

**Czech Republic: Report on the Observance of Standards and Codes—
Banking Supervision—Update**

This update to the Report on the Observance of Standards and Codes on Banking Supervision for the **Czech Republic** was prepared by a staff team of the International Monetary Fund as background documentation for the periodic consultation with the member country. It is based on the information available at the time it was completed on **August 8, 2003**. The views expressed in this document are those of the staff team and do not necessarily reflect the views of the government of the **Czech Republic** or the Executive Board of the IMF.

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CZECH REPUBLIC

**Report on the Observance of Standards and Codes
Czech Republic—Banking Supervision: Factual Update**

Prepared by European I and Monetary and Financial Systems Departments

August 8, 2003

This note provides factual updates on material recent developments with respect to observance of international standards in the banking sector since the publication of the Czech Republic: Financial System Stability Assessment, including Reports on the Observance of Standards and Codes on the following topics: Monetary and Financial Policy Transparency; Banking Supervision; Insurance Regulation; Securities Regulation; Corporate Governance; and Payment Systems (IMF Country Report No. 01/113, 7/01) and the factual update in the Czech Republic: Report on the Observance of Standards and Codes—Fiscal Transparency, Banking Supervision, Insurance Regulation, Securities Regulation, Payment Systems, and Monetary and Financial Policy Transparency—Updates (IMF Country Report No. 02/169, 8/02). It draws on the Czech National Bank's recently completed second self-assessment of the Basel Core Principles.

I. SUMMARY OF FSAP CONCLUSIONS

1. The June 2001 FSAP mission assessed the Czech Republic's compliance with the Basel Core Principles for Effective Banking Supervision.¹ The 2001 report disclosed that the Czech authorities placed high priority on implementing and observing the international standards relevant for financial stability. It also noted that supervisory staff exhibited a high understanding of best international supervisory standards, policies, and practices. Nevertheless, the report noted significant weaknesses in laws governing debtor-creditor relations, inefficiencies in the judicial process, cumbersome administrative requirements, and low supervisory skills to assess market risk, audit computer-based systems, and evaluate risk management systems. The July 2001 report included recommendations to enhance the legal and regulatory framework, to build up supervisory capacity, to move toward consolidated supervision, and to increase attention to supervisory coordination and cooperation.

II. SUMMARY OF REPORT ON OBSERVANCE OF STANDARDS AND CODES (ROSC)— AUGUST 2002

2. The IMF issued a ROSC—Banking Supervision, August 2002.² It found that the authorities had made improvement in the legal framework, licensing rules and procedures, and methods of risk-based and consolidated supervision, following the adoption of new legislation, in particular, amendments of the Act on the Czech National Bank (CNB) and the Act on Banks. Even so, it also disclosed shortcomings in progress toward strengthening the legal protection of supervisors and the use of differential capital ratios based on individual banks' business and control risks. Since the 2001 FSAP and the August 2002 ROSC factual update, the CNB has issued rules for risk management for credit risk and market risk. Regarding protection of supervisors, the CNB asserts that the Criminal Code ensures general protection of all citizens, as for instance, benefit of the doubt. Legal protection of supervisors is covered by a general protection of civil servants according to the Act on Liability for damage caused in the execution of public authority by decision or incorrect official procedure No. 82/1998 Coll.

¹ Czech Republic: Financial System Stability Assessment, including Reports on the Observance of Standards and Codes on the following topics: Monetary and Financial Policy Transparency; Banking Supervision; Insurance Regulation; Securities Regulation; Corporate Governance; and Payment Systems (IMF Country Report No. 01/113, 7/01). The report is available on the IMF website www.imf.org/external/np/rosc/rosc.asp.

² Czech Republic: Report on the Observance of Standards and Codes—Fiscal Transparency, Banking Supervision, Insurance Regulation, Securities Regulation, Payment Systems, and Monetary and Financial Policy Transparency—Updates (IMF Country Report No. 02/169, 8/02). The report is available on the IMF website www.imf.org/external/np/rosc/rosc.asp.

III. FACTUAL UPDATE OF MATERIAL RECENT DEVELOPMENTS—MAY 2003

3. Since the Financial System Stability Assessment (IMF Country Report No. 01/113) and the 2002 Reports on the Observance of Standards and Codes Update (IMF Country Report No. 02/169), the CNB has issued further amendments to the Act on Banks and adopted new examination practices.

Preconditions for Effective Bank Supervision

- (i) Weaknesses in corporate governance and the availability of transparent and accurate financial data from borrowers continue.
- (ii) Shortcomings in the judicial and legal systems continue. The courts suffer from insufficient resources and lack of wider experience amongst the judges in understanding modern business law and corporate finance. Other problems include costly, cumbersome, and nontransparent court processes. In addition, even though amendments to the Bankruptcy Act over the past few years have strengthened creditors' rights, problems persist. Deficiencies, *inter alia*, include slow court proceedings, leading to a significant backlog of filed and pending bankruptcy cases and weak legal protection of creditors' rights. Additionally, the existing bankruptcy law does not adequately address financial institution liquidation. A new bankruptcy bill that reportedly addresses these weaknesses has been drafted and will be discussed by government ministries and financial sector participants in the near future.

Objectives, Autonomy, Powers, and Resources (CP 1)³

- (iii) In March 2003, a Memorandum of Understanding (MOU) for the Performance of Banking Supervision and State Supervision over the Financial Market was signed among the domestic supervisory agencies, allowing consolidated supervision of banking, insurance, pension funds, and the capital market (www.cnb.cz). It replaced the previous agreement of 1998. Additionally, the CNB signed MOUs with foreign supervisory counterparts: Austria, Belgium, France, Germany, the Slovak Republic, and the State of New York, USA (www.cnb.cz). MOUs with regulators from Italy and the Netherlands are underway.
- (iv) With respect to risk-based supervision in 2002, the CNB started preparing a new concept of the assessment of bank performance based on banks' individual risk profiles. This system will include all quantitative and qualitative information from reports, on-site inspection, and contacts with banks and other sources of information. The aim of the assessment is the evaluation of the bank's overall

³ Subsequent to the mission, the Ministry of Finance issued a draft proposal calling for consolidation of supervision for financial institutions/markets into one agency.

position and the customization of future supervisory activities based on the conclusions. The pilot version of this project should be completed by end-2003 and tested in 2004.

Licensing and Structure (CPs 2–5)

- (v) In December 2002, the CNB published the official information regarding the assessment of persons nominated for executive managerial positions in banks and foreign bank branches.

Prudential Regulation and Requirements (CPs 6–15)

- (vi) The use of differential capital ratios based on individual banks' risk profile will be taken under consideration when the New Basel Capital Accord (NBCA) comes into force at end-2006.
- (vii) The CNB provisions on credit risks management in banks and asset classification and provisioning came into force in January 2003. The Act on Banks (AoB) does not permit supervisors discretion in interpreting the definition of "connected or related parties." The right of the CNB to obtain bank's documents outside the discharge of on-site inspections is not sufficiently provided for in the legal regulations; however, the CNB reports that banks mostly provide the information requested. The CNB intends to initiate an amendment to the respective provisions of the AoB to unequivocally provide for access to a bank's documents outside the discharge of on-site inspections.
- (viii) Provision no. 3/2002 by the CNB on credit risk management lays down requirements on all key aspects of credit risk management, including country and credit risk. Additionally, provisions requiring banks to have internal audit departments, adopt policies on market risk management, and perform testing of internal management and control systems came into effect in January 2003. The CNB is advancing the supervisory staff's practical experience for approving the market risk models.
- (ix) The CNB does not have a regulation for operational risk management; work is underway to correct this deficiency.

- (x) The authorities are undertaking amendments to the anti-money laundering (AML) Act to incorporate the second European Union directive on money laundering, and reporting of financing of terrorism. Also, the frequency of the CNB's targeted on-site inspections for compliance with AML and combating the financing of terrorism (CFT) rules have increased. Still missing are some legal requirements regarding the application of the "know your customer" rule and guidance from the CNB on bank procedures necessary to comply with the rule. The provisions of the CNB on the prevention of abuse of banks for the legalization of proceeds from criminal activities are under preparation.⁴

Methods of Ongoing Supervision (CP 16–20)

- (xi) The CNB is working on developing its framework for macro prudential analysis and stress testing capacity.
- (xii) Amendments to the AoB require banks to provide information on all members of a consolidated group to the CNB. Also, the CNB has the authority to monitor credit and market risks at a consolidated level, following the Decree of the CNB No. 333 Coll of July 2002, which stipulates prudential rules of parent undertakings on a consolidated basis. The CNB is advancing the supervisory staff's practical experience to monitor credit and market risks on a consolidated basis.
- (xiii) Examination procedural manuals for supervision have not been completed yet.
- (xiv) In March 2003, the CNB amended provisions that address requirements for external auditors.
- (xv) The CNB does not collect comprehensive data necessary to monitor trends and developments for the banking sector as a whole or individual banks with respect to risks associated with exposure to the household sector (including household indebtedness, delinquency information, and housing and property prices) and SMEs.

Information Requirements (CP 21)

- (xvi) The regulation on information disclosure by banks in their annual reports, stipulating the layout and content of items of the profit and loss account and the

⁴ An assessment of the Czech Republic's compliance with the FATF recommendations is in progress, and a separate ROSC will be circulated to the Board (date to be decided) for information.

extent of information to be disclosed for banks and certain financial institutions, came into force on January 1, 2003.

Cross-Border Banking (CPs 23–25)

- (xvii) The CNB has signed MOUs with Austria, France, Germany, the Slovak Republic, the State of New York, USA, and Belgium; agreements with the Netherlands and Italy are under preparation. Examination manuals need to be expanded to address, in a more comprehensive manner, information reporting on its overseas operations of banks.