragraph 1 of the Act on Banks, Article 28, paragraph 1 of the Act on Credit Unions). Under Article 26, paragraph 1 subparagraph a) point 2 of the Act on Banks and Article 28, paragraph 1 subparagraph a) point 2, the CNB may require a reduction in the number of sales points or sales representatives, a reduction in the number of distribution points. When exercising the supervision of a bank's foreign activities, the CNB can also strongly rely on the international cooperation in banking supervision based on the relevant agreements with foreign regulators (Memoranda of Understanding).

10. The supervisor confirms that oversight of a bank's foreign operations by management (of the parent bank or head office and, where relevant, the holding company) is particularly close when the foreign activities have a higher risk profile or when the operations are conducted in jurisdictions or under supervisory regimes differing fundamentally from those of the bank's home country.

COMPLIANT

Regulation:

Under the Prudential Rules Decree (Article 16), the board of directors shall approve and regularly evaluate the overall strategy and the risk management strategy. At the same time, the board of directors shall approve a set of limits that the bank or credit union will employ in order to mitigate risk. The Prudential Rules Decree also sets out requirements that banks and credit unions must meet as regards risk mitigation and coverage (Article 25 et seq.) and orders them to take into account any factors that influence the results of an evaluation or measurement of the risks undertaken. These strategies and limits must also cover any foreign activities.

Supervision:

When exercising supervision, the CNB checks the compliance of a bank or credit union with the requirements set out by laws, the Prudential Rules Decree and other regulations. A bank or a credit union must prove that it is aware of, monitors, evaluates and manages all the risks undertaken.

Additional criteria

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

- **the supervisor has the power to review the activities of parent companies and of companies affiliated with the parent companies, and uses the power in practice to determine the safety and soundness of the bank; and**
- **the supervisor has the power to establish and enforce fit and proper standards for owners and senior management of parent companies.**

COMPLIANT

In addition to the regularly submitted and updated information for consolidated groups and besides consolidated reports concerning the compliance with prudential rules, the CNB has the right to carry out an on-site examination at any entity belonging to a consolidated group (Article 26c of the Act on Banks and Article 25d of the Act on Credit Unions) or to ask the competent supervisor of this entity to carry out such an examination on an individual basis. The CNB has the right to ask that an examination is carried out abroad (based on reciprocity under a Memorandum of Understanding).

Acquiring a qualifying holding, becoming an entity controlling a bank or increasing a qualifying holding so that it reaches or exceeds 20%, 30% or 50% of a bank's or credit union's registered capital or voting rights (Article 20, paragraph 3 of the Act on Banks, Article 2b, paragraph 3 of the Act on Credit Unions) is subject to the consent of the CNB. An entity with a qualifying holding in a bank or credit union must prove that it is trustworthy and competent to exercise shareholder rights in such a bank or member rights in such a credit union. An application must state detailed information concerning the entity to acquire a qualified holding, including the professional competence and trustworthiness of members of the management of the entity with a qualified holding. A summary of documents that must be submitted to the CNB by the entity with a qualified holding, including the persons in executive managerial positions at these companies, is provided in a Decree. The law requires that the prescribed documents to prove professional competence and trustworthiness must be also submitted by a person who is in an executive managerial position at a financial holding entity where a member of its consolidated group is a bank or a credit union.

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

Not applicable.

3. The supervisor arranges to visit the foreign locations periodically, the frequency being determined by the size and risk profile of the foreign operation. The supervisor meets the host supervisors during these visits. The supervisor has a policy for assessing whether it needs to conduct on-site examinations of a bank's foreign operations, or require additional reporting, and has the power and resources to take those steps as and when appropriate.

COMPLIANT

Supervision:

The domestic banks have only a very few subsidiary banks and branches abroad. The agreements signed with foreign regulators provide for an option to carry out on-site examinations. The CNB performs on-site examinations abroad as necessary and there are also regular meetings with foreign regulators (colleges of supervisors, meetings on the validation of internal models, etc.). At these meetings, the participants exchange the latest information on banks and entities of common interest and discuss matters related to the current general issues of the financial market regulation.

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.

Overall Assessment of the Principle:

COMPLIANT

Essential criteria

The key element of consolidated supervision is the establishment of contacts and exchange of information with other supervisors involved, especially authorities in the host country. The legislative basis for cooperation with foreign regulators is [Act No. 21/1992 Coll., on Banks, as amended](#) (hereinafter the "Act on Banks") and [Act No. 87/1995 Coll., on Credit Unions and Certain Related Measures and on the Amendment of Czech National Council Act No. 586/1992 Coll., on Income Taxes, as amended, as amended](#) (hereinafter the "Act on Credit Unions"), which empower the CNB to exchange information on everything necessary for the exercise of banking supervision over banks and credit unions with cross-border operations and which also provide home supervisor with an option to carry out on-site examinations in the host country. This legal regulation is harmonised with the law of EU law. Another law that provides for cooperation between supervisors is [Act No. 377/2005 Coll., on supplementary supervision of banks, savings and credit cooperatives, electronic money institutions, insurers and investment firms in financial conglomerates and on the amendment of other Acts](#) (hereinafter the "Act on Financial Conglomerates"), which, among other, provides for cooperation between supervisors in order to ensure the efficient exercise of supplementary supervision.

Since 2001, the CNB has gradually entered into cooperation agreements with foreign supervisors in both home and host countries,⁹⁾ namely with supervisors from Austria, Germany, France, Slovakia, the USA (the State of New York), Belgium, the Netherlands and Italy. The last cooperation agreement signed was in 2009 with the Chinese banking supervisor (the China Banking Regulatory Commission), bringing the total number of banking supervisors with whom the CNB has a bilateral agreement (a MoU) to nine. These agreements specify in detail the mutual cooperation and exchange of information that is necessary for supervision.

During 2009, the supervision authorities responsible for the supervision of groups with cross-border operations within the EU started establishing colleges of supervisors with the aim to bolster the mutual cooperation, coordination and exchange of information. In the area of banking supervision, the CNB has so far signed a total of 7 multilateral agreements on cooperation in the supervision of cross-border banking groups. These apply to the following banking groups: Societe Generale, KBC, ING, UniCredit, Erste, Volksbank and Raiffeisenbank. The home supervisors of these banks are Commission bancaire (Societe

⁹⁾ A majority of these cooperation agreements (except the one with China) were signed before 1 April 2006, i.e. before the integration of the financial market supervision. Consequently, the agreement do not provide for the exchange of information concerning credit unions. It would be therefore appropriate, by an amendment to the agreement or by other means, to ensure that the exchange of information will also apply to credit unions.

Generale), the Banking, Finance and Insurance Commission (KBC), De Nederlandsche Bank (ING), Banca d'Italia (UniCredit) and the Financial Market Authority (Erste, Volksbank, Raiffeisenbank). Besides the foregoing banking groups, a similar multilateral cooperation takes place (though not formalised in a MoU) with regard to the LBBW, Wüstenrot and GE Capital groups.

The subsidiaries of foreign banks are subject to the same prudential rules as domestic institutions. The same applies to branches of foreign banks that do not enjoy the benefits of the single licence under the EU law, unless the Act on Banks or a decree or another regulation of the CNB stipulates that the relevant rules do not apply to these entities.

The establishment of a subsidiary or branch of a foreign bank is subject to the provisions of Act No. 513/1991 Coll., the Commercial Code, as amended (hereinafter the "Commercial Code"). Article 1 of the Act on Banks stipulates that for the purposes of the Act on Banks "banks" shall mean joint-stock companies having their registered offices in the Czech Republic that accept deposits from the public and provide loans and that have been granted a banking licence to carry on these activities. Considering that the establishment of a credit union is subject to the condition that the credit union must have at least 30 members, it is impossible for a foreign bank to establish a subsidiary legal entity in the form of a credit union.

Analysis of individual criteria

Essential criteria

1. Information to be exchanged by home and host supervisors should be adequate for their respective roles and responsibilities.

COMPLIANT

Regulation:

Article 38c of the Act on Banks and Article 22 of the Act on Credit Unions require the CNB to perform consultation and information duties vis-à-vis the supervisory authorities of other states. At the same time, these Acts specify the main information to be reported and consulted.

Since 2001, there have been intensive negotiations and exchange of information with foreign banking supervisors especially from the countries where parent companies or headquarters of banks and foreign banks' branches that operate in the Czech Republic have their registered offices. The CNB have familiarised itself with the manner and scope of supervision in the country where the parent bank or company has its registered office and all the banking supervision authorities contacted by the CNB have confirmed that they exercise supervision on a consolidated basis. In connection with the introduction of Basel II, the cooperation with consolidating supervisors in EU countries has deepened with regard to the assessment of applications jointly filed by a parent bank abroad and a subsidiary bank for the approval of special (advanced) approaches to credit and operational risk management. The distribution of tasks and cooperation is made under the coordination of a consolidating supervisor.

The exchange of information between home and host supervisors has been bolstered as a result of signing multilateral cooperation agreements. Since 2009, the CNB has signed 7 multilateral agreements on the cooperation in the supervision of cross-border banking groups. These agreements formalise the activities of the colleges of supervisors. To facilitate the

exchange of information, each college has created a secure website that serves for the exchange of information concerning the relevant financial group and its individual members.

2. For material cross-border operations of its banks, the supervisor identifies all other relevant supervisors and establishes informal or formal arrangements (such as memoranda of understanding) for appropriate information sharing, on a confidential basis, on the financial condition and performance of such operations in the home or host country. Where formal cooperation arrangements are agreed, their existence should be communicated to the banks and banking groups affected.

COMPLIANT

Regulation:

The CNB has signed 9 agreements on cooperation in the exercise of banking supervision with foreign banking supervisors from Germany, France, Slovakia, Austria, the USA (the State of New York), Belgium, the Netherlands, Italy and China. The negotiations on these agreements have significantly strengthened the contact between employees of both supervisors and have allowed for a more intense exchange of information. This information is used much more than in the past. In accordance with Article 25a, paragraph 3 of the Act on Banks, these agreements also provide for the exchange of information on any and all facts necessary for the proper exercise of banking supervision of cross-border institutions. The scope of these agreements is the same as that of standard agreements between regulators from EU countries. The agreements substantially reinforce the trustworthiness of the CNB. The cooperation on contractual basis marks another improvement in the standard of cooperation between banking supervisors of EU countries.

The current agreements are published on the CNB website, if the counterparty gives its consent thereto (the consent to publication has not been given by the supervisors from Italy, the Netherlands and China).

The subject matter of the current agreements is the confirmation of mutual cooperation, the achievement of mutual understanding in the area of banking regulation and banking supervision procedures and the promotion of information sharing. The cooperation mainly covers the granting of a licence (issue, modification, revocation) and consent to the acquisition or increase of a qualifying holding in a bank and the exercise of banking supervision over subsidiary banks and branches, including information sharing and on-site examinations according to the agreed terms. Furthermore, the agreements also contain an obligation that both parties will inform each other about penalties or other remedial measures imposed on a branch, subsidiary bank or parent bank, if they are aware of such measures or penalties and if they may be deemed important for the activities of the relevant branch, subsidiary bank or parent bank. The agreements also contain the parties' commitment to inform each other about any significant changes in banking regulation and banking supervision policies in their respective countries.

The conditions that must be fulfilled to be able to provide information acquired in the context of exercising banking supervision to authorities responsible for banking supervision abroad and to authorities responsible for the supervision of financial institutions and financial markets in the Czech Republic and abroad are set forth in Article 25a of the Act on Banks and Article 22a of the Act on Credit Unions. 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. The provision that sets forth the obligation to

respect confidentiality of information obtained as part of cooperation with a foreign banking supervision authority is embedded in each of the agreements concluded by the CNB with foreign banking supervision authorities.

During 2009, the supervision authorities responsible for the supervision of groups with cross-border operations within the EU started establishing colleges of supervisors with the aim to bolster the mutual cooperation, coordination and exchange of information. In the area of banking supervision, the CNB has so far signed a total of 7 multilateral agreements on cooperation in the supervision of cross-border banking groups. These apply to the following banking groups: Societe Generale, KBC, ING, UniCredit, Erste, Volksbank and Raiffeisenbank. In accordance with the current agreements, CNB officials take active part in the meetings of colleges of supervisors and are actively involved in the activities of these colleges.

Besides the foregoing banking groups, a similar multilateral cooperation takes place (though not formalised in a MoU) with regard to the LBBW, Wüstenrot and GE Capital groups.

3. The home supervisor provides information to host supervisors, on a timely basis, concerning:

- **the overall framework of supervision in which the banking group operates;**
- **the bank or banking group, to allow a proper perspective of the activities conducted within the host country's borders;**
- **the specific operations in the host country; and**
- **where possible and appropriate, significant problems arising in the head office or other parts of the banking group if these are likely to have a material effect on the safety and soundness of subsidiaries or branches in host countries.**

A minimum level of information on the bank or banking group will be needed in most circumstances, but the overall frequency and scope of this information will vary depending on the materiality of a bank's or banking group's activities to the financial sector of the host country. In this context, the host supervisor will inform the home supervisor when a local operation is material to the financial sector of the host country.

COMPLIANT

Regulation:

Under Article 38h, paragraph 2 of the Act on Banks and Article 22a, paragraph 2 of the Act on Credit Unions, the CNB shall, on request, supply supervisory authorities especially with information on holdings in a bank, foreign bank or credit union, on the management of a bank, foreign bank or credit union, on the capital of financial companies controlled by a bank or foreign bank, on capital adequacy on an individual and consolidated basis, on financial holding entities and information of relevance to the supervision of such entities, in particular with regard to liquidity, solvency, deposit insurance, capital adequacy, consolidated supervision, accounting, internal controls and monitoring of the risks arising from open positions on financial markets within the territory of the Czech Republic or within the territory of the state in which a bank or credit union has undertaken such risks.

Furthermore, in accordance with the Act on Banks (Article 38h, paragraph 3) and the Act on Credit Unions (Article 22a, paragraph 3), the CNB shall, on request, or on its own initiative, provide supervisory authorities with information that materially influences the assessment

of the financial situation of a foreign bank or financial institution in the state concerned, in particular information concerning:

- identification of the structure of a consolidated group, all significant banks and credit unions in this consolidated group, and the authorities responsible for supervising the banks and credit unions in this consolidated group;
- procedures for the collection of information from the banks and credit unions in a consolidated group, and the verification of that information;
- developments in a bank, credit union or another entity in a consolidated group that could seriously jeopardise the financial situation of a bank in the consolidated group;
- major sanctions and remedial measures of exceptional significance imposed on a bank or credit union in accordance with the Act on Banks, in particular a requirement for a capital increase, and the non-granting of consent to the use of a special approach for the calculation of a capital requirement or the restriction thereof.

The CNB has the power to request the same information from the supervisory authority of another Member State exercising supervision of an entity that is a member of a consolidated group. It also has the power to ask the authority exercising consolidated supervision of a European parent bank for information regarding the approaches and methods applied in respect of compliance with prudential rules.

The Act on Banks (Article 38f) and the Act on Credit Unions (Article 2h) further stipulate that prior to making any decision to change or revoke the licence of a bank or a credit union that has a branch within the territory of a member state of the European Union or another state party to the Agreement on the European Economic Area (hereinafter “Member State”), the CNB shall consult the banking supervisory authority of that state. In emergencies, the CNB shall inform the supervisory authority about its intention to change or revoke the licence. The same applies to the intention to revoke the licence of a branch of a bank having its registered office outside of the territories of the Member States if such bank has a branch within the territories of the Member States. In this case, the CNB shall endeavour to coordinate its activities with competent authorities in the Member States. The CNB shall also without delay inform the competent supervisory authority of the Member State in which a bank, a foreign bank having its registered office outside of the territories of the Member States or a credit union has a branch about the adjudication of bankruptcy on the assets of the bank, a branch of the foreign bank or the credit union.

In the event of revocation of the licence of a bank or eligible financial institution enjoying the benefits of the single licence under the Act on Banks (Article 5l) and under the Act on Credit Unions (Article 2h), the CNB shall without delay inform the host supervisory authority. The host supervisory authority shall take the necessary measures to put an end to the activities of the bank or eligible financial institution within its territory and to safeguard the interests of depositors.

4. The host supervisor provides information to home supervisors, on a timely basis, concerning:

- **material or persistent non-compliance with relevant supervisory requirements, such as capital ratios or operational limits, specifically applied to a bank’s operations in the host country;**
- **adverse or potentially adverse developments in the local operations of a bank or banking group regulated by the home supervisor;**
- **adverse assessments of such qualitative aspects of a bank’s operations as risk management and controls at the offices in the host country; and**

- **any material remedial action it takes regarding the operations of a bank regulated by the home supervisor.**

A minimum level of information on the bank or banking group, including the overall supervisory framework in which they operate, will be needed in most circumstances, but the overall frequency and scope of this information will vary depending on the materiality of the cross-border operations to bank or banking group and financial sector of the home country. In this context, the home supervisor will inform the host supervisor when the cross-border operation is material to the bank or banking group and financial sector of the home country.

COMPLIANT

Regulation:

Both the Act on Banks (Article 25a, paragraph 3) and the Act on Credit Unions (Article 22, paragraph 3) allow for the disclosure of information to a supervisory authority of the country where a foreign bank, financial institution or branch of a credit union have their registered offices.

Under the Act on Banks (Article 5k), if the CNB discovers that a bank or eligible financial institution that enjoys the benefits of the single licence is in violation of the statutory provisions in the areas falling within the powers of the host state when providing services within the territory of the host country and such a bank or eligible financial institution fails to rectify such violation on the CNB's request, the CNB will have the right to contact the competent authority of the home country, which shall promptly take the necessary measures to rectify the violation and shall communicate those measures to the competent authority of the host country. If, despite the foregoing measures, the problem is not removed and the violation continues, the CNB may, in accordance with the Act on Banks and after prior notification to the supervisory authority of the home state, take the necessary measures to rectify the violation and, in so far as is necessary, to terminate the activities of the bank or eligible financial institution within the territory of the host state. The Act on Banks also empowers the CNB to take the necessary measures to prevent or punish any conduct within the territory of the Czech Republic that is in violation of the statutory provisions of the Czech Republic in the public interest area, including measures to terminate the activities of the bank or financial institution within the territory of the Czech Republic.

A similar approach is applied to credit unions (Article 2g, paragraph 3 of the Act on Credit Unions) with the only difference that the CNB acts only as a supervisory authority of the home country.

Under Article 38i of the Act on Banks, prior to making a decision

- on the conclusion of an agreement under which the business (enterprise) or part thereof is disposed of in any way (e.g. an agreement on the sale of the business or part thereof or an agreement on the lease of the business or part thereof), on the general meeting's resolution to wind up a bank, on the merger of a bank or transfer of assets to a bank acting as a partner, on the reduction of a bank's registered capital, unless the capital is being reduced to cover a loss, on the general meeting's resolution that an existing bank will cease to carry on any activity for which a licence is required, and prior to the acquisition or increase of a qualifying holding in a bank or prior to taking control of a bank;
- on imposing sanctions or remedial measures of exceptional significance on a bank, in particular a requirement for a capital increase;

- on refusing an application for the consent to the use of special approach to the calculation of a capital requirement

the CNB shall consult with the supervisory authority exercising consolidated supervision of the consolidated group of which the bank concerned is a member, and with the other supervisory authorities also concerned. The CNB need not consult in cases of urgency or where such consultation may jeopardise the effectiveness of the decisions. In this case, it shall inform the other supervisory authorities without undue delay. The existing cooperation agreements with foreign supervisors also define and detail the exchange of information concerning all remedial measures or other actions against parent banks and cross-border institutions that are of significant nature. This includes the exchange of information about any event that might threaten the soundness of a bank that owns a branch or a subsidiary bank in the country of the other party to the agreement, about penalties or other measures relevant to the activities of a branch, subsidiary bank or parent bank operating in the country of the other party to the agreement, about the restriction or termination of any activities specified in the licence, about the requirements for changes in a bank's board of directors or supervisory board, about the requirements for creating the appropriate level of provisions and reserves, about a reduction in the registered capital of a bank, about the imposition of conservatorship, about the revocation of the licence, etc. The required information should be disclosed to the other party automatically, in writing and without undue delay.

Under the Act on Credit Unions (Article 2h), the CNB shall inform the relevant host supervisor about making a decision to prohibit the depositors from disposing of their deposits under the Act on Credit Unions in the event that the credit union concerned operates within the territory of such country; this information must be provided to the relevant supervisor without undue delay after making the decision. Furthermore, before making a decision to change or revoke the licence of a credit union that operates within the territory of a host country, the CNB shall consult its intention with the host supervisor. In cases of urgency, the CNB shall inform the supervisor about its intention to change or revoke the licence. The CNB shall promptly communicate the information about a change or revocation of the licence to the supervisory authorities of the countries where the credit union operates. The CNB shall also promptly inform the supervisory authority of the host country where the credit union operated about revocation of the credit union's licence for any of the following reasons:

- if serious shortcomings persist in the credit union's activities;
- the credit union has ceased to accept deposits from its members or to provide loans for a period of 6 months, or the licence was obtained through false information stated in the application; or
- the CNB discovers that the credit union's capital adequacy is lower than 1/3 of its individual capital requirements.

Under Article 22, paragraph 5 of the Act on Credit Unions, the CNB shall promptly inform the relevant supervisory authority of the Member State in which the credit union has a branch about the issuance of an insolvency decision and the adjudication of bankruptcy on the credit union's assets.

5. A host supervisor's national laws or regulations require that the cross-border operations of foreign banks are subject to prudential, inspection and regulatory reporting requirements similar to those for domestic banks.

COMPLIANT

Regulation:

The requirements placed on domestic and foreign applicants during the licensing process are

the same. Under the Act on Banks (Article 12, paragraph 1), a bank or a foreign bank branch shall carry on its activities with prudence and, in particular, pursue its business in a manner that is not detrimental to the interests of its depositors in respect of the recoverability of their deposits and that does not endanger the safety and soundness of such a bank or a foreign bank branch. Moreover, under the Act on Banks (Article 12, paragraph 2) a bank or a foreign bank branch may not conclude any agreements (contracts) under conspicuously disadvantageous conditions for such a bank or a foreign bank branch, especially such that bind the bank to economically unjustified performance or performance that fails conspicuously to correspond to the countervalue provided. Any agreements (contracts) concluded in contravention of this provision shall be invalid.

Banks (i.e. including subsidiaries of foreign banks) and foreign bank branches that do not enjoy the benefits of the single licence under the EU law are obligated to observe the prudential rules stipulated by an Act or by a Decree, unless the law provides otherwise. This concerns the requirements for:

- the system of governance (Article 8b of the Act on Banks) which shall be comprehensive and proportionate to the nature, scale and complexity of the activities of the bank or foreign bank branch;
- the disclosure of information (Article 11a of the Act on Banks);
- capital (Article 12a of the Act on Banks);
- the rules that limit the amount of assets and off-balance-sheet items vis-à-vis an entity or group of entities in relation to capital (hereinafter the "exposure rules") on an individual basis (Article 13 of the Act on Banks);
- the maintenance of solvency at all times (Article 14, paragraph 1 of the Act on Banks).

The Act on Banks (Article 11) defines operational requirements applicable to banks and foreign bank branches. These requirements are associated with an obligation to provide clients on the premises of the bank or foreign bank branch with written information in the Czech language about the terms and conditions applying to the acceptance of deposits, the provision of loans and other banking transactions and services. The same rules also apply to the publication of the client complaint procedure.

Under the Act on the CNB (Article 41, paragraphs 2 and 3), banks and foreign bank branches shall submit reports and statements or other information for the purposes of banking and monetary statistics, liquidity and the Central Register of Credits to the CNB according to the applicable provision on reporting.

Under the Act on Banks (Article 5h, paragraph 2), the CNB shall provide foreign bank branches that enjoy the benefits of the single licence with a summary of some legal or other regulations in the area of banking that apply to foreign bank branches operating under the single licence regime. An up-to-date summary of these regulations will be posted on the CNB website.

Supervision:

Off-site supervision and on-site examination at foreign bank subsidiaries is exercised in a standard fashion like the supervision at banks owned by Czech entities. In the case of foreign bank branches operating under the single licence, the supervision is limited under the EU law to liquidity and the prevention of the legalisation of the proceeds from criminal activities.

- 6. Before issuing a licence, the host supervisor establishes that no objection (or a statement of no objection) from the home supervisor has been received (or a statement of no objection). For purposes of the licensing process, as well as ongoing supervision of cross-border banking operations in its country, the host supervisor assesses whether the home supervisor practises global consolidated supervision.**

COMPLIANT

Regulation:

The requirement to obtain before granting a licence the consent of the banking supervisory authority of the country where the foreign bank concerned has its registered office is set forth in the Act on Banks (Article 4, paragraph 3) and in the Act on Credit Unions (Article 2j), which stipulate that prior to making a decision on an application for a licence or for a permit the CNB shall seek the opinion of the competent supervisory authority supervising banks, investment firms or insurance companies in a member state of the European Union in the event that the entity to which the licence or permit is to be granted is controlled by:

- a) a foreign bank having its registered office in the Member State;
- b) an entity having a permit from the competent supervisory authority in the Member State to provide investment services;
- c) an insurance company having a permit from the competent supervisory authority in the Member State;
- d) an entity having control over the entity mentioned above.

These Acts further stipulate that the CNB shall require that such opinion in particular contain information relevant for the assessment of whether the following conditions have been met: persons having a qualifying holding in the bank must be eligible to exercise shareholder rights in the bank's business activities and the persons who are nominated for executive managerial positions in the bank must be competent, trustworthy and experienced. The Act on Credit Unions further sets out the requirement for regular exchange of information relevant to the issue of permits and to the inspection of the activities of the members and executives of entities being supervised.

In the area of bank licensing, the Act on Banks [Article 4, paragraph 5 subparagraph i)] and the Act on Credit Unions [Article 2a, paragraph 4 subparagraph i)] stipulate that the granting of a licence is also subject to the condition that in the state within whose territory the group has close links there must be no legal or factual impediments to the exercise of banking supervision.

In the case of an application for establishing a branch of a foreign bank having its registered office outside of the territories of the Member States under the Act on Banks (Article 5, paragraph 2), the application must be accompanied by the opinion of the banking supervisory authority of the country in which the foreign bank has its registered office on its intention to establish a branch in the Czech Republic, as well as that authority's declaration that the branch will be subject to banking supervision.

Furthermore, under [Decree No. 233/2009 Coll., on applications, approval of persons and the manner of proving professional qualifications, trustworthiness and experience of persons, and on the minimum amount of funds to be provided by a foreign bank to its branch](#) (hereinafter "Decree No. 233/2009 Coll.") Article 4, paragraph 3 subparagraph h), Article 6, paragraph 2 subparagraph f) and Article 18, paragraph 2 subparagraph f), an application for a licence or an application for the consent to the acquisition or increase of a qualifying holding in a bank

must be accompanied by a written statement of the authority that exercises supervision over the bank or, if the applicant is a financial institution, over the financial institution regarding the applicant's intention to establish a branch in the Czech Republic or intention to acquire or increase a qualifying holding in a bank.

The agreements signed with foreign regulators specify in detail the exchange and scope of information to be provided by home supervisor to host supervisor about the parent bank that is applying for a licence to establish a cross-border institution or for the consent to the acquisition of a qualifying holding in a bank in the Czech Republic.

7. Home country supervisors are given on-site access to local offices and subsidiaries of a banking group in order to facilitate their assessment of the group's safety and soundness and compliance with KYC requirements. Home supervisors should inform host supervisors of intended visits to local offices and subsidiaries of banking groups.

COMPLIANT

Regulation:

Under the Act on Banks (Article 25, paragraph 1), the activities of banks, including branches thereof carrying on activities within the territory of another country, shall be subject to banking supervision of the CNB, including on-site examinations. The activities of foreign bank branches shall be subject to supervision by the home country of the foreign bank and to the extent stipulated by law to the banking supervision exercised by the CNB. The Act on Banks (Article 25, paragraph 2) allows for carrying out an on-site examination by the banking supervisory authority of the home country of the foreign bank or institution at a bank or a foreign bank branch that is subject to such authority's supervision operating within the territory of the Czech Republic 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 by the home banking supervisory authority in the country of the host banking supervisory authority.

Foreign banks that carry on business activities within the territory of the Czech Republic through a branch and enjoy the benefits of the single licence are subject to the provisions of Article 5a, paragraph 7 of the Act on Banks. Under these provisions, the CNB may carry out an on-site examination at these branches or at entities comprising a consolidated group containing the foreign bank concerned, if so requested by the supervisory authority of the country in which the foreign bank has its registered office. The supervisor authority of the country in which the foreign bank enjoying the benefits of the foreign licence has its registered office may, after having first informed the CNB, carry out on-site examination within the territory of the Czech Republic at the foreign bank branch concerned.

Under the Act on Credit Unions (Article 2g and Article 22), the CNB may exercise supervision of credit unions, including their branches within the territory of a host country, by carrying out on-site examinations. Both in the case of banks and credit unions, the CNB acts in accordance with the Act on State Inspection.

8. The host supervisor supervises shell banks, where they still exist, and booking offices in a manner consistent with internationally agreed standards.

Not applicable.

9. A supervisor that takes consequential action on the basis of information received from

another supervisor consults with that supervisor, to the extent possible, before taking such action.

COMPLIANT

Regulation:

The Act on Banks (Article 25a, paragraph 8) stipulates that information obtained from the authorities of foreign states 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. The Act on Banks, the Act on Credit Unions and the cooperation agreements signed with foreign supervisors set forth the requirement to inform each other about all significant activities in the area of licensing, supervision, remedial measures, penalties and licence revocations (see clauses 3, 4 and 5), i.e. including those that would be performed on the basis of information obtained from another supervisor.

Additional criterion

- 1. Where necessary, the home supervisor develops an agreed communication strategy with the relevant host supervisors. The scope and nature of the strategy should reflect the size and complexity of the cross-border operations of the bank or banking group.**

COMPLIANT

Regulation:

Although there is not any law explicitly providing for the development of a communication strategy with host supervisors, the signed cooperation agreements include a commitment of the parties to discuss between themselves any significant information on banks that have branches or subsidiary banks within the territories of the parties. At the same time, these agreements contain a commitment that the representatives of supervisory authorities will meet each other anytime when either of the parties deems it necessary to discuss possible solutions to problems concerning banking supervision of branches and subsidiary banks. We believe that this contractual arrangement is sufficient.

ANNEX

Summary of acts and documents

Directly binding EU regulations

- [Regulation \(EC\) No. 1889/2005 of the European Parliament and of the Council](#) of 26 October 2005 on controls of cash entering or leaving the Community
- [Regulation \(EC\) No. 1781/2006 of the European Parliament and of the Council](#) of 15 November 2006 on information on the payer accompanying transfers of funds

Acts

- Act No. 40/2009 Coll., the Criminal Code, as amended
- Act No. 2/1969 Coll., on the establishment of ministries and other central bodies of state administration of the Czech Republic, as amended
- Act No. 513/1991 Coll., the Commercial Code, as amended
- Act No. 552/1991 Coll., on State Inspection, as amended
- Act No. 563/1991 Coll., on Accounting, as amended
- Act No. 21/1992 Coll., on Banks, as amended
- Act No. 591/1992 Coll., on Securities, as amended
- Act No. 6/1993 Coll., on the Czech National Bank, as amended
- Act No. 42/1994 Coll., on State-Contributory Supplementary Pension Insurance and on Amendments to Certain Acts, as amended
- Act No. 87/1995 Coll., on Credit Unions and Certain Related Measures and on the Amendment of Czech National Council Act No. 586/1992 Coll., on Income Taxes, as amended, as amended
- Act No. 219/1995 Coll., the Foreign Exchange Act, as amended
- Act No. 15/1998 Coll., on the Capital Market Supervision and on the Amendment of Other Acts
- Act No. 82/1998 Coll., on Liability for Damage Caused During the Exercise of State Authority by a Decision or Maladministration and on the Amendment of Czech National Council Act No. 358/1992 Coll., on Notaries and their Activities (the Notarial Code), as amended
- Act No. 93/2009 Coll., on Auditors, as amended
- Act No. 284/2009 Coll., on Payment Systems, as amended
- Act No. 189/2004 Coll., on Collective Investment, as amended
- Act No. 256//2004 Coll., on Capital Market Undertakings, as amended
- Act No. 500/2004 Coll., (the Administrative Procedure Code) as amended
- Act No. 627/2004 Coll., on European Companies, as amended
- Act No. 377/2005 Coll. on Financial Conglomerates, as amended
- Act No. 57/2006 Coll., on the Amendment of Acts in Relation to the Unification of Supervision over the Financial Market, as amended
- Act No. 69/2006 Coll., on International Sanctions
- Act No. 262/2006 Coll., the Labour Code, as amended
- Act No. 253/2008 Coll., on Certain Measures against the Legitimation of the Proceeds of Crime and Financing of Terrorism, as amended
- Act No. 269/1994 Coll., on the Criminal Register, as amended

CNB Decrees

- Decree No. 164/2002 Coll., on the conditions of access to information contained in the information database of the Czech National Bank – the Central Registry of Credits, as amended
- Decree No. 233/2009 Coll., on applications, approval of persons and the manner of proving professional qualifications, trustworthiness and experience of persons, and on the minimum amount of funds to be provided by a foreign bank to its branch, as amended
- Decree No. 123/2007 Coll., stipulating the prudential rules for banks, credit unions and investment firms, as amended
- Decree No. 281/2008 Coll., on certain requirements for the system of internal principles, procedures and control measures against the legitimisation of the proceeds of crime and financing of terrorism

CNB Provisions

- [Consolidated version of Provision No. 2/2009 CNB Bulletin \(pdf, 159 kB\)](#), on reporting by banks and foreign bank branches to the Czech National Bank, as amended by Provision No. 2/2010 CNB Bulletin
 - [Annex No. 1 \(pdf, 138 kB\)](#) – A list and deadlines for submitting reports of banks and foreign bank branches
 - [Annex No. 2A \(pdf, 1,0 MB\)](#) – Basic characteristics and contents of reports being submitted in an electronic form
 - [Annex No. 2B \(pdf, 127 kB\)](#) – Characteristic of the contents of the report “BD(CNB)14-04”
 - [Annex No. 3 \(pdf, 119 kB\)](#) – Alternatives of the scope of reporting by banks and foreign bank branches
 - [Annex No. 4 \(pdf, 113 kB\)](#) – Additional information to the report “E(CNB)8-01”
- [Provision No. 1 of 19 October 2010 \(pdf, 235 kB\)](#), on reporting by credit unions to the Czech National Bank. The Provision comes into force on 1 January 2011
- [Provision No. 5 of 11 June 2004 \(pdf, 124 kB\)](#), stipulating the content, method of keeping and requisites of the records of coverage of mortgage bonds in circulation
- [Provision No. 5 of 1 August 2002 \(pdf, 852 kB\)](#), stipulating the methodology for submission of selected data for the Central Register of Credits by banks and branches of foreign banks to the Czech National Bank

Official Information of the CNB

[Prudential Rules – Official Information](#) to Decree No. 123/2007 Coll., regarding the prudential rules for banks, credit unions and investment firms

- [Official Information of 19 April 2011 \(pdf, 152 kB\)](#) regarding the registration of representative offices of foreign banks and financial institutions carrying on banking activities
- [Official Information of 29 December 2010 \(pdf, 101 kB\)](#) on certain provisions of CNB Provision No. 1/2010 CNB Bulletin, on reporting by credit unions to the Czech National Bank

- [Official Information of 20 December 2010 \(pdf, 187 kB\)](#) on applications for the granting of the consent of the Czech National Bank in matters of the disposal of the business, the winding up or the transformation of a credit institution, the reduction in the registered capital of a bank, the takeover of debts of a bank under conservatorship or the reduction in the basic membership contribution of a member of a credit union
- [Official Information of 10 December 2010 \(pdf, 237kB\)](#) regarding the pursuit of business in the financial market: Qualitative Requirements Relating to the Conduct of Business – Fundamental Information
- [Official Information of 21 May 2010 \(pdf, 185 kB\)](#) regarding the evaluation of management employees of banks, branches of foreign banks from third countries, financial holdings and electronic money institutions
- [Official Information of 21 May 2010 \(pdf, 267 kB\)](#) regarding the interpretation of the terms trustworthiness and competence
- [Official Information of 14 January 2010 \(pdf, 105 kB\)](#) regarding certain provisions of CNB Provision No. 2/2009 CNB Bulletin, on reporting by banks and foreign bank branches to the Czech National Bank
- [Official Information of 7 July 2008 \(pdf, 145 kB\)](#), informing about the practice of the Czech National Bank regarding extract or copy from the Crime Register
- [Official Information of 12 November 2007 \(pdf, 211 kB\)](#) regarding certain provisions of the Act on Banks relating to the single licence
- [Official Information of 10 December 2004 \(pdf, 118 kB\)](#) regarding Article 20a (3) of Act No. 21/1992 Coll., on Banks, as amended by Act No. 257/2004 Coll.
- [Official Information of 29 October 2004 \(pdf, 121 kB\)](#) regarding the provisions of Article 1(3)(i) and Article 1(4) of Act No. 21/1992 Coll., on Banks, as amended
- [Official Information of 19 March 2003 \(pdf, 193 kB\)](#) regarding Article 22(3) of Act No. 21/1992 Coll., on Banks, as amended by Act No. 126/2002 Coll.
- [Official Information of 31 January 2002 \(pdf, 93 kB\)](#) regarding the conclusion of control agreements by banks
- [Official Information of 31 August 2001 \(pdf, 162 kB\)](#) on the procedure to be applied by a bank and the law enforcement authorities to acquire an exhibit located in a safe deposit box of the bank
- [Official Information of 14 August 1998 \(pdf, 92 kB\)](#) regarding certain provisions of Act No. 16/1998 Coll., amending Act No. 21/1992 Coll., on Banks, as amended

Foreign legal and other documents

- Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast Directive 2000/12/EC),
- Directive 2006/49/EC of the European Parliament and of the Council of 14 June 2006 on the capital adequacy of investment firms and credit institutions (recast Directive 93/6/EHS)
- Directive 2000/46/EC of the European Parliament and of the Council of 18 September 2000 on the taking up, pursuit of and prudential supervisions of the business of electronic money institutions
- Directive 2007/44/EC of the European Parliament and of the Council of 5 September 2007, amending Council Directive 92/49/EEC and Directives 2002/83/EC, 2004/39/EC, 2005/68/EC and 2006/48/EC, as regards procedural rules and evaluation

criteria for the prudential assessment of acquisitions and increase of holdings in the financial sector

- International Accounting Standards (hereinafter the "IAS")
- Financial Action Task Force on Money Laundering (hereinafter the "FATF")

International Convergence of Capital Measurement and Capital Standards: A Revised Framework, June 2004 (hereinafter the "Basel II Accord").