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Česká národní banka
2011

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ANNUAL REPORT

2010

ANNUAL REPORT

MANDATE AND OBJECTIVES OF THE CZECH NATIONAL BANK

- to maintain price stability,
- to oversee the stability of the financial system,
- to ensure smooth circulation of money and smooth payments,
- to support the balanced and smooth development of the Czech financial market.

- Through *monetary policy* we seek to preserve price stability, i.e. low and stable inflation, and thereby maintain confidence in the value of money and the exchange rate of the Czech koruna.
- By *supervising the financial market, issuing prudential rules and conducting financial market operations* we care for the stability and development of the financial system and protect its clients.
- By *managing the clearing system and issuing banknotes and coins* we ensure smooth payments and cash flows.
- *We administer the foreign exchange reserves* of the Czech state.

What we build upon

INDEPENDENCE

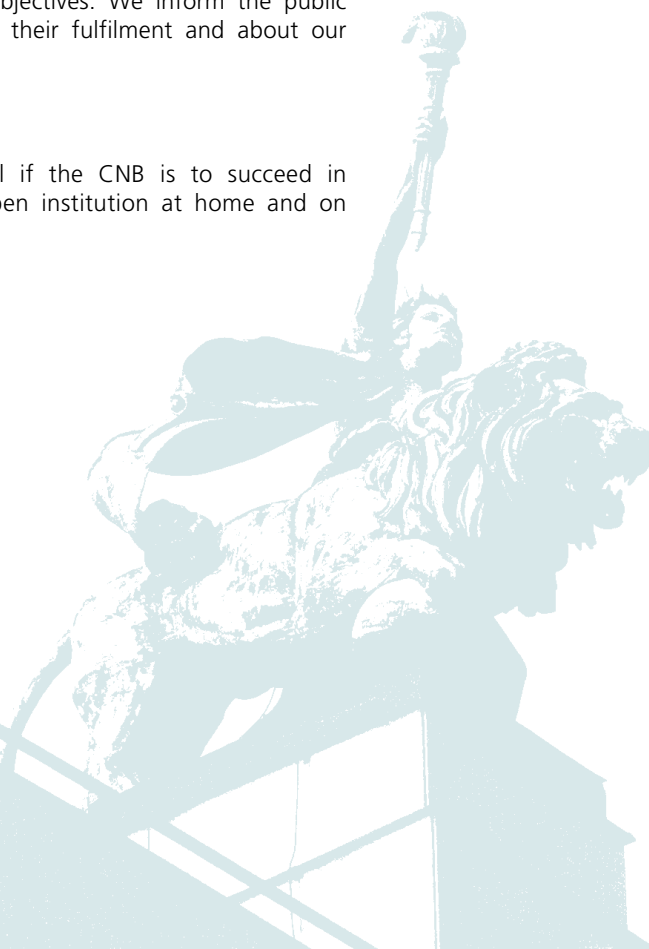
- Broad independence of the central bank is a key condition for successful implementation of monetary policy, i.e. for sustained non-inflationary growth of the economy, as well as for objective supervision of the financial market.

OPENNESS

- A high degree of independence must go hand in hand with a high degree of accountability to the public for fulfilling our objectives. We inform the public regularly and openly about our objectives and their fulfilment and about our opinions, plans and predictions.

PROFESSIONALISM

- Proficient and competent employees are vital if the CNB is to succeed in enhancing its reputation as a credible and open institution at home and on the international stage.



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The recovery of the domestic economy, which started in mid-2009, continued into 2010. It was driven mainly by replenishment of inventories and growth in external demand, reflected above all in faster growth of industrial production and exports. Foreign trade was the main channel through which the Czech economy was affected by the global financial and economic crisis, and 2010 confirmed that it will be the export sector that will help extricate the economy from the crisis.

While the economic downturn in 2009 H1 was particularly sharp and deep, the return to pre-crisis output levels has so far been gradual and accompanied by uncertainties originating almost exclusively abroad. The overall risks decreased somewhat in 2010 by comparison with the previous two years, but they by no means disappeared. In the various stages of the crisis they underwent significant changes. At the start of the crisis they were linked with the potential systemic default of the financial sector in the most advanced economies, but soon after they began to stem from a sharp deterioration in economic sentiment, a contraction in economic activity and rapid growth in unemployment. At the start of 2010 the largest risks began to be associated with destabilisation of public finances in the most indebted euro area countries and with their uncertain macroeconomic and financial prospects. As the risks are mostly external in nature, the small and open Czech economy needs appropriate adjustment mechanisms that will dampen the impact of disturbances and shocks coming from abroad.

The Czech National Bank conducted monetary policy in 2010 amid persisting uncertainty. Following sharp and repeated monetary policy interest rate cuts in 2008 and 2009, it seemed at the beginning of 2010 that rates had bottomed out and we would start increasing them in the second half of the year. However, external and domestic inflationary pressures remained subdued for the entire year, and every new CNB forecast pushed the expected timing of a rate increase further into the future. In Q2, the downside risks to inflation intensified to such an extent that we decreased rates by a further 0.25 percentage point to an all-time low of 0.75%. They remained at this level until the end of the year.

Given the favourable financial market situation, the CNB decided in August 2010 to modify the extraordinary liquidity-providing monetary policy measures it had introduced in October 2008. Three-month liquidity-providing repo operations were discontinued at the end of 2010 and two-week liquidity-providing repo operations started to be conducted less frequently – once a week – starting in January 2011. The discontinuation of measures adopted during the crisis confirmed that the situation on the financial markets had calmed.

Not even the most critical stages of the financial and economic crisis changed our conviction of the advantages of inflation targeting. This monetary policy decision-making framework proved successful even at a time of extraordinary volatility of all macroeconomic and monetary variables and unprecedented growth in uncertainty. It thus became one of the anchors of the economy. Although the difference between monetary policy rates and market rates persisted in 2010 owing to an increased risk premium, we still regarded the transmission mechanism of our monetary policy as functional.

We continue to view the existence of an independent Czech koruna as beneficial. Its depreciation in the initial months of 2009 dampened the adverse effects of the crisis on the corporate sector without jeopardising price stability in an environment of subdued domestic demand-pull inflation pressures. The floating exchange rate also had a favourable effect on inflation in the final months of 2010, when the external cost shock caused by a sharp rise in commodity and food prices was dampened by a strengthening koruna. The independent Czech currency has therefore acted in recent years as a useful buffer against external shocks, moderating their impact on the domestic economy.

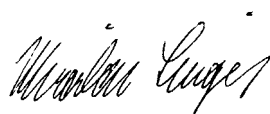
The serious debt crisis in some countries of the euro area uncovered its long-running structural heterogeneity and revealed weaknesses in its institutional set-up and functioning. Some of the political decisions made by euro area representatives helped to moderate the acute problems relating to the debt crisis, but a solution to the systemic shortcomings has yet to take shape. This prompts us to be very cautious when considering the potential advantages of the single currency for the Czech Republic.

We consider the planned transfer of supervisory powers from national to supranational European authorities to be a significant risk going forward. We believe that the analysis of the causes of the financial crisis carried out by some European institutions following its outbreak was erroneous and that weakening the position of the national supervisors may prove to be the least appropriate response to the problems we – fortunately – encountered merely as observers. None of this alters the fact that the domestic banking sector is in excellent shape, as evidenced, among other things, by the results of the very tough stress tests we conduct every quarter, which we have been publishing regularly since February 2010.

Turning to events inside the central bank, the Bank Board underwent significant changes in composition last year. In July I was appointed Governor, replacing Zdeněk Tůma, who resigned more than six months before his term of office expired. On the same day, Kamil Janáček was appointed a new Bank Board member and Bank Board Member Vladimír Tomšík was appointed Vice-Governor. The responsibilities of most Bank Board members changed in connection with these personnel changes. One of many noteworthy events was the establishment of an independent Financial Stability Department. The organisational independence of this area of work reflects how central this field is to smooth economic development.

The CNB organised an open day in June for the first time in several years. The event proved to be popular with the public. Its motto was "How currency is made" and one of its main themes was the central bank's contribution to enhancing the financial literacy of the general public. It is worth mentioning that the CNB worked in partnership with the Ministry of Finance and the Ministry of Education, Youth and Sports to create a National Financial Education Strategy. One of the projects the CNB was involved in as part of this strategy was a measurement of adult financial literacy.

In September we were pleased to learn that 77% of Czechs trust the Czech National Bank. This was the highest figure since 1999, when STEM started to measure confidence in the CNB. We value the public's opinion acknowledging the independent central bank's systematic effort to be as open and competent as possible. We are fully aware of the responsibility we have towards the public. I firmly believe that having successfully maintained our good reputation even at times of extraordinary economic uncertainty, we will be no less successful in fulfilling our mission in the years ahead.



Miroslav Singer
Governor

MANAGEMENT AND ORGANISATION



The CNB's organisational structure consists of a headquarters in Prague and seven branches in Prague, České Budějovice, Plzeň, Ústí nad Labem, Hradec Králové, Brno and Ostrava. The CNB has a two-tier management system. The Bank Board makes fundamental decisions relating to monetary policy, the development of core activities and the institutional development of the bank. Responsibility for implementing the Bank Board's decisions and the day-to-day running of the bank is delegated to the executive directors of departments and branches.

BANK BOARD

The Bank Board is the supreme governing body of the CNB and takes decisions as a collective body by a simple majority of the votes cast. It has seven members: the Governor (who chairs the Board meetings), two Vice-Governors and four other members. The members of the Bank Board, in addition to collectively managing the CNB, oversee the activities performed by the CNB's organisational units according to a scheme approved by the Bank Board (see the organisational chart of the CNB).



The Bank Board sets monetary policy in accordance with the CNB's primary objective, namely to maintain price stability, and decides on monetary policy measures, approves monetary instruments and the principles for CNB transactions, approves key measures relating to financial market supervision and financial stability, and rules on appeals in administrative proceedings. It sets the CNB's overall development strategy and decides on the bank's organisational structure and the responsibilities of the organisational units at its headquarters and branches. It also approves the CNB's budget and the CNB's Annual Financial Report, Inflation Reports, Financial Stability Reports and Financial Market Supervision Reports.

Following the resignation of Zdeněk Tůma from the post of Governor as of 30 June 2010, the President of the Czech Republic appointed Miroslav Singer as Governor, Vladimír Tomšík as Vice-Governor and Kamil Janáček as new member of the Bank Board with effect from 1 July 2010. The Bank Board then approved a new division of responsibilities among the Bank Board members in the oversight of the CNB's activities performed by the organisational units at its headquarters and branches.

CNB SENIOR MANAGEMENT

The executive directors of the CNB's departments and branches are responsible – subject to the CNB's overall strategy – for the performance of the activities falling within their areas of competence and powers as set out in the Organisational Statute.

Their competences and responsibilities include in particular methodological and line management activities, including presenting proposals for solutions to issues of fundamental significance to the Bank Board. They carry out the decisions adopted by the Bank Board and set targets for the staff under them. They also perform the employer's rights and duties under labour law in respect of employees. They are responsible for coordinating with other organisational units of the bank and with domestic and foreign partner institutions.

HEADQUARTERS

The fundamental organisational units of the CNB's headquarters are departments, which are responsible for the performance of activities and methodological management in specific areas defined by the Organisational Statute. The bank's main activities, including methodological management of branches, and ancillary and service activities are concentrated in the organisational units of its headquarters. Coordination of activities, which in many cases covers the areas of competence of several organisational units and depends on close cooperation between them, is provided for by standing advisory bodies, committees and project teams.

Several new legal regulations affected the competences of the CNB and its organisational units in 2010. For example, Act No. 295/2009 Coll., amending Act No. 2/1969 Coll., on the Establishment of Ministries and other Central Government Authorities of the Czech Republic, and Act No. 6/1993 Coll., on the Czech National Bank, changed the competences of the CNB and the Ministry of Finance in the preparation of laws in the area of currency, the central bank and money circulation. The provisions of Act No. 160/2010 Coll., Amending Some Acts in Connection with the Adoption of the Regulation of the European Parliament and of the Council on Credit Rating Agencies, were reflected in the responsibilities of the supervisory departments. With effect from 1 January 2011, Act No. 145/2010 Coll., on Consumer Credit and on the Amendment of Some Acts, entrusted the CNB with responsibility for overseeing compliance by the financial market entities supervised by the CNB with the obligations stipulated in this Act.

The Bank Board decided to divide the economic research and financial stability activities carried out by the Economic Research and Financial Stability Department between two independent departments: the Economic Research Department and the Financial Stability Department. Some organisational units were renamed. The responsibilities of some units were specified more clearly and some activities were transferred between organisational units of the CNB headquarters.

BRANCHES

The CNB's branches represent the bank in their regions of jurisdiction and are contact points for the CNB's relations with state and local authorities and other legal and natural persons that have registered offices or residence addresses in the relevant region when dealing with the CNB under the relevant legal rules. This does not affect the right of the said entities to deal with the CNB's headquarters in Prague.

The CNB's branches are responsible mainly for managing money reserves (with the exception of the branches in České Budějovice and Ústí nad Labem), maintaining accounts of the state budget and other CNB clients falling within their fields of competence, and making payments. To a specified extent they also perform supervision and foreign exchange inspections of financial market entities, including supervision in the area of consumer protection. They collect and process data on exchange office operations and regional data for business surveys. They receive and record enquiries, suggestions, notifications and announcements from the public and deal with them within their defined areas of competence.



The Bank Board as of 31. December 2010

Pavel Řežábek, Eva Zamrazilová, Robert Holman,
Vladimír Tomšík, Miroslav Singer, Mojmír Hampl, Kamil Janáček

**Executive Directors of Departments**

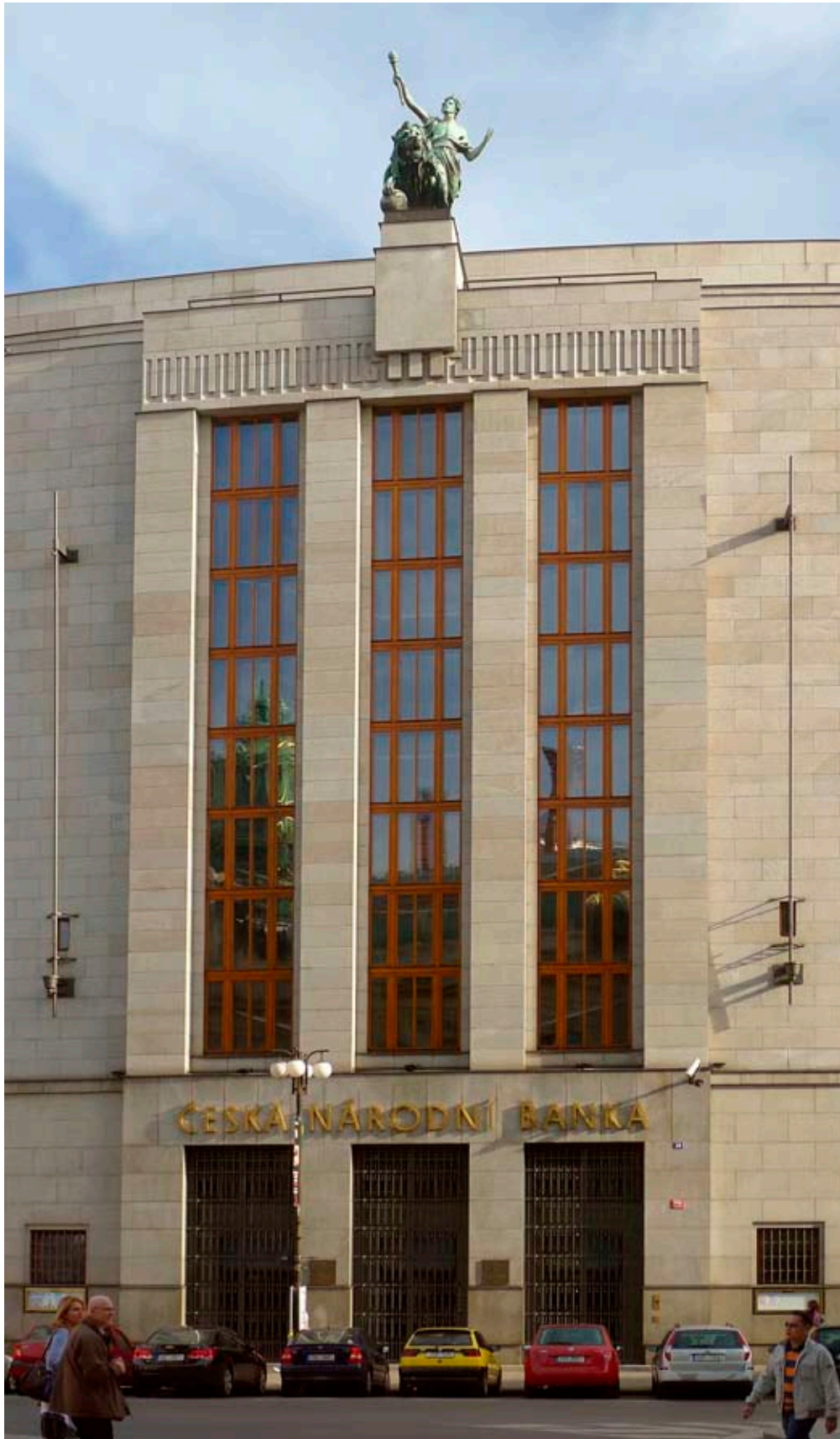
David Rozumek, Tomáš Holub, Marek Petruš,
Hélène Kolmanová, Jana Báčová,
Jan Frait, Tomáš Hládek, Jan Schmidt

**Executive Directors of Departments**

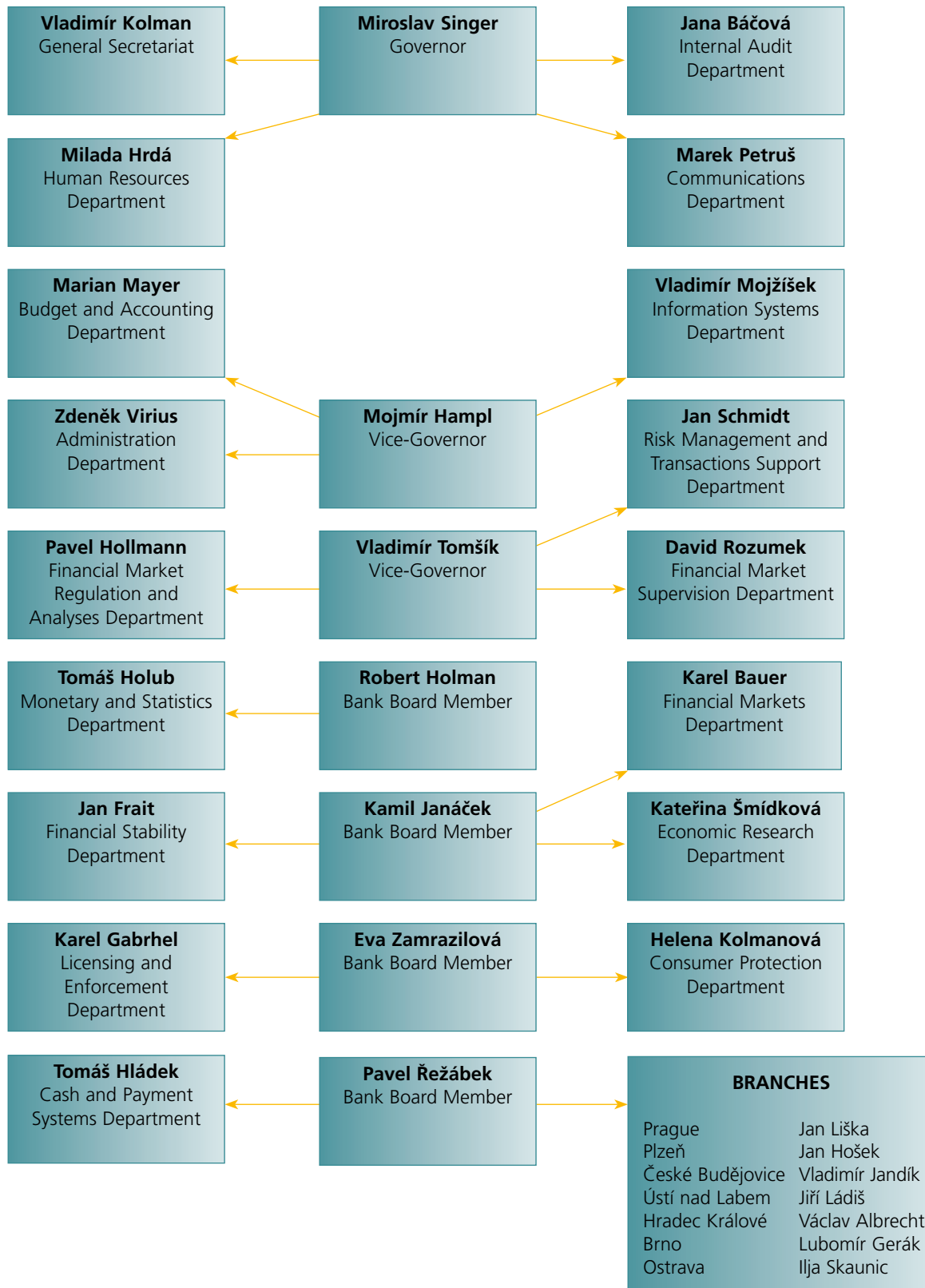
Vladimír Mojžíšek, Karel Bauer, Vladimír Kolman,
Karel Gabrhel, Marian Mayer,
Pavel Hollmann, Milada Hrdá, Zdeněk Virius

**Executive Directors of Branches**

Jiří Ládiš, Jan Hošek,
Václav Albrecht, Lubomír Gerák, Jan Liška, Ilja Skaunic, Vladimír Jandík



ORGANISATIONAL CHART AS OF 31 DECEMBER 2010



OBJECTIVES AND TASKS AND THEIR FULFILMENT

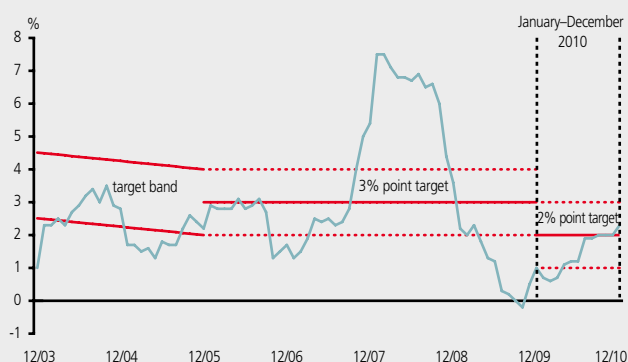
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MONETARY POLICY AND ECONOMIC DEVELOPMENTS

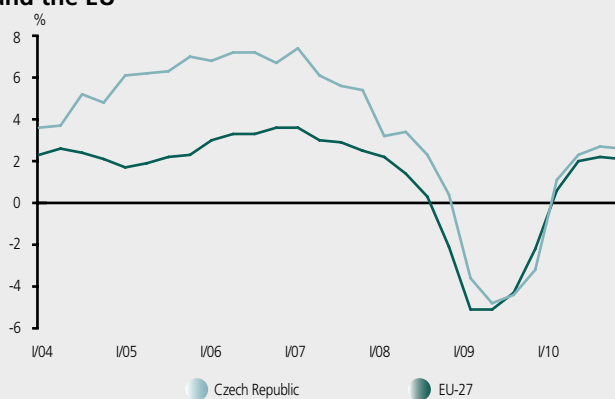
The CNB's primary monetary policy objective as laid down in the Act on the CNB is to maintain price stability. Since January 1998, this has been achieved under an inflation targeting regime in which the CNB tries to keep inflation close to a declared target. Since the start of 2010, the CNB's inflation target in terms of the consumer price index (CPI) has been set at 2% with a tolerance band of ± 1 percentage point.

In 2010 monetary policy operated in an environment of gradual recovery of the economy from the impacts of the global financial and economic crisis. Unlike in the previous year, the Czech economy recorded growth. However, the growth rate was only about one-third of that observed in 2005–2007 and the fall in the level of economic activity was reversed only gradually in 2010 (as in the second half of 2009). The gradual recovery of the domestic economy led to an only modest improvement in the labour market – the decline in employment slowed in 2010 and the unemployment rate started to decrease with some fluctuations. Inflation, which had been slightly below the lower boundary of the tolerance band in Q1, was close to the 2% target from July onwards. The low inflation and above all the subdued inflation outlook at the monetary policy horizon allowed the CNB to cut its key rates by another 0.25 percentage point (except for the discount rate, which remained at 0.2%). In 2010 the exchange rate of the koruna continued to be affected mainly by external factors, especially the Greek crisis and subsequently the banking sector problems and fiscal crisis in Ireland and concerns about the debt crisis spreading to other euro area countries.

Fulfilment of the inflation target



Gross domestic product growth in the Czech Republic and the EU



The Czech economy followed a similar path to that of other European Union members in 2009–2010. This reflects the fact that both the decline and subsequent recovery in GDP were due mainly to external demand developments. A marked recovery in economic growth in Germany, which is our main trading partner, played a particularly positive role from the perspective of the Czech Republic.

As in previous years, the Bank Board's monetary policy decisions in 2010 were based on quarterly macroeconomic forecasts prepared by the Monetary and Statistics Department. These forecasts were described and published in the quarterly Inflation Reports – the CNB's key communication tool in the monetary policy area. In August 2010 the Inflation Reports switched to a new, more reader friendly format to make the CNB's decision-making more transparent. More specifically, the order of the sections was changed starting with Inflation Report III/2010. Section II presents the CNB forecast, which is enriched by a detailed comparison of the new forecast with the previous one. Section III then describes current economic developments.

Greater emphasis is also placed on the CNB forecast in the summary of the Report. In addition, the subsections of section III have been rearranged and their analytical coverage extended. Together with these changes, the Inflation Report was merged with a non-public document called the Situation Report on Economic and Monetary Developments to form a single document that is discussed by the Bank Board and serves as a fundamental input for its monetary policy decisions. Since August 2010, the public has thus also been able to learn, for example, about sensitivity scenarios which describe and quantify the risks to the baseline scenario of the forecast and which may have influenced the Bank Board's monetary policy decisions.

The first Inflation Report in 2010 was based on an assessment of economic developments in late 2009 and early 2010. Quarterly growth in economic activity from 2009 Q3 onwards and a slowing year-on-year decline and subsequent switch to growth in late 2009 and early 2010 suggested that the Czech economy was gradually recovering from the global crisis. By contrast, domestic consumption was very subdued owing to an adverse labour market situation. Fixed capital investment was still being affected by the global crisis at the close of 2009 and therefore made a negative contribution to GDP growth. In late 2009 and early 2010, the lagged effect of the economic downturn was reflected in a deeper year-on-year decline in employment and increases in both the general and registered unemployment rates, while wage growth accelerated slightly. The exchange rate of the koruna appreciated against the euro but depreciated against the US dollar in this period owing to external factors, especially the Greek crisis and its resolution in the form of foreign financial assistance. The spread between the CNB's key rate and PRIBOR money market rates remained wide, but was significantly below the all-time highs observed at the end of 2008. Inflation fell below the lower boundary of the tolerance band around the inflation target at the start of the year owing to falling administered price inflation and an accelerating decline in adjusted inflation excluding fuels, due chiefly to falling import prices and low domestic demand.

The forecast contained in Inflation Report I/2010 (published in the first half of February 2010), which was based on the above data, expected a W-shaped path for both foreign and domestic economic activity, i.e. a return to growth of around 2% at the start of the year, followed by a gradual slowdown during 2010 and a renewed recovery in 2011. Inflation was expected to rise gradually, moving temporarily above the inflation target in 2010 Q4 and fluctuating close to the target in 2011. The forecast predicted a gradual increase in market interest rates starting in 2010 H2. In line with the forecast and its risks, which were assessed as balanced overall, the Bank Board decided unanimously to leave key interest rates unchanged at its February meeting. The rates also remained unchanged at the monetary policy meeting in March.

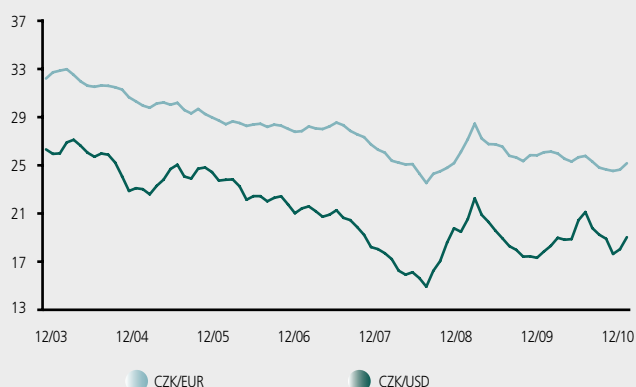
In line with the forecast, economic activity shifted to growth in year-on-year terms as well in 2010 Q1. However, the year-on-year decline in employment deepened further and wage growth slowed as some one-off effects subsided. Both the general and registered unemployment rate increased. At the beginning of Q2, the continuing depreciation of the euro due to the Greek crisis was reflected in a further strengthening of the koruna against the euro and a weakening against the dollar. The spread between the CNB's key rate and PRIBOR money market rates did not narrow significantly.

The forecast contained in Inflation Report II/2010 (published in the first half of May 2010) somewhat reduced the expected intensity of the slowdown in economic growth in 2010 H2 and shifted its renewed acceleration to 2011 Q2. Compared to the previous forecast, the expected inflation path was slightly lower over the entire forecast horizon, as was the outlook for interest rates. A decline in rates was expected initially, followed by a gradual rise from the beginning of 2011. In line with the forecast and its risks, which were assessed as balanced, the Bank Board decided by a majority of the votes cast (4:2) to decrease key interest rates by

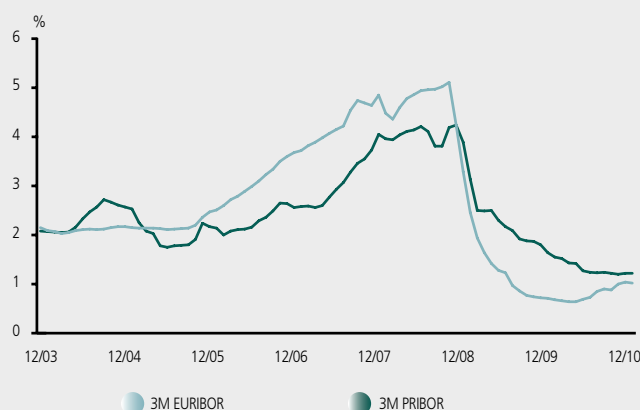
0.25 percentage point at its meeting in May (with the exception of the discount rate, which remained unchanged at 0.25%). The two-week repo rate was thus lowered to 0.75% with effect from 7 May. Rates remained unchanged at the monetary policy meeting in June.

In reality, economic growth in Q2 was stronger than expected in the forecast described above. Net exports were still the main source of GDP growth. The first signs of a possible improvement in the labour market appeared. The year-on-year decline in employment moderated. This had a favourable downward effect on both the general and registered unemployment rate. In Q2 and early Q3, the koruna continued to appreciate against the euro and depreciate against US dollar. The exchange rate was affected mainly by external factors (sentiment of short-term investors vis-à-vis Europe and Central Europe), while domestic fundamentals continued to play a negligible role. Market interest rates fell in reaction to the repo rate cut in May and were subsequently flat. Inflation increased owing to faster growth in administered prices and a slower decrease in food prices, and was just above the lower boundary of the tolerance band around the inflation target.

Nominal exchange rate of the koruna against the euro and dollar



Money market interest rates



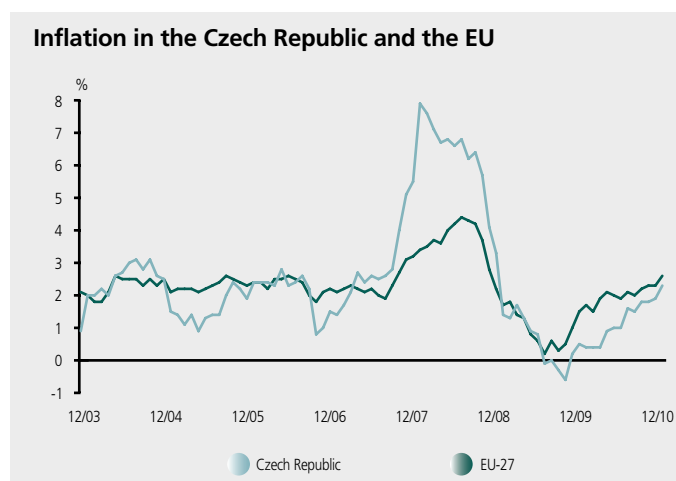
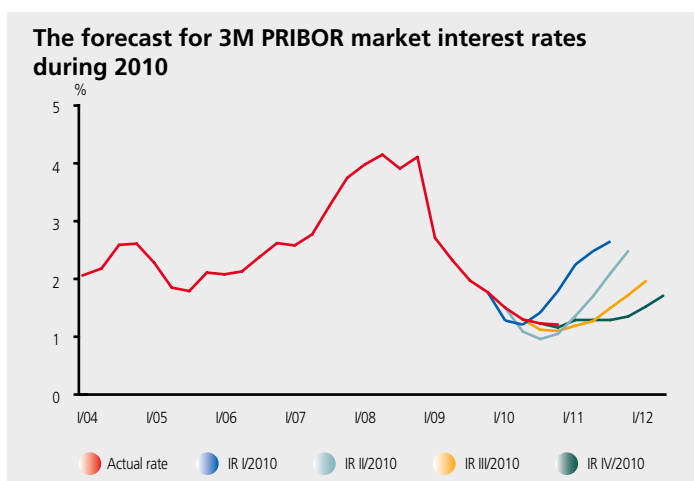
The forecast contained in Inflation Report III/2010 (published in the first half of August 2010) somewhat smoothed the previous expectations of a W-shaped path of economic activity. The inflation forecast was moved slightly upwards as a result of a higher outlook for administered prices in 2011. However, inflation was still expected to be close to the target. The expected timing of interest rate growth was shifted back further to 2011 H2. In line with the forecast and its risks, which were assessed as slightly anti-inflationary, the Bank Board decided unanimously to leave key interest rates unchanged at its August meeting. No changes were made to rates at the monetary policy meeting in September either.

The pick-up in economic growth in Q3 was again somewhat stronger than expected. It was driven by investment, which started to increase sharply due to rapid replenishment of inventories depleted during the crisis. At the same time, a wave of investment in photovoltaic power stations commenced. The year-on-year decline in employment moderated considerably, leading to a decrease in both the general and registered unemployment rate.¹ The already modest growth in total wages slowed

¹ In December, however, the registered unemployment rate rose again (by 1 percentage point to 9.6%). This increase was largely due to amendments to the Employment Act motivating job applicants who would have normally registered with labour offices in early January to register before the end of 2010.

further as a result of an annual wage decline in the non-business sector. In Q3 and October the koruna strengthened against the euro and, unlike in the previous period (and to a greater extent), also against the dollar, supported by information of a possible upgrading of the Czech Republic's rating in connection with planned deficit-reducing measures.² Market interest rates remained stable and above foreign EURIBOR rates despite some convergence. The spread between market rates and monetary policy rates decreased only marginally owing to a persisting high risk premium.

Inflation increased by almost 1 percentage point and moved closer to the inflation target in Q3. The marked upswing in consumer price inflation was due to food prices and to a lesser extent to administered prices. Inflation as measured by the Harmonised Index of Consumer Prices (HICP) was more than 1 percentage point lower than in the EU as a whole in the first half of 2010. This difference narrowed to roughly one-half in H2.



The last forecast in 2010 (published in the first half of 2010) further postponed the peak of the temporary economic recovery to the end of 2010 and predicted that the subsequent slowdown in growth would be more marked and longer-lasting compared to the previous forecast. The stronger economic growth in 2010 was expected to be driven chiefly by higher household consumption and a peaking boom in investment in solar power stations. By contrast, a subsequent drop in this investment, a fading effect of inventory replenishment and fiscal consolidation were expected to curb economic growth noticeably in 2011 amid a slowing recovery abroad. The inflation forecast was little changed, still expecting headline inflation to hit the CNB's target over the entire forecast horizon. The predicted increase in market interest rates was more gradual than in the previous forecast and its start was postponed to 2012 Q1. The interest rate outlook was thus repeatedly shifted during 2010, usually in the direction of a later start for rate growth. In line with the final forecast in 2010 and its risks, which were assessed as balanced, the Bank Board decided by a majority of the votes cast (5:1) to leave key interest rates unchanged at its November meeting. Rates also remained unchanged at the Bank Board meeting in December.

² Between mid-November and the end of the year, however, the koruna weakened temporarily against the dollar, which was appreciating on world markets, and to a smaller extent against the euro.

The Czech economy slowed slightly in the final quarter of 2010. In line with the forecast, investment was the biggest contributor to the growth, while household consumption surprisingly fell. This can be partially explained by a sharp slowdown in annual total wage growth to below one per cent as wages rose more slowly in the business sector and fell more quickly in the non-business sector. Rising food and fuel price growth caused inflation to rise just above the target in December, but inflation fell back below the target at the start of 2011.

More detailed information on economic developments and monetary policy implementation can be found in the quarterly Inflation Reports available on the CNB website (*Monetary policy – Inflation reports*).

In addition to monetary policy decision-making, the CNB continued to work on other issues, among them euro adoption. In autumn 2010, the CNB in cooperation with the Czech Ministry of Finance drew up an *Assessment of the Fulfilment of the Maastricht Convergence Criteria and the Degree of Economic Alignment of the Czech Republic with the Euro Area* (available in the *Monetary policy – MP strategic documents – Euro area accession* section of the CNB website). This document, prepared and submitted to the Government every year, again resulted in a recommendation not to set a target date for adopting the euro yet and thus not to attempt to enter the ERM II during 2011. This recommendation was based mostly on the fact that in the current conditions it is very unlikely that the Czech Republic will be able to fulfil the Maastricht convergence criteria in the medium term. A general government deficit of above 3% will be the principal barrier to joining the monetary union. The maintenance and further necessary increase in the Czech economy's alignment with the euro area in the coming years are also very uncertain. In addition, a new adverse factor as regards future euro adoption was identified, namely the fiscal and economic problems in the euro area, which are fostering uncertainty and increased volatility in financial markets.

FINANCIAL STABILITY

Since 2004 the CNB's definition of financial stability has been a situation where the financial system operates with no serious failures or undesirable impacts on the present and future development of the economy as a whole, while showing a high degree of resilience to shocks. Maintaining financial stability has been defined in the Act on the CNB as one of the CNB's primary objectives since 2006.

The CNB's financial stability analyses monitor risks to the financial system as a whole. They simulate the effects of potential domestic and foreign adverse shocks and possible risks stemming from the interconnection of financial systems on a global scale. The members of the CNB Bank Board meet with experts from key departments in "macrofinancial panels" held every quarter to discuss the current risk outlook. A wide range of information on developments in the domestic financial system and abroad is presented at these meetings. These discussions precede the Board's monetary-policy meetings held to discuss the new CNB macroeconomic forecast, and provide the participants with a comprehensive picture of the economic and monetary situation. The CNB informs the public about the risks identified and their potential impacts in presentations given by CNB representatives and by publishing the results of financial stability analyses in the *Financial Stability* section of its website.

The main communication tool used in the pursuit of the financial stability objective is the Financial Stability Report, which is published once a year. The report is submitted to the Chamber of Deputies (the lower house of the Czech Parliament) as required by law and is also published on the CNB website. Its conclusions are also discussed with the members of the Committee on National Economy, Agriculture and Transport of the Senate of the Czech Parliament. The report aims to identify new risks arising from domestic economic developments or the external environment.



The second key objective is to assess the ability of the domestic financial system to withstand the impacts of existing sources of financial instability. The Financial Stability Report views the financial system above all in the context of developments in the real economy, i.e. non-financial corporations and households, and financial markets. This structure allows a dynamic approach to the assessment of risks to the financial system that takes into account potential transmission of risks between individual economic sectors. As the domestic economy has been facing the effects of the financial crisis affecting many countries since 2007, the Financial Stability Report published in June 2010 considered the risks to financial stability to be still elevated and strong. According to the report, the main sources of risks were the feedback of weak economic activity to the financial sector, insufficient consolidation of public finances in Europe and the potential return of recession in the Czech Republic's main trading partner countries. However, stress tests, which were an integral part of the report, confirmed the ability of the domestic financial system to withstand these risks.

Since 2004 the CNB has regularly assessed the resilience of the domestic financial sector to adverse economic developments in stress tests of banks, insurance companies and pension funds. In the wake of the financial crisis, which significantly affected the financial systems of many countries, the CNB has since the start of 2010 also published the results of quarterly stress tests of the Czech banking sector in the *Financial Stability – Stress testing* section of its website. These tests simulate the size of the impact on the soundness of the financial system of shocks that can be regarded as improbable but still possible, and whether the banking sector has a sufficient capital buffer to absorb such shocks.

The organisation of, and approach to, financial system analysis at the CNB has changed in connection with the financial crisis, which has greatly increased the need for financial stability analysis. A Financial Stability Department was established in October 2010 by division of the former Economic Research and Financial Stability Department. The establishment of the Financial Stability Department mainly reflects

the fact that a new economic policy pillar, referred to as macro-prudential policy, has started to be implemented at various levels – global, European and national – in response to the financial crisis. The European Systemic Risk Board (ESRB) has been established at the EU level to conduct such policy. Together with three European sectoral authorities (ESAs) it makes up the European System of Financial Supervision (ESFS) – see the *Financial market supervision* section. The ESRB, which the CNB will also be involved in, will focus on the identification of new risks in the EU as a whole. It will operate mainly in a preventive manner to counter future signs of financial instability. It can issue warnings or recommendations if it identifies significant risks.

FINANCIAL MARKET SUPERVISION

The CNB's competences as a supervisory authority

In accordance with Act No. 6/1993 Coll., on the Czech National Bank, the CNB is the supervisor of the financial market in the Czech Republic. To the extent stipulated in legal rules, the CNB supervises entities operating on the financial market, analyses the evolution of the financial system, sees to the sound operation and development of the financial market in the Czech Republic and contributes to the stability of the Czech financial system as a whole. When performing its tasks, the CNB cooperates with central banks and authorities supervising the financial markets of other countries and with international financial institutions and organisations engaged in financial market supervision. The CNB also works in close partnership with the Czech Ministry of Finance and with other state authorities to create a single strategy and unified rules applying to financial market regulation and supervision and to address important issues, e.g. the building of structures of joint EU supervision of financial markets, crisis management and information sharing.

CNB supervision covers decisions on applications for licences, authorisations and prior approvals; inspection of adherence to the conditions stipulated in licences and authorisations; inspection of adherence to laws and directly applicable legal rules of the European Communities insofar as the CNB has the power to conduct such inspections under the law or special legal rules; inspection of adherence to the decrees and provisions issued by the CNB; collection of information needed to perform supervision; verification of whether such information is true, complete and up-to-date; imposition of remedial measures and penalties; and proceedings regarding administrative offences.

The CNB supervises banks, branches of foreign banks, credit unions, electronic money institutions, branches of foreign electronic money institutions, small-scale electronic money issuers, payment institutions and small-scale payment service providers and sees to the sound operation of the banking system. It also supervises insurance and reinsurance companies, pension funds, investment firms, investment intermediaries, securities issuers, entities keeping a register of investment instruments, management companies, investment funds, settlement system operators, investment instrument market operators and other persons specified in relevant legal rules.

The CNB informs the Chamber of Deputies, the Senate and the Czech Government about its financial market supervision activities in its annual Financial Market Supervision Report,³ which contains detailed information on the CNB's supervisory activities and developments in the individual sectors of the financial market. The Financial Market Committee, established pursuant to the Act on the CNB in 2006, is also informed about the CNB's main financial market supervisory activities twice a year.

³ The CNB publishes this report and other in-depth information on financial market supervision and regulation relevant to both specialists and the public on its website.



Financial market regulation

The enhancement of financial market stability and transparency through the implementation of new regulatory frameworks is a long-term process linked with changes to European law. The preparation of EU legal rules in the financial market area stepped up a gear in 2010. The CNB paid great attention to the European Commission's proposals, preparing opinions in which it actively promoted its positions in EU structures.

The CNB also worked to implement the rapidly changing EU financial market rules and enhance the regulatory framework in the Czech Republic. It worked with the Ministry of Finance and other state authorities to prepare draft legal rules relating to the financial market and the business of financial institutions and other entities subject to its regulation and supervision. It prepared a number of decrees and official information documents for individual financial market sectors and opinions interpreting the application of regulatory requirements pertaining to financial market participants.

One major legislative change was an amendment to the Act on Banks, the Credit Unions Act and the Capital Market Undertakings Act transposing the amended capital requirements directives (Directives 2006/48/EC and 2006/49/EC) and defining new powers of the CNB (relating, for example, to the determination of the significance of branches, remedial measures to ensure a sufficient amount and appropriate structure of capital, and activities of supervisory colleges). The CNB made a number of comments on the proposed amendment, most of which were accepted. The law was passed by the Chamber of Deputies in December 2010.

The Act on Financial Collateral and a related amending act transposed into Czech law Directive 2009/44/EC amending Directive 98/26/EC on settlement finality in payment and securities settlement systems and Directive 2002/47/EC on financial collateral arrangements (an amendment of the settlement finality directive). In the comments procedure the CNB successfully submitted important comments relating to the use of credit receivables as financial collateral, the expansion of the set of entities that may provide financial collateral and the possibility of pooling financial collateral. The Act on Financial Collateral was passed by the Chamber of Deputies in December 2010.

An amendment to the Collective Investment Act was proposed in connection with Directive 2009/65/EC (UCITS IV), which Member States are obliged to transpose by 1 July 2011. The directive contains new provisions to increase the efficiency of the standard collective investment fund sector. In particular, these provisions should simplify the cross-border activities of such funds (by allowing a management company to establish standard funds in a state other than the one in which its registered office is situated) and streamline asset management by maximising the volume of portfolios managed (cross-border mergers, asset pooling, master-feeder structure). The CNB made a number of comments on the proposal (concerning, for example, standardisation of information duties and equal access to standard and special funds for the public, as well as numerous terminological adjustments in authorisations to issue decrees), most of which were accepted. The draft amendment was submitted to the Government in November 2010.

By amending the Payment System Act, the Czech Republic is transposing Directive 2009/110/EC on the taking up, pursuit and prudential supervision of the business of electronic money institutions and partly also the amendment to the settlement finality directive. The amended act will improve the conditions for the business of electronic money institutions, simplify small-scale electronic money issuance and create a level playing field for all market participants. The amendment will also cover the protection of interconnected payment systems and systemic risk reduction. The draft amendment was debated in the first reading in the Chamber of Deputies in December 2010.

The CNB also participated in the preparation of an amendment to the Building Savings Schemes Act and the Act on Income Tax. The bulk of the CNB's major comments were incorporated. The amendment was issued in November 2010.

The CNB issued six decrees in 2010 on the basis of authorisations laid down in individual acts. Many other decrees were under preparation. It also published 15 official information documents, in which it clarified the details of regulations and informed financial market participants about other facts, and provided market participants and the public with information in the form of opinions and replies to queries, which it published on its website. A complete and up-to-date list of the CNB's decrees, provisions, official information and opinions relating to the financial market can be found in the *Financial market supervision – Legislation* section of the CNB website.

International cooperation

The CNB's supervisory departments were actively involved in international activities. Within EU structures, participation in the activities of the European Commission's committees and working groups, the Lamfalussy Level 3 committees (CEBS, CESR and CEIOPS) and the European Central Bank's committees was of key importance.

The Level 3 committees and their working groups worked on enhancing the regulations and on further strengthening and harmonising supervisory practice. This work included, in particular, the revised single framework for capital adequacy and disclosure, remuneration, risk management and monitoring, stress testing, preparation of the European cross-border crisis resolution framework, support and monitoring of supervisory colleges, revision of accounting standards, reporting, capital and liquidity, preparation of Solvency II implementing measures, preparation of implementation of collective investment directives, registration of rating agencies, revision of the investment services directive and preparation for regulation of OTC derivatives and European market infrastructure.

To a great extent, 2010 marked a turning point in financial market regulation and supervision in the EU, as legislative changes in the institutional arrangement of EU financial market regulation and supervision were completed so that new supervisory structures could start to work on 1 January 2011. Regulations of the European Parliament

and of the Council of 24 November 2010 established the European Systemic Risk Board (ESRB) and three European Supervisory Authorities (ESAs), namely the European Banking Authority, the European Securities and Markets Authority and the European Insurance and Occupational Pensions Authority. The former Level 3 committees ceased to exist at the end of 2010 when the ESAs commenced their activities.

The ESRB is responsible for macro-prudential oversight of the financial system within the EU. Its job is to contribute to the prevention or mitigation of systemic risks to financial stability in the EU. Under the regulations establishing the ESAs, their objective is to protect the public interest by contributing to the stability and effectiveness of the financial system, for the EU economy, its citizens and businesses. The ESAs are also meant to contribute to improving the functioning, integrity and transparency of the internal market, primarily by ensuring a sound, efficient and consistent level of financial market regulation and supervision. Consistent application of regulation should prevent regulatory arbitrage and promote equal conditions of competition.

In relation to the EU Council and its structures, the CNB worked with the Ministry of Finance on the preparation of opinions on the documents discussed in the Ecofin Council and in the Financial Services Committee (FSC) and the Economic and Financial Committee (EFC). In line with its objectives, the CNB supported in the discussions on European topics the safeguarding of financial stability and fiscal sovereignty of the Czech Republic, an appropriate degree of regulation, independence of the national supervisory authority, the prevention of delegation of powers to the EU level while preserving the responsibility of Member States for decisions taken, the reduction of costs of proposed solutions vis-à-vis market participants and the clear definition of the competences of the newly proposed structures.

Within European Central Bank structures, the CNB also participated in the activities of the Banking Supervision Committee (BSC). In addition to the half-yearly ECB Financial Stability Review, the BSC addressed, among other things, counter-cyclical capital buffers, deleveraging in the financial system, liquidity stress testing and efforts to improve reporting of consolidated data. The CNB was also actively involved in the work of three BSC working groups.

In the Basel Committee on Banking Supervision (BCBS) the CNB was represented in the Basel Consultative Group (BCG). In 2010 the BCG discussed above all the changes in the regulatory capital framework, the results of a comprehensive quantitative impact study focused on Basel III and potential variants of parameter settings within Basel III. The Committee also discussed developments in the international accounting standards for financial instruments and leasing, the preparation of Basel standards and the methodology for assessing their implementation, and the issue of moral hazard in systemically important institutions.

Other international organisations in whose work the CNB is involved include the International Organization of Securities Commissions (IOSCO), which continued its activities responding to the financial crisis and the regulatory proposals discussed within the FSB and the G20. For example, IOSCO published a report on OTC derivatives trading, and updated its reports on the aims and principles of capital market regulation and on the transparency of structured investment products.

In 2010 the International Organization of Pension Supervisors (IOPS) completed its long-running project to develop an application facilitating risk-oriented supervision of pension funds. The CNB also contributed to the creation of this application, which contains a summary of internationally recognised recommendations and standards for pension funds and examples of their application in specific cases.

The CNB significantly stepped up its contribution to the work of the International Association of Insurance Supervisors (IAIS), which adopted a number of internationally recognised insurance supervision standards and recommendations during the year.

As regards cooperation between supervisory authorities, CNB representatives regularly participated in meetings of the supervisory colleges for the most important banking groups in the Czech banking sector (Erste, Raiffeisenbank, Volksbank, UniCredit, KBC, Société Générale, ING).

Financial market supervision

The CNB supervises the financial market in the form of both off-site surveillance (continuous monitoring of the stability of the individual supervised sectors) and on-site inspections.

Off-site surveillance

Off-site surveillance consists in continuously monitoring the activity and financial performance of the individual entities operating on the financial market and assessing the evolution of the market as a whole and its key segments. The supervisory work involves checking compliance with the relevant legal rules and prudential rules and regularly assessing the financial condition of individual regulated entities.

Information is obtained mainly from the statements and reports regularly submitted by individual entities on a solo and consolidated basis. Where more intensive monitoring of the financial situation is needed, an extraordinary reporting duty is imposed on financial institutions. In addition to the regular reports, all available information from various sources is used for continuous monitoring of entities and the market. These sources include financial statements, annual reports, auditors' reports, information from on-site inspections and information-gathering visits, public presentations and press releases.

Supervision of credit institutions involves supervision of banks, foreign bank branches, building societies and credit unions. The main analytical instrument employed in off-site surveillance is regular comprehensive analyses to assess the financial condition of individual entities and the credit institutions sector as a whole. An analysis of the financial condition of each bank and credit union and the risks it undertakes is prepared quarterly. This serves as a basis for decisions on the intensity and manner of their supervision. The observance of prudential limits and rules (e.g. for credit exposure) is monitored on a monthly basis for all credit institutions. Early warning information is also assessed every month; this comes from an automatic system which helps supervisors to identify potential negative tendencies in the financial indicators of individual banks. Branches of foreign banks from EU countries are assessed under a simpler regime, as the CNB's powers of supervision of these entities are limited.⁴ Ratings dividing banks into five categories according to their financial condition and management quality are prepared for internal CNB supervisory purposes twice a year.

The CNB, together with selected banks, continued its regular half-yearly stress testing of banks' loan portfolios. This project started in 2009 and involved six selected banks (eight as of mid-2010) which have received approval to use the IRB approach⁵ for calculating the capital requirement for credit risk or which are in the process of IRB pre-validation by the CNB. The loan portfolio stress-testing project consists in an assessment of the impact of pre-defined economic scenarios on the loan portfolios of individual banks and the entire Czech banking sector. Two economic scenarios were drawn up in both rounds of stress tests, namely a baseline scenario corresponding

⁴ Primary responsibility for supervision of foreign bank branches lies with home country supervisors. In the case of branches of foreign banks from EU Member States, the CNB monitors their liquidity and compliance with the obligations in the Act on Banks.

⁵ The Internal Ratings Based approach; see Articles 90–101 of Decree No. 123/2007 Coll.

to the official CNB macroeconomic forecast and an adverse scenario simulating a strong double-dip recession. These scenarios were then transformed into average percentage increases in the probability of default in the most important segments of the loan portfolio. The banks involved then applied these increased probabilities of default to their loan portfolios in order to calculate the change in their capital requirements and capital adequacy ratios in the two scenarios. The aggregated results of the two rounds confirmed that domestic banks are relatively resilient to the potential adverse economic developments tested. These stress tests supplement the quarterly tests conducted by the Financial Stability Department, which are calculated on the basis of individual bank data available from the banks' regular reporting duty (see the *Financial Stability* section of this report).

Off-site surveillance of insurance companies is based on regular assessments of their financial condition and compliance with the prudential rules, as well as the imposition of remedial measures where shortcomings are detected. An early warning system is also used to analyse the financial condition of insurance companies. This system assesses current trends in insurance companies at quarterly frequency on the basis of indicators obtained from regular statements and enables the CNB to identify potential weaknesses in their financial performance. In 2010 work was completed on the implementation of a system of comprehensive internal ratings of insurance companies. Additionally, a pilot round of joint CNB bottom-up stress testing of selected insurance companies took place. The tests confirmed that the sector as a whole has sufficient capital to withstand relatively significant changes in selected risk factors. Professional care of insurance companies and insurance intermediaries vis-à-vis clients was also an important topic of supervision. The significance of this area is confirmed by the fact that out of all the financial market sectors the largest number of complaints related to insurance companies.

As regards the investment firms sector, compliance with disclosure duties was monitored continuously. Compliance with exposure limits, the correctness of reporting thereof in the CNB's information system and the calculation of capital adequacy were examined in 2010.



In connection with an amendment to Decree No. 123/2007 Coll., on prudential rules for banks, credit unions and investment firms, as amended, which now also stipulates exposure rules for investment firms (especially as regards exposures to financial institutions, which will be subject to stricter limits), non-bank investment firms were asked to submit detailed information on client assets on current accounts with commercial banks.

The activities of the exchange chamber, exchange committees and bodies of the Exchange Guarantee Fund were monitored. Information sent by regulated market operators under their disclosure duty was regularly evaluated.

In the area of private pension schemes, testing of a prudential mechanism for maintaining the financial stability of pension funds was completed in 2010 and the mechanism went into routine operation.

Off-site surveillance of the collective investment sector focused on statutory disclosure duties. Formal shortcomings in compliance with disclosure duties were discussed ad hoc with the entities concerned and subsequently remedied.

Following the transposition of the payment services directive and the e-money directive, the CNB's supervisory responsibilities were extended to include non-bank payment services providers and non-bank electronic money issuers. The newly supervised entities include payment institutions, electronic money institutions, small-scale payment services providers and small-scale electronic money issuers.

In the foreign exchange area, the CNB supervises almost 900 non-bank foreign exchange entities (a total of 873 entities with around 1,500 establishments were registered by the CNB as of 31 December 2010). The CNB's foreign exchange supervisory work involves checking compliance with the foreign exchange regulations, examining anti-money-laundering and anti-terrorist-financing measures and also inspecting measures relating to international sanctions.

On-site inspections

On-site inspections were performed in accordance with the legislation in force and focused on checking compliance with the regulatory rules laid down in legal and implementing regulations. The inspections focus either on verifying all the relevant activities of the examined entity (comprehensive inspections) or on verifying selected areas thereof (partial inspections).

Eight on-site inspections of credit institutions were performed in 2010, of which six were carried out in banks. Comprehensive examinations were carried out in two large banks. These examinations concerned most areas of risk management (credit, market, liquidity and operational risks, prevention of money laundering, regulatory reporting, the internally set capital system, compliance with rules of conduct and professional care in the provision of investment services, etc.). In addition, two examinations were performed in credit unions.

In the collective investment sector, on-site inspections were completed in three management companies and one non-autonomous investment fund, focusing on prudential rules and on the rules of conduct and professional care in the management of collective investment fund assets.

One on-site inspection was performed in the area of private pension schemes, focusing on prudential rules and professional care in the management of pension fund assets.

In 2010 one on-site inspection was terminated in a depository, concentrating on the verification of compliance with remedial measures stemming from the conclusions of the previous inspection.

An on-site inspection was also carried out in a regulated market operator, focusing on compliance with legal rules and prudential rules in the area of information system and technology risk management.

As regards investment service providers, ten on-site inspections were completed in 2010, of which six focused on investment firms, one on an investment intermediary and three on tied agents cooperating with that investment intermediary. Nine of these inspections were comprehensive, pertaining to compliance with the rules for prudent provision of investment services (in particular, administrative and accounting principles, internal control systems, financial risk management systems and liquidity management systems), rules of conduct towards clients and maintenance of registers. One inspection in an investment firm was more specific and concerned rules of conduct and professional care in the provision of investment advice, procurement of OTC trades in bonds and the investment service of safekeeping and administration of investment instruments.

Three inspections were carried out in the area of prudential supervision of insurance companies. One of them examined only a partial topic, namely the IS/IT risk management system. The other inspections, relating to non-life insurance, focused on insurance risk management, administration and price-setting of insurance policies, loss adjustment, financial market settlement processes, payments, reinsurance and procedures for conducting passive legal disputes, determination of the level and use of technical reserves, IS/IT risk management systems (including outsourcing and contracts in this area), financial placement and risk management connected therewith, conditions for sound corporate governance and internal control systems.

The CNB conducts on-site foreign exchange inspections through its branches. The inspections aim to examine all activities performed by the non-bank foreign exchange entity and its individual establishments and thereby contribute to the enforcement and strengthening of discipline in the supervised areas. The CNB carried out 363 on-site inspections in a total of 553 establishments in 2010.

Licensing, approval and authorisation activities in the financial market area

In 2010, the CNB conducted 95 administrative proceedings concerning regulated credit institutions, 21 of them related to banks and the remainder to credit unions. In all, 88 administrative decisions were issued in these proceedings. The largest number of proceedings as usual related to prior consents to the acquisition of qualifying holdings (47 proceedings) and to the approval of members of bodies and senior officers of credit unions (27 proceedings).

The CNB conducted 94 administrative proceedings and issued 89 administrative decisions in the insurance sector. The largest number of decisions (75) related to the granting of prior consent to membership of a statutory or supervisory body of an insurance or reinsurance company.

A total of 307 administrative proceedings were conducted and 273 decisions were made in the collective investment area. The most frequent administrative proceedings were those regarding the approval of changes in the statutes of collective investment funds (171). A total of 37 administrative proceedings concerned prior consents to the discharge of office of director of a management company or an investment fund. In 2010 the CNB recorded increased interest in special funds for qualified investors specialising in investment in real estate and real estate companies established in the form of non-autonomous investment funds (investment funds whose assets are managed by a management company).

The CNB received 33 applications for the opening of administrative proceedings from the private pension sector. A total of 36 administrative proceedings were conducted in 2010, of which three were continued from 2009. Most of them concerned the approval of persons to pension fund bodies and all of them were closed in 2010.

Numbers of entities providing services on the financial market				
	As of 31 Dec. 2009	Additions	Losses	As of 31 Dec. 2010
Credit institutions, total	56	2	3	55
Banks	21	1	0	22
of which: building societies	5	0	0	5
Branches of foreign banks (operating under the single licence regime)	18	1	0	19
Credit unions	17	0	3	14
Insurance companies (incl. branches and reinsurance companies)	54	3	3	54
Domestic insurance companies	36	0	0	36
Branches of insurance companies from EU/EEA	16	3	2	17
Branches of insurance companies from third countries	1	0	1	0
Reinsurance companies	1	0	0	1
Management companies	22	3	2	23
Investment funds	27	22	0	49
Open-end mutual funds	139	20	10	149
of which: standard funds	36	1	0	37
Closed-end mutual funds	2	1	2	1
Pension funds	10	0	0	10
Depositories	8	0	0	8
Investment firms	39	1	3	37
Non-bank investment firms	28	0	3	25
Investment firms – banks	11	1	0	12
Issuers of listed securities	65	6	6	65
of which: foreign	17	3	2	18
Regulated market operators	3	0	0	3
Settlement systems	3	0	0	3
Central depository	1	0	0	1

The CNB issued 336 decisions in the area of investment services provision. In two cases, proceedings to grant investment firm licences were discontinued. The largest number of decisions (311) related to the withdrawal of registration of investment intermediaries.

The CNB issued 91 decisions in the area of securities issuance and regulated markets. Most of them (86) concerned the approval of documents relating to new securities issues.

In addition to these approval proceedings, one proceeding concerned the disclosure duties of issuers of listed securities (the granting of an exemption from the disclosure duty to an issuer having its registered office in a non-EU Member State). Two takeover bids were also considered.

The CNB issued one licence for the business of a payment institution in 2010. However, the licence became null and void as a result of merger with a bank. No payment institutions were operating in the Czech Republic as of 31 December 2010. The CNB registered 22 entities in the register of small-scale payment services providers as of the end of 2010.

In 2010, a total of 20,143 intermediaries were entered in the register of insurance intermediaries and independent loss adjusters, 128 of which were insurance agents and 56 insurance brokers. At the end of 2010, a total of 126,123 insurance intermediaries were entered in the register, 8,370 of them foreign. The CNB holds

professional examinations of insurance agents and insurance brokers (to verify whether the applicants are competent to perform such activities at a medium or higher level of competence). In all, 504 candidates took these examinations and 471 passed.

A total of 54 small-scale electronic money issuers were registered with the CNB at the end of 2010. These entities issued electronic money totalling CZK 814.2 million in 2010. One entity was entered in the register of small-scale electronic money issuers (a carrier) in the second half of 2010. Two issuers merged.

Notifications (under the single licence)

During 2010, the CNB received 452 announcements by foreign regulators of notifications of cross-border provision of services, of which 26 from banks (two of them electronic money institutions), 44 from insurance companies,⁶ 111 from collective investment funds, three from investment companies and 268 from investment services providers.

Five banks (of which one electronic money institution), seven insurance companies, two investment companies, 213 foreign collective investment funds and 44 investment services providers terminated their activities under the cross-border provision of services.

The competent supervisory authorities from EU countries were notified of the intention of three domestic insurance companies to carry on insurance business within their territory under the free movement of services. The activities of three insurance companies were extended. At the same time, two domestic insurance companies provided notification of their intention to carry on business within host states under the free movement of services. Two banks were granted consent to establish branches in Slovakia. Three domestic banks have branches in Slovakia and four domestic credit unions operate in Slovakia, Poland, Hungary and Cyprus.

One bank, two insurance companies and one investment firm provided notification of the provision of services in the Czech Republic in the form of establishment. No bank terminated its activities under the right of establishment in the Czech Republic, while two insurance companies terminated them. One branch of a third-country insurance company became a branch of an EU-country insurance company due to a change in the registered office of its parent company. The CNB received 131 prospectus notifications from foreign regulators.

The CNB received notifications of the intention to carry on business in the Czech Republic from 221 insurance intermediaries having a home Member State other than the Czech Republic (74 of them from Slovakia). 194 insurance intermediaries residing or having their registered office in the Czech Republic provided notification of their intention to commence business in host Member States.

Enforcement

Activity in the penalty proceedings area consisted in the investigation of petitions for the opening of administrative proceedings, decision-making on the opening of administrative proceedings or the deferral of cases, and the conduct of first-instance administrative proceedings, within which fines and remedial measures were imposed, licences revoked and registrations cancelled. Administrative

⁶ In addition to insurance companies, branches of insurance companies operating in other EU/EEA countries are notified in this manner. In 2010, the CNB was notified by foreign regulators of the intention of 10 branches to provide services in the Czech Republic (this figure is included in the total of 44 notifications).

proceedings are conducted with both regulated entities and entities that provide services on the financial market without the relevant licence.

Five penalty administrative proceedings were opened in the area of supervision of credit institutions. Five decisions became final and conclusive (two decisions to revoke a licence, one to impose a remedial measure, one to discontinue the proceeding and one to impose a fine). The total fines imposed amounted to CZK 100,000.

Nine administrative proceedings were opened in the area of supervision of the insurance industry. Four fines totalling CZK 1,522,000 were imposed.

A total of 33 penalty or offence proceedings were opened in the area of the capital market and 29 fines totalling CZK 33,050,000 were imposed.

A total of 53 administrative proceedings were opened due to violation of foreign exchange regulations. The CNB issued final decisions in 47 administrative penalty proceedings – licences were revoked in two cases and fines were imposed in 45 cases. The fines amounted to CZK 775,000 in all.

Three administrative proceedings were opened and one administrative decision was issued in the consumer protection area. The fine imposed amounted to CZK 3,000,000.

Central Credit Register

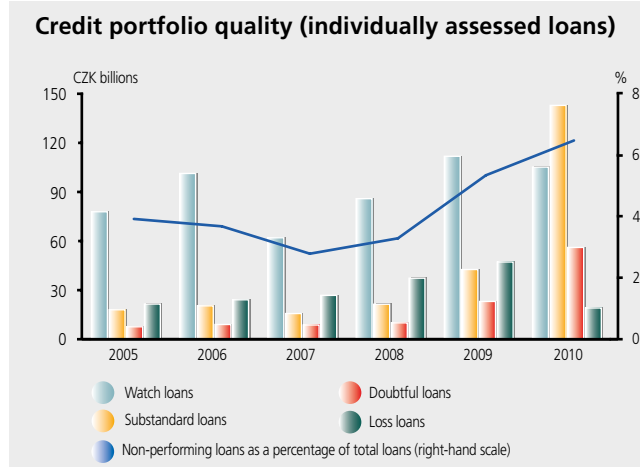
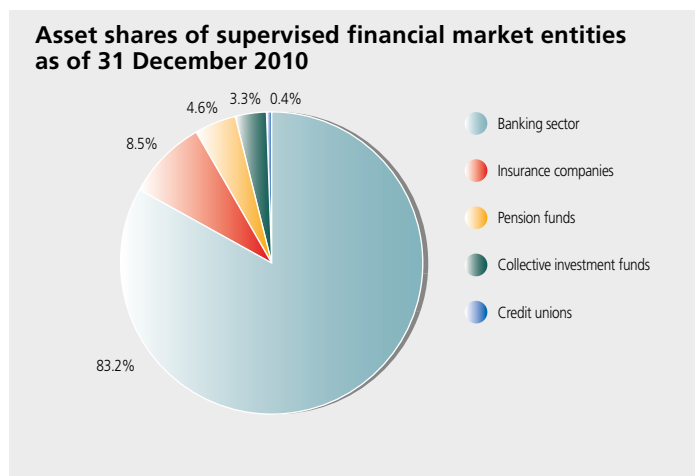
The Central Credit Register (CCR) is an information system administered by the CNB since 2002 which enables banks and foreign bank branches operating in the Czech Republic to share information on the credit commitments and payment discipline of businesses.

The next development phase of the “CCR Optimisation and Stabilisation” project was approved and commenced in 2010. This phase is focused mainly on the construction of a new data warehouse and involvement in international data sharing. The new data warehouse will enable the data contained in the CCR to be used more efficiently for supervisory and analytical purposes and to be interlinked with other internal and external databases.

Main operational characteristics of CCR				
	12/2007	12/2008	12/2009	12/2010
Number of registered debtors	403,417	461,277	497,726	539,540
of which: natural persons (entrepreneurs)	237,703	271,770	291,458	313,129
legal entities	165,714	189,507	206,268	226,411
Total volume of loans outstanding (CZK billions)	1,141	1,265	1,200	1,219
Number of CCR application users	2,422	2,472	2,194	2,362
Ad hoc credit commitment enquiries (thousands per year)	148	180	205	213
Number of pieces of credit commitment information in monthly reports (thousands per year)	2,390	2,800	3,038	3,640
Number of extracts made for clients (per year)	225	278	453	492

The financial market

As in the two previous years, the Czech financial market showed great resilience to external shocks in 2010 and was a small but stable segment of the EU financial market. The Czech financial market is firmly linked to the domestic economy. In 2010 it responded to the economic recovery with growth in capital market indices and in financial institutions' assets. Although the assets of non-banks grew faster than those of the banking sector, the latter still forms the basis of the Czech financial system.



At the end of 2010, the banking sector consisted of 41 banks and foreign bank branches. Foreign capital played a dominant role, controlling directly or indirectly 95.6% of the banking sector's total assets. In December, the banking sector's total assets recorded an annual increase of 2.4% to CZK 4.2 trillion. Funds from clients rose by 3.3% year on year to CZK 2.8 trillion and the capital adequacy of banks by 1.4 percentage points to 15.5%. Net profit amounted to CZK 55.7 billion, the second-highest figure since 2005. This shows that the banking sector is dynamic and profit-making.

Banking sector indicators						
	12/2005	12/2006	12/2007	12/2008	12/2009	12/2010
No. of banks and foreign bank branches	36	37	37	37	39	41
Total assets (CZK billions)	2,954.4	3,151.8	3,750.6	4,044.5	4,094.6	4,194.4
Liabilities to clients (CZK billions)	1,919.6	2,102.2	2,459.9	2,597.1	2,728.0	2,819.5
Net profit (CZK billions)	39.1	38.0	47.0	45.7	59.7	55.7
Administrative expenses (CZK billions)	51.8	55.7	59.7	61.7	60.5	62.3
Capital adequacy (%)	11.9	11.5	11.6	12.3	14.1	15.5
Non-performing loans to client loans (%)	3.9	3.7	2.8	3.3	5.4	6.5
Recalculated no. of employees	37,199	37,894	38,708	38,577	37,573	38,828
No. of banking units	1,825	1,877	1,865	1,993	1,998	1,990
No. of ATMs	3,005	3,281	3,357	3,406	3,573	3,754

Only lending is defying the above-mentioned favourable trends somewhat. While the Czech economy continued to grow in 2010, two unfavourable lending trends – which had been either triggered or aggravated by the previous recession – persisted from the previous year, namely a deterioration in loan quality and a decline in loans to non-financial corporations and sole proprietors.

The medium-term trend of a partial deterioration in the quality of the banking sector's credit portfolio continued. The non-performing loans (NPL) ratio rose by 1.1 percentage point year on year to 6.5% in December 2010. Although the composition of NPLs improved as a result of a decrease in loss loans, the increase in substandard and doubtful loans is a warning signal for 2011.

Loans to non-financial corporations decreased by 0.3% year on year. Compared to the fall of 8% observed in 2009, this is an improvement. By contrast, the decline in loans to sole proprietors accelerated to 5.4% in 2010 from 4% in 2009. Nevertheless, the total volume of loans recorded an annual increase of 3.4% to almost CZK 2.2 trillion in December 2010 due to a 9% rise in loans to households and 12% growth in loans to non-residents, i.e. thanks to the allocation of funds to final demand and abroad. However, the experience of numerous advanced

countries suggests that such credit growth hardly increases the competitiveness of the economy directly and that its contribution to reducing unemployment is debatable.

Sectoral breakdown of claims (in CZK millions)						
	12/2005	12/2006	12/2007	12/2008	12/2009	12/2010
Residents and non-residents, total	1,178,670.4	1,413,083.5	1,783,987.7	2,075,687.4	2,102,088.5	2,174,428.1
Residents	1,118,659.2	1,338,650.3	1,668,895.4	1,926,553.3	1,952,988.7	2,006,787.6
Non-financial corporations	525,350.3	634,875.6	743,380.0	848,068.4	782,184.5	779,713.8
public	25,194.1	23,986.9	37,170.1	34,465.4	28,000.3	25,814.5
national private	359,434.5	444,020.7	513,947.1	590,374.3	529,815.5	535,906.6
foreign controlled	140,721.6	166,868.0	192,262.8	223,228.7	224,368.8	217,992.8
Financial corporations	96,931.8	99,754.0	147,117.9	150,832.1	129,812.8	118,433.4
General government	81,463.2	67,630.0	57,481.6	54,278.9	66,240.6	64,886.9
Households	412,895.3	530,804.8	707,819.5	851,470.4	940,482.9	1,027,827.0
Households – trades	33,360.8	35,922.7	39,058.5	43,112.7	42,519.0	40,239.0
Households – individuals	379,534.5	494,882.1	668,761.0	808,357.7	897,963.9	960,466.0
Other households – owners' associations	x	x	X	X	x	27,122.0
Non-profit institutions serving households	2,018.5	5,586.0	13,096.4	21,903.4	34,267.9	15,926.5
Non-residents	60,011.1	74,433.1	115,092.3	149,134.2	149,099.8	167,640.5

The insurance sector experienced no major events that endangered its proper functioning and stability in 2010. A total of 35 domestic insurance companies (excluding the Czech Insurers' Bureau), of which 3 were life insurers, 17 were non-life insurers and 15 were universal insurers, along with 17 branches of foreign insurance companies (4 life, 13 non-life) and one domestic reinsurance company were operating on the Czech market as of 31 December 2010. In addition to these insurers, insurance undertakings and branches thereof from other EU/EEA member states may provide services on the Czech insurance market under the freedom to provide services. Their number rose further to 665 at the end of 2010. These undertakings are active mainly on the non-life insurance market, where they are helping to increase competition.

As for capital origin, 24 domestic insurance companies are foreign-controlled and 11 are domestically controlled. Of the foreign shareholders, those from Austria accounted for the largest share (26.2%) of the total registered capital of Czech insurance companies.

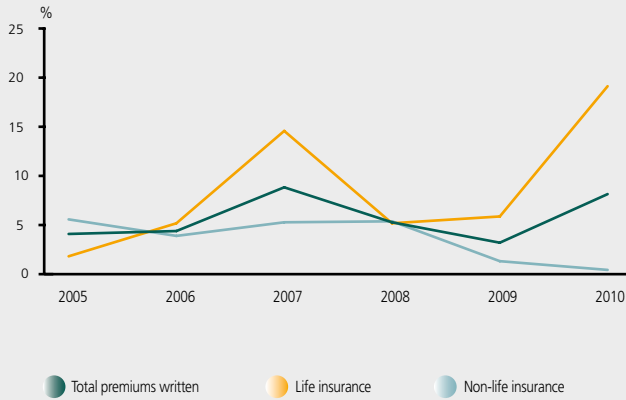
The economic recovery and the return to GDP growth in the Czech Republic were reflected in a higher growth rate of premiums written, which rose by 5 percentage points to 8.1% compared to 2009. This was due mainly to a considerable increase in premiums written on the life insurance market, which rose by 19.2% year on year in 2010. The life insurance market was affected mainly by increases in single premium payments. This sector had also recorded growth in 2009, when the whole economy was hit by the financial crisis. Premiums written in non-life insurance are flat compared to the previous two years; having risen by 1.2% in 2009, they grew only by 0.3% in 2010.

In 2010, the share of life insurance in total premiums written increased by 4.2 percentage points compared to 2009, reaching a historical high of 46.0%. This share, however, is still lower than in advanced EU countries.

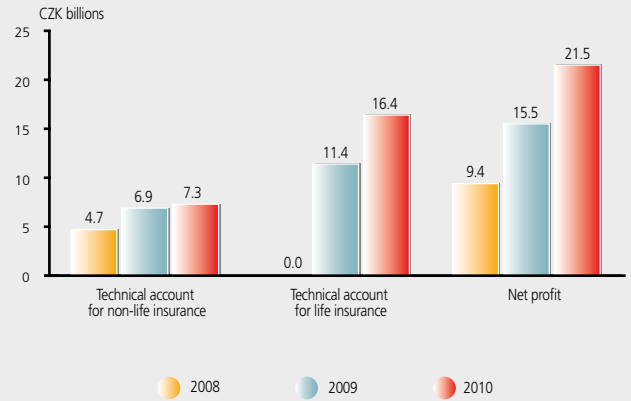
The Czech capital market was positively affected by the domestic economic recovery, higher investor confidence and the generally more optimistic sentiment in global markets. However, the problems of some euro area countries acted in the opposite direction.

The assets managed by domestic collective investment funds open to the public amounted to CZK 123.7 billion at the end of 2010, up by 4.0% compared to the end of 2009.

Rate of growth of premiums written



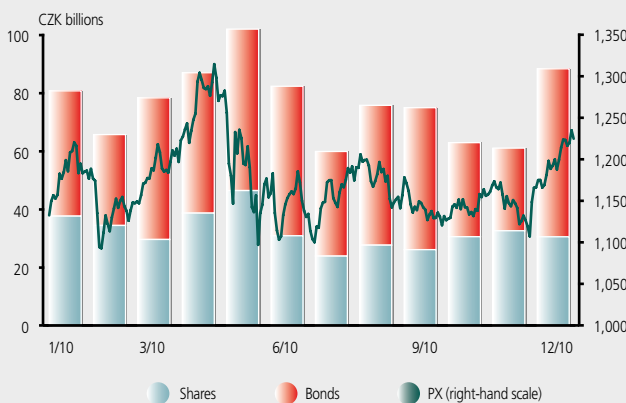
Profits of insurance undertakings



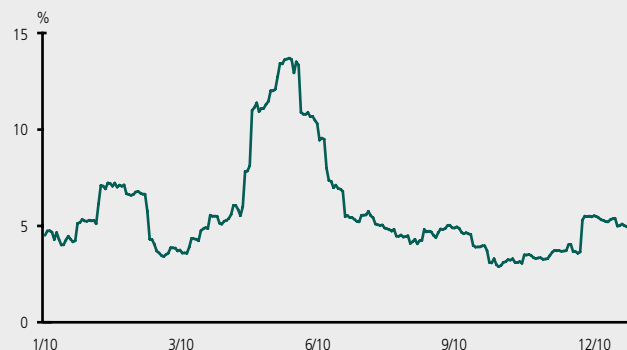
Ten entities were active in the pension fund sector. The sector's total assets increased to CZK 232.4 billion, up by 7.7% on a year earlier. The volume of planholders' funds in pension funds' liabilities also grew by 7.7% year on year to CZK 216.1 billion. The pension fund sector made a profit of CZK 4.6 billion in 2010.

Except for growth in the spring to a yearly high (1,314.6 points on 26 April) and a subsequent sharp fall to levels close to the yearly low (1,097.0 points on 25 May; the yearly low of 1,092.8 points was reached on 8 February), the developments on the Prague Stock Exchange (PSE) were generally subdued, with only small volumes being traded. However, the PX index reached 1,224.8 points at the end of 2010 after rallying in December. This represents a year-on-year increase of 9.6%. The annual volume of share trades on the PSE was CZK 389.9 billion, a decline of 16.0% from the previous year. The volume of bond transactions dropped by 9.5% year on year to CZK 529.9 billion. The trading volume on the other domestic stock exchange, RM-SYSTÉM, also decreased by 12.4% in 2010, from CZK 10.5 billion to CZK 9.2 billion. The RM index rose by 7.6% year on year from 2,340.7 points to 2,518.2 points.

PSE trading volumes and PX index



Historical volatility of PX index (20D, %)



CURRENCY IN CIRCULATION AND THE PAYMENT SYSTEM

Currency in circulation

The currency circulation area was governed by the same legislation in 2010 as in previous years. Numerous decrees relating to the issuance of silver and gold coins were issued as usual. In cooperation with the Ministry of Finance, the CNB completed work on a proposal for a completely new law on the circulation of banknotes and coins. This law, together with new decrees, should replace the relevant provisions on currency circulation that currently form part of the Act on the CNB (completion of the legislative process is expected during 2011).

The value of currency in circulation was CZK 391.7 billion on 31 December 2010, up by CZK 4.4 billion, or 1.1%, on a year earlier. Following an extraordinary overall decline in 2009, the increase in the value of currency in circulation represents a return to the usual upward trend.

The number of banknotes in circulation decreased for the second year in a row, from 349.7 million at the end of 2009 to 344.3 million on 31 December 2010. This was due mainly to two factors. First, the number of CZK 50 banknotes in circulation fell by 8.5 million owing to their substitution by coins of the same value. Second, the CZK 1,000 banknotes in circulation are continuing to be replaced by CZK 2,000 banknotes.

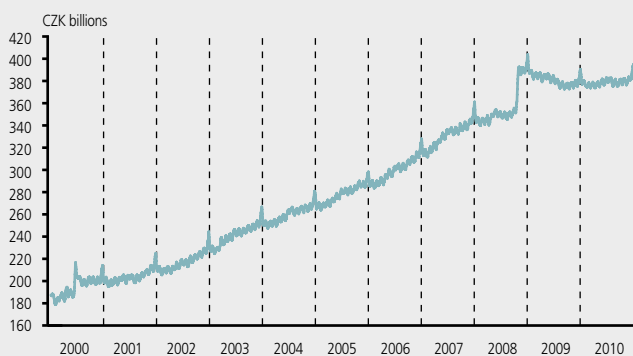
The number of coins in circulation rose by 50.6 million, or 3% (from 1,647.9 million on 31 December 2009 to 1,698.5 million at the end of 2010).

Cash turnover at the CNB's branches amounted to CZK 1,330 billion in 2010, down by around 10% from a year earlier (CZK 1,481 billion in 2009). The CNB's cash offices received 676.3 million banknotes (747.9 million a year earlier) and 428.8 million coins (500.5 million in 2009). A total of 671.3 million banknotes and 482.8 million coins, representing 6,636 tonnes of money, were put into circulation.

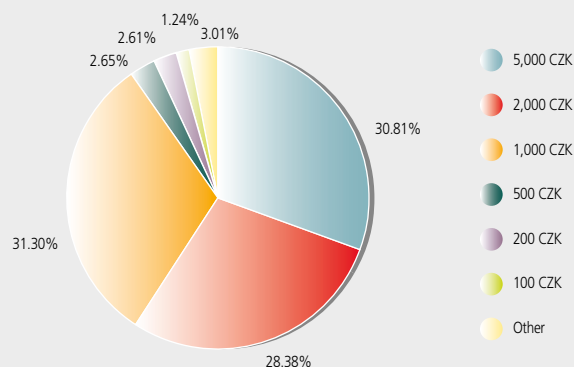
The CNB put into circulation five commemorative silver coins and two gold coins in 2010, thereby completing the Industrial Heritage Sites cycle issued over the last five years.

A total of 123,100 commemorative silver coins with a nominal value of CZK 24.6 million were minted in 2010, of which 49,100 (39.9%) were of normal quality and 74,000 (60.1%) were of proof quality. A total of 26,600 gold coins with

Currency in circulation – 1 Jan. 2000 to 31 Dec. 2010



Structure of currency in circulation





a nominal value of CZK 66.5 million were issued, of which 7,500 (28.2%) were of normal quality and 19,100 (71.8%) were of proof quality.

The CNB made a total of CZK 121 million from the sale of these precious metal coins. In 2009, when a higher total number of silver and gold coins had been issued (145,450 and 28,000 respectively), the resulting sales had been lower (CZK 95.6 million). This difference was due to growth in prices of precious metals, which are continuously reflected in the prices of coins.

In all, 1,440.3 kg of silver was used to produce the commemorative silver coins in 2010 (one coin of 900 purity contains 11.7 g of pure silver). The amount of gold in the minted coins was 206.8 kg (one coin of 999.9 purity contains 7.776 g of pure gold).

Non-cash payment system

By law, the Czech National Bank is responsible for various functions in the non-cash payment system: it maintains the accounts of the central bank and operates systems for transfers of interbank payments and for the settlement of short-term securities transactions. Non-cash payment transactions are executed through the CERTIS, SKD and ABO systems. These systems ran smoothly during 2010, with no problems or disruptions.



In 2010, work began under the leadership of the Ministry of Finance on the preparation of another amendment to Act No. 284/2009 Coll., on the Payment System, in which the CNB was actively involved. This was due to the need to transpose European legislation (Directive 2009/44/EC of the European Parliament and of the Council and Directive 2009/110/EC of the European Parliament and of the Council on the taking up, pursuit and prudential supervision of the business of electronic money institutions) into the national legislation.

The central bank prepared new draft decrees relating to the above-mentioned amendment, whose approval process has not yet been completed and which is expected to take effect in mid-2011. These decrees are also at various stages of the legislative approval process.



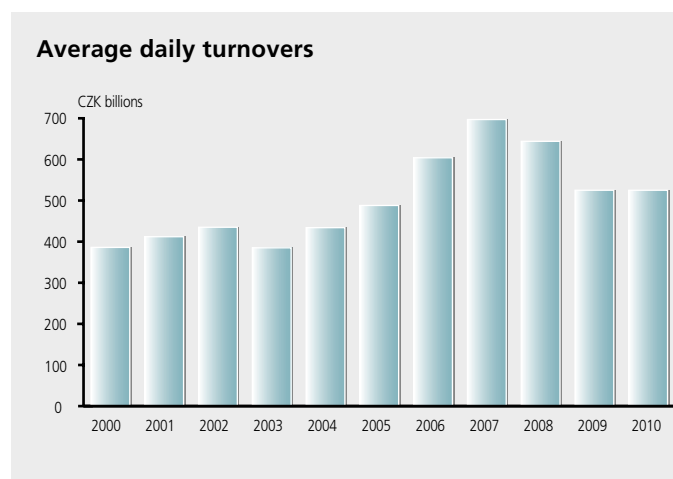
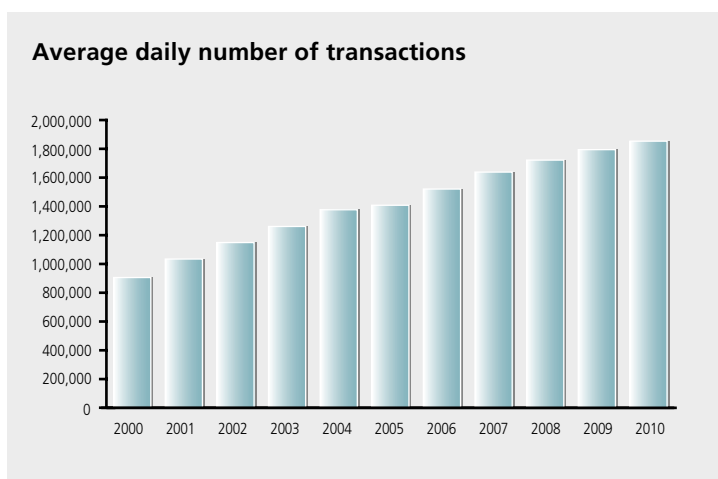
CERTIS – interbank payment system

The CERTIS system processes interbank payments in the Czech Republic. Banks, credit unions and foreign bank branches are participants in this system. As of 31 December 2010, CERTIS comprised 47 direct participants and 7 third parties, for example, card payment clearing houses and securities clearing and settlement institutions.

CERTIS processed 469 million transactions in 2010 (up by 4.2% year on year) with a total value of CZK 132,882 billion (up by 0.9%). The system processed a daily

average of 1.85 million transactions. The average daily value of the transactions was CZK 525 billion.

The following charts show the number of transactions processed and the volume of funds transferred in CERTIS since 2000.



SKD – short-term securities settlement system

The short-term securities settlement system (SKD) operated by the CNB is a separate register of securities and a settlement system for the securities recorded therein.

In 2010, SKD underwent a switch from the use of certificates issued by the central bank's own certification authority to the use of qualified certificates issued by accredited providers of certification services. The certificates are used for electronically signing data entered into the system.

As of 31 December 2010, a total of 157 owner accounts – belonging to 113 clients (securities owners) – were registered in SKD. In all, 19 agents and 6 custodians use the system. In this case, agents are banks that provide securities settlement services to their securities-owning clients. They have direct interactive access to the SKD system. Custodians administer securities accounts owned by persons other than custodians, i.e. customers of custodians.

The securities recorded in SKD are also used as collateral for intraday credit, which the CNB extends to banks for accounting purposes within CERTIS, for the needs of the CNB's repo operations and for the needs of the Ministry of Finance for daily management of Treasury liquidity during the year.

ABO – the CNB's accounting and payment system

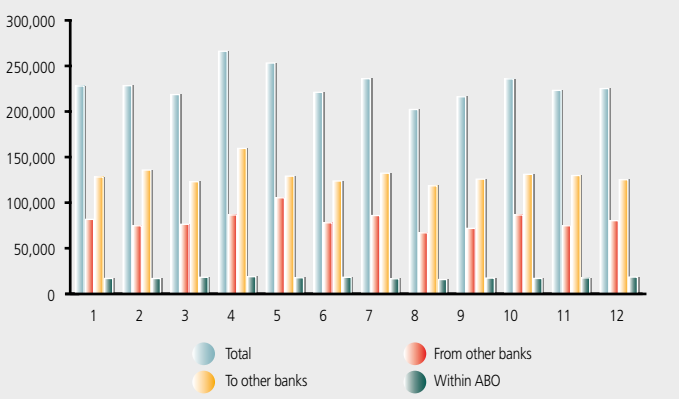
As of 31 December 2010, the ABO system, which the central bank uses to make payments and which also provides payment services to the Treasury, maintained almost 42,000 live accounts. About quarter of them were internal accounts of the bank and just under 24,000 accounts came under the Single Treasury Account. The other accounts are mostly owned by state institutions, other institutions connected to the state budget, as well as banks, foreign financial institutions and employees.

The functions of the ABO system are continuously adjusted and developed to ensure that they meet not only the needs of the Treasury but also the CNB's internal needs. Emphasis is put on the reliability and security of the system as a whole. New ABO-K

internet banking functions were put into operation in 2010, gradually replacing older methods of electronic communication with clients. Use of the core functions of the ABO-K system gradually increased during 2009, when more than 20 million transactions were sent through the system. In 2010, after the migration process had been completed, almost 39 million transactions were submitted to the central bank through the ABO-K system.

The following chart shows the average daily number of accounting transactions processed in 2010. The total number of transactions increased by 2.6% from 2009.

ABO – Average daily number of transactions



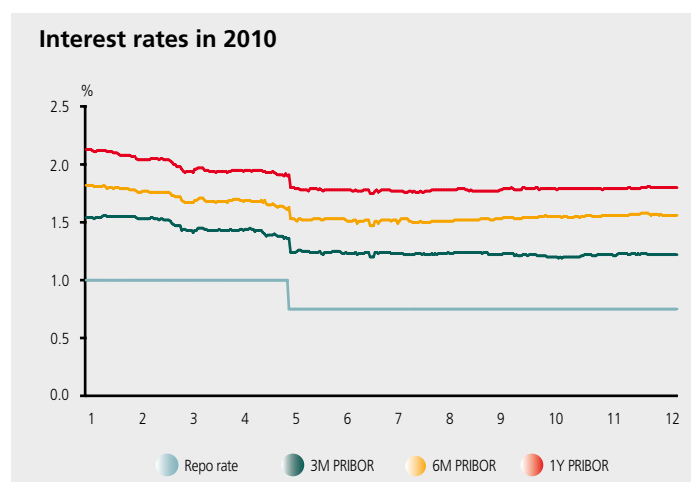
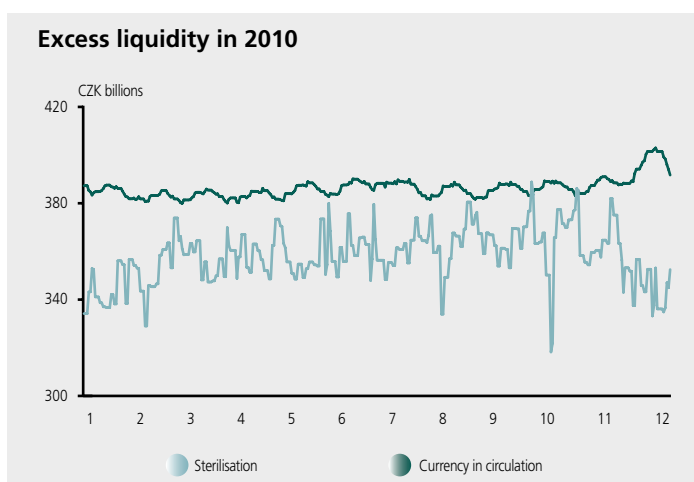
FINANCIAL MARKET OPERATIONS

The CNB implements monetary policy by means of a system of monetary policy instruments. The main instruments used are financial market operations, automatic facilities and reserve requirements. Financial market operations play a pivotal role in steering short-term interest rates on the interbank market. The CNB Bank Board sets three interest rates: the two-week repo rate, the discount rate and the Lombard rate. The main monetary policy rate is the two-week repo rate. A change in these interest rates produces a monetary policy impulse that transmits through financial market operations to short-term interest rates on the interbank market. The discount and Lombard rates provide the floor and ceiling respectively for short-term interest rates on the money market. Changes in the repo rate (set half-way between the above two rates under standard conditions) are usually accompanied by symmetrical changes in the discount and Lombard rates.

The repo rate was lowered from 1.00% to 0.75% during 2010. The repo rate was reduced on 6 May and remained unchanged thereafter. The discount rate was left at 0.25% for the entire year. In the past the discount rate had always been 100 basis points below the repo rate. However, it was considered useful to leave the discount rate above zero, as the discount rate is often used in the legislation as a reference rate for the calculation of interest. The Lombard rate was adjusted so that the spread vis-à-vis the repo rate was always 100 basis points. In line with the repo rate, the Lombard rate was thus lowered to 1.75%.

The CNB manages the liquidity of the banking sector through money market operations so as to maintain an optimum liquidity level for compliance with the reserve requirement. This ensures that short-term interest rates are stable at the desired level. The decision-making on the central bank's money market operations is based on a daily analysis and forecast of banking sector liquidity and on the money market situation.

In 2010, the main instrument for managing short-term interest rates was the repo, announced three times a week with a maturity of 14 days. Given the persistent excess liquidity in the Czech banking system, the CNB used these operations to absorb excess reserves (unlike, for example, the ECB, which provides liquidity). The liquidity absorbed is remunerated at the repo rate at most. The excess liquidity absorbed in monetary operations in 2010 varied between CZK 318 billion and CZK 389 billion, the average being CZK 385 billion. The average amount of liquidity absorbed fell by approximately CZK 18 billion relative to the 2009 average.



This was due mainly to an increase in international reserves as a result of foreign exchange transactions with clients.

The CNB's instruments also included two "automatic" facilities – the marginal lending facility and the deposit facility. Under the lending facility, the CNB lends overnight funds to banks in the form of a repo operation. Such funds are charged interest at the Lombard rate. The Lombard rate thus provides a ceiling for short-term interest rates. The CNB accepts CNB-issued bills, bonds issued and unconditionally guaranteed by the Czech Republic and koruna securities issued or unconditionally guaranteed by EU governments and selected multilateral issuers as collateral for monetary repo operations. The deposit facility gives banks the option of making overnight deposits with the CNB at the discount rate. The discount rate provides a floor for short-term interest rates. The minimum volume for these operations is CZK 10 million.

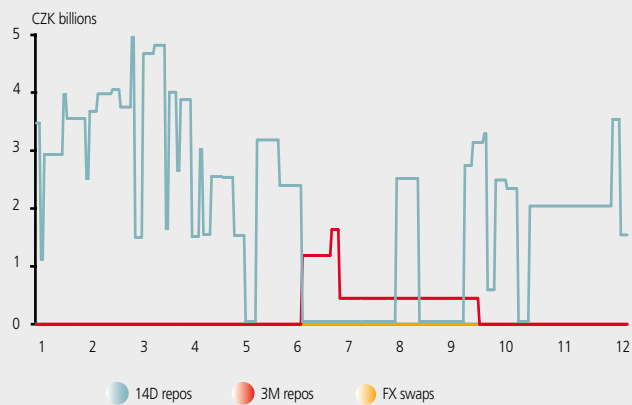
The CNB also has fine-tuning operations (ad hoc repos and reverse repos under market conditions) in its monetary policy toolkit. This instrument is used only rarely and was not applied at all in 2010. The CNB continued issuing its own bills in 2010, which it used as collateral for open market operations. In addition, CNB bills are used by banks as collateral against intraday credit from the CNB. Such credit is provided to ensure the smooth running of the payment system at CNB Clearing. The CNB charges no interest on such credit. There is automatic spillover into the marginal lending facility in the event of non-repayment of intra-day credit at the end of the day.

The CNB also executed collateral exchanges. These were technical operations in which the CNB usually exchanged a security settled in the Central Securities Depository for a security settled in the Short-term Bond System (SKD). The aim of these operations was not to affect the banking sector's excess liquidity, but to provide liquid securities to banks, for instance for obtaining intraday credit.

Extraordinary operations

These operations are not standard instruments. The CNB executed them in October 2008 in response to the financial crisis. Extraordinary operations continued to be available to banks in 2010 and their discontinuation was scheduled for the end of 2010. During the year, the Bank Board decided to continue the extraordinary operations in 2011, but to a more limited extent. These operations are aimed at increasing liquidity on the secondary government bond market and opening other channels for providing funds to banks that may be facing restricted access to loans on the interbank market. They take the form of reverse repos and foreign exchange swaps. In the liquidity-providing repos, the CNB supplied liquidity to banks with maturities of 14 days or three months. The interest rate on the 14-day operations was set 10 basis points above the CNB's repo rate and the rate on the three-month operations equalled the CNB's repo rate plus 30 basis points. Foreign exchange swaps to provide koruna liquidity against the euro were offered to banks with maturities of up to three months. Of these operations, the 14-day liquidity-supplying repos were used the most often, although there was minimal interest in terms of the number of counterparties and so the liquidity-providing operations were generally supplementary. Foreign exchange swaps were not used for monetary policy purposes at all in 2010. These measures were welcomed even by banks that did not use the facilities, as they provided a channel for obtaining liquidity if the need arose.

Amount of liquidity provided in extraordinary operations

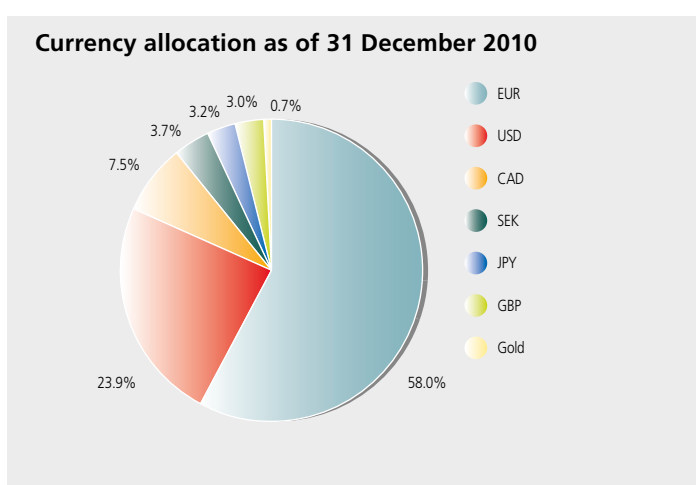


Management of the CNB's international reserves in 2010

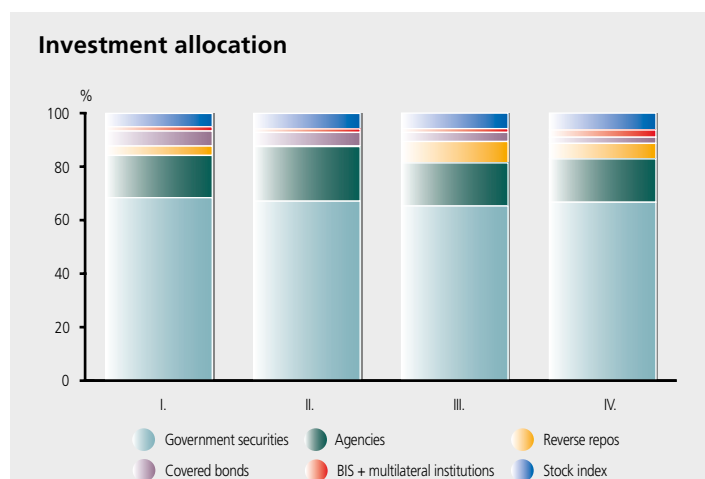
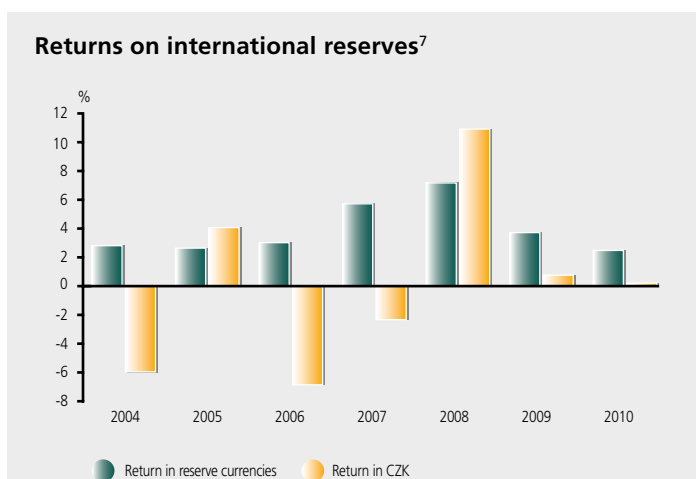
The CNB holds international reserves to support its independent monetary and exchange rate policy-making and as a source of foreign exchange liquidity for CNB clients, to whom the CNB sells foreign currency in exchange for koruna. International reserves form a major part of the CNB's balance sheet – they accounted for around 97% of total assets at the end of 2010. The volume and structure of the reserves, which amounted to CZK 801 billion at the end of 2010, are regularly published in the *Financial markets* section of the CNB website.

The actively managed portfolio accounts for around 95% of the international reserves. The remainder consists of passively held assets – SDR (3%), monetary gold (0.8%) and reserve positions with the IMF (0.8%). In 2010, part of the euro (EUR) portfolio was transferred into newly created Canadian dollar (CAD) and Swedish krona (SEK) portfolios in order to achieve more effective credit diversification of the total reserves amid the escalating sovereign debt crisis. Both portfolios are managed internally as bond portfolios. The investments made in Canadian and Swedish government

securities significantly enhanced the credit profile of the reserves. The actively managed international reserves portfolio can therefore be divided roughly into a EUR portfolio, a CAD portfolio, an SEK portfolio and a USD portfolio, which is partly diversified into JPY and GBP using currency forwards. The return on the JPY and GBP positions forms part of the return on the USD portfolio. As regards the currency structure, the actively managed international reserves portfolio was allocated as follows at the end of 2010: 58.0% EUR, 23.9% USD, 7.5% CAD, 3.7% SEK, 3.0% GBP, 3.2% JPY and 0.7% gold. By comparison with the previous year, therefore, the share of EUR decreased in favour of CAD and SEK and the share of USD fell slightly owing to the long-running gradual transfer of a portion of the dollar portfolio into the euro portfolio.



The largest part of the reserve portfolio is invested in debt securities issued by selected governments of OECD countries, selected government-guaranteed bonds or securities issued by eligible multilateral institutions. Given the continued sovereign debt crisis in the EU, the CNB responded to the latest developments in 2010, as in 2009, by tightening the limits for the government bonds concerned. Other eligible instruments for international reserves management include repos, reverse repos, specific covered bonds, shares, futures, and interest rate, currency and equity swaps. All derivative transactions are collateralised.



⁷ Returns measured by market valuation do not necessarily equal accounting revenues.

The market value of the CNB's actively managed international reserves portfolio was CZK 756 billion at the end of 2010, up by CZK 26 billion on a year earlier. The rise in the reserves in koruna terms was due to external flows⁸ into the reserves (CZK +55 billion), portfolio returns (CZK +18 billion) and valuation changes against USD (CZK +5 billion) and SEK (CZK +1 billion). By contrast, the sell-off of previous returns in exchange for koruna (CZK -25 billion) and appreciation of the koruna against the euro (CZK -25 billion) and CAD (CZK -3 billion) acted towards a decrease in the reserves. No foreign exchange interventions were made in 2010. In euro terms, the market value of the international reserves was EUR 30.2 billion (an annual increase of EUR 2.6 billion) and in dollar terms it rose by USD 0.6 billion to USD 40.3 billion. Besides the aforementioned factors, the market value of the international reserves (expressed in these terms) was affected by the euro-dollar exchange rate.

The overall rate of return on the international reserves, measured as a weighted average for all portfolios in the corresponding currency, was 2.48%, i.e. down by 1.24 percentage points from 2009. The weighted average of the return on the portfolios in koruna terms, i.e. including exchange rate gains and losses, was 0.01%, i.e. down by 0.75 percentage point from a year earlier.

As the bulk of the reserves portfolio is invested in debt instruments, low interest rates were the main factor determining the overall rate of return on the reserves. A very strict credit risk policy, including the policy for setting limits for government bonds, virtually eliminated the possibility of achieving credit-contingent extraordinary returns. On the other hand, the equity part and the performance of currency forwards in JPY and GBP in the dollar portfolio positively affected the rate of return on the overall reserves.

The parameters defining the interest rate risk assumed are set separately for the internally managed bond portfolios. The parameters set in 2010 continued to be based on the requirement that the portfolios should not record a loss over the investment horizon, which is one year for the EUR portfolio and three years for the USD, CAD and SEK portfolios. The interest rate risk measured for all portfolios by means of the modified duration⁹ did not change significantly in 2010. The modified duration of the EUR portfolio was 1 year, while that of the USD, CAD and SEK portfolios was around two years.

In 2010, the rate of return on the EUR portfolio was 1.41%, that on the USD portfolio was 4.67%, that on the CAD portfolio was 1.70% and that on the SEK portfolio was -0.17%. The rate of return on the internally managed bond portfolios is measured both in absolute terms and relative to benchmark portfolios. Measuring the relative rate of return indicates how successful the strategies implemented by the portfolio managers were relative to the benchmark portfolios. The relative rate of return (i.e. the difference between the rate of return on the actual portfolio and that on the benchmark) was -5.3 basis points for the euro portfolio, 12.9 basis points for the USD portfolio, -11.2 basis points for the CAD portfolio and -21.1 basis points for the SEK portfolio. The negative relative rate of return on the euro portfolio was due mainly to widening credit spreads on government securities in late April and early May. The negative relative rate of return on the CAD and SEK portfolios was due to technical factors relating to the building of the two portfolios. The rate of return on the gold portfolio in USD including exchange rate gains was 27.75%; in koruna terms the yield was 30.42%.

⁸ External flows originate from purchases/sales of foreign currency from/to CNB clients and client deposits in foreign currency. The biggest contribution came from a one-off deposit by the Ministry of Finance of EUR 1,982 million (income on a eurobond issue).

⁹ A variable expressing the sensitivity of the price of an interest-bearing instrument to interest rate movements. The same decrease in interest rates means a larger increase in the price of an instrument with a longer duration and a smaller increase in the price of an instrument with a shorter duration.

The equity portfolios are managed externally by BlackRock and State Street. A third step in investing in stock indices was taken in 2010. At the end of 2010, stocks represented 6.3% of the market value of the international reserves. According to the plan approved by the Bank Board, the equity exposure will increase steadily to 10% of the international reserves in 2011. The rate of return on the euro portfolio with the MSCI Euro benchmark was 1.20%, the dollar equity portfolio with the S&P 500 benchmark returned 15.00%, the sterling portfolio with the FTSE 100 benchmark generated 12.47% and the return on the yen portfolio with the Nikkei 225 benchmark was -1.38%.

In 2010, an agreement was concluded with the International Monetary Fund (IMF) regarding the provision of a bilateral loan, under which the aggregate amount of the loan calculated on the basis of the cumulative amount of the tranches drawn can reach the equivalent of up to EUR 1.03 billion. The IMF drew three credit tranches totalling SDR 52.5 million during the year. This represents about 6% of the total credit limit.

STATISTICS

In 2010, CNB Statistics continued to expand its database for analytical activities and also widened the range of products for informing the public about monetary developments. In line with the CNB's open communication strategy, migration to a system of publication of accompanying commentaries together with statistical data was prepared. The statistics compiled by the CNB were brought closer into harmony with European standards and the vast majority are now methodologically comparable with those in the most advanced EU countries. CNB statisticians continued to be involved in developing the methodology and structure of new EU statistical products through membership in three standing committees and more than ten ECB and Eurostat working groups. Other staff were involved in the activities of temporary work teams set up to address special methodological issues relating to the creation of new statistics. This issues included harmonisation of statistical and regulatory reporting by credit institutions and the preparation of a project to compile Europe-wide statistics on securities holdings.

The most significant enhancement of the CNB's statistical products was the creation and publication of a complete set of quarterly financial accounts statistics since 2004. These comprehensive statistics cover financial relationships and stocks and flows between all economic sectors and provide information about their creditor and debtor positions and their evolution over time. This successfully concluded the phase of development of the quarterly financial accounts statistics, which started back in 2005. As regards monetary financial institutions, data collection and processing were launched in accordance with amended ECB regulations relating to balance sheet statistics and client interest rate statistics. The collection of data from financial vehicle corporations engaged in securitisation transactions was enacted into legislation. The financial crisis revealed a need to monitor loan securitisation, although this phenomenon does not currently play an important role in the Czech Republic.

Statistical reporting continued to focus on progressive data collection methods, i.e. the collection of primary data. For the purposes of compiling the balance of payments, the reports on individual securities were expanded to cover pension funds and non-bank investment firms in the case of client services. By agreement with banks and in cooperation with financial market supervisory staff, a derivative transactions report was drawn up. Coordination of data collection within the CNB and with the Czech Statistical Office (CZSO) has recently become the main principle for efficient dealings with respondents. A data-sharing agreement was signed with the Czech Statistical Office, under which the CNB will provide information for the whole financial sector. This cooperation is unique even within the EU and has enabled the CZSO to discontinue numerous statistical surveys in financial institutions.

In addition to reducing the reporting burden on respondents, the agreement will harmonise the underlying data for the compilation of interrelated statistics. Source data were also harmonised between the CNB and the CZSO in the area of government financial statistics. The use of Ministry of Finance administrative sources was harmonised with the CNB's statistical reports.

The CNB is also preparing for the introduction of new international standards, for example the new NACE2 classification of economic activities and the sixth edition of the IMF's Balance of Payments Manual, which will take effect in 2014. The introduction of the latter is being coordinated with the CZSO's procedures for the introduction of a new national accounts standard. A revision to the 2009 and 2010 data on foreign trade in goods and services was prepared in 2010 in cooperation with the CZSO; the data were published in March 2011. The national foreign trade data used for the purposes of the national accounts and the balance of payments eliminate manifestations of economic globalisation and replace the cross-border goods movement statistics with the concept of change of ownership. The new data are harmonised with the national compilation methodology used for the balance of payments and the national accounts. Experts were informed about the planned data revision at several seminars.

A relatively large project was the preparation of a joint statistical survey of non-financial corporations by the CNB and the Confederation of Industry of the Czech Republic. The two institutions will use this survey for analytical purposes. Methodological activities within the ESCB were also an important area of work. This included the issue of including imputed rentals in the Harmonised Index of Consumer Prices (HICP) and the compilation and experimental calculation of the HICP sub-index for administrative prices.

THE CNB AS THE BANK OF THE STATE

The CNB provides banking services for the state and the public sector under Act No. 6/1993 Coll., on the Czech National Bank, as amended, and Act No. 218/2000 Coll., on Budgetary Rules and on the Amendment of Some Related Acts (Budgetary Rules), as amended. The clients of the CNB – for which it maintains accounts and provides payment services – are state organisational units,



the Czech Social Security Administration, labour offices, and revenue and customs offices. The CNB's clients also include subsidised organisations and business entities that receive subsidies from the state budget. The CNB also maintains accounts for state funds (such as the National Transport Infrastructure Fund and the National Environmental Fund) and accounts connected to the budget of the European Communities. Compared to 2009, the number of accounts maintained for the above clients declined by around 400, but still exceeded 27,000. The accounts were used for tens of thousands of transactions daily. For example, 7.8 million health insurance and employment policy contributions and 5.6 million transactions relating to state social benefits were recorded on these accounts in 2010 as a whole.

Support for treasury liquidity management

Since 2000, the CNB has been working with the Ministry of Finance on a Treasury development project. Within the project, it provides numerous services relating to the payment system and daily management of Treasury liquidity. It provides budget chapter administrators with an internet application that enables them to interactively set budget limits for individual Treasury expenditure accounts and to check limit settings and drawings on individual accounts.

In the area of Treasury liquidity management, the CNB is responsible for daily consolidation of state funds on the Single Treasury Account¹⁰ and works closely with the Ministry of Finance to manage intra-day liquidity. Every morning, CNB and Ministry of Finance staff compile an estimate of Treasury revenues and expenditures and an outlook for the coming days. During the day, current-day expenditures are compared with their coverage on the state accounts in the CNB's settlement and payment system (ABO). To monitor these financial flows, the CNB created and is constantly improving a system of automated transmission of information on the Treasury balance. Information from this system is available to relevant CNB and Ministry of Finance staff several times an hour, from early in the morning until the end of the accounting day. Real-time monitoring of movements on Treasury accounts allows the direction (investment or borrowing) and volume of daily money market operations vis-à-vis the Treasury to be set so that current expenditures can be covered and effective use can be made of any temporary free liquidity. Surplus Treasury funds are invested in the financial market in the form of repos or saved as deposits. Conversely, if there is a temporary lack of coverage of Treasury expenditures, additional funds are obtained by selling T-bills in the financial market.

Although billions of korunas pass through the Treasury accounts every day, the daily balance on the aggregate Treasury account is maintained at around CZK 7 million thanks to good liquidity management.

Support for state debt financing

The Czech National Bank acts as fiscal agent for the Ministry of Finance in the area of state debt management. This chiefly involves organising and carrying out primary sales of government bonds at both short and long maturities.

In the area of short-term debt, the CNB organised 28 primary sales of T-bills with maturities of 3, 6, 9 and 12 months on behalf of the Ministry of Finance in 2010. The bills were sold by Dutch auction and totalled CZK 169 billion. In 2010, the CNB also executed 24 auctions of medium-term and long-term government bonds for

¹⁰ The Single Treasury Account is defined in Act No. 218/2000 Coll., on Budgetary Rules and on the Amendment of Some Related Acts (Budgetary Rules), as amended, which specifies the accounts subject to consolidation. Above all, they include revenue and expenditure accounts of the state budget, revenue offices' accounts, state financial assets accounts, accounts of funds of state organisational units and Treasury liquidity management accounts.

the Ministry of Finance, mainly in the form of the re-opening of existing issues. There were three new issues of government bonds, with maturities of 3, 5 and 11 years. Government bonds totalling almost CZK 165 billion (excluding sales from the Ministry of Finance portfolio) were sold in these auctions.

The CNB also acts as administrator of government bond issues. This mainly involves making coupon payments to government bond holders and redeeming the principal on maturing issues. The coupons of 15 government bond issues and the principal of one maturing issue worth CZK 56.9 billion were paid in 2010.

The amount of long-term debt (in CZK and foreign currency) increased from CZK 1,031.6 billion in 2009 to CZK 1,163.3 billion in 2010.

ECONOMIC RESEARCH

Economic research at the CNB creates an analytical and knowledge base for monetary policy-making, financial market supervision and maintaining financial stability, and furthers the development of the central bank's human capital. Economic research also helps to develop the CNB's position within the ESCB and vis-à-vis the domestic and international academic community. Details on research activities can be found in the *Economic research* section of the CNB website.

In 2010, a total of 16 internationally reviewed articles were published in the CNB Working Paper Series and the CNB Research and Policy Notes. Two review issues of the Economic Research Bulletin also came out, the first focusing on ten years of economic research in the CNB and the second on wage adjustment in Europe. Ten research papers were published in prestigious professional journals such as *Economics of Transition*, the *Scandinavian Journal of Economics* and the *Journal of the European Economic Association*. Experts from foreign central banks, multilateral organisations and major universities collaborate with CNB economists on research projects. According to RePEc (the world's largest bibliographical database of economic research papers), the CNB ranked among the top 10% of economic research institutions in Europe. The relevance and quality of research outputs were assessed in a document entitled *CNB Economic Research in 2010*. The names and abstracts of the 265 journal articles produced by CNB economists in the past ten years were published on the occasion of the tenth anniversary of the establishment of economic research in the CNB.

The research project coordinators are involved in the monetary policy-making process through the preparation of opinions on the situation reports on economic developments and the minutes and transcripts of monetary policy meetings. These opinions ensure that the usual analytical activities are subject to internal review, thereby fostering better decision-making by the CNB Bank Board. The topics raised during monetary policy discussions are taken into account when setting research priorities so that the CNB's research projects focus on topics relevant to the future needs of the central bank. Research project results are also regularly used in CNB documents – more than 50% of research papers are included directly in the situation reports, the Financial Stability Report and the Analyses of the Czech Republic's Current Economic Alignment with the Euro Area.

In 2010 the CNB held its sixth Research Open Day, which presented the results of CNB economic research to a broader professional audience. The Economic Research Department Award for the best research paper is regularly presented at this event. As in previous years, the CNB organised four seminars of leading world economists jointly with the Czech Economic Society and the Centre for Economic Research and Graduate Education (CERGE-EI). The speakers were Adam Posen (Bank of England), Pierre Siklos (Wilfrid Laurier University), Glenn Rudebusch (Federal Reserve Bank of San Francisco) and Michael Woodford (Columbia University).



The CNB joined the newly established Eurosystem Macroprudential Research Network (MaRs) working group in 2010. The activities of this working group are coordinated by the European Central Bank and are focused on incorporating financial stability models and indicators into the decision-making processes of central banks.

The CNB Bank Board's advisory body for economic research is the Research Advisory Committee, whose members include leading foreign experts. The Committee's main role is to provide recommendations and a foundation for the Bank Board's decisions on research projects. In 2010, the members of the Committee were: Nicoletta Batini (International Monetary Fund), Iain Begg (European Institute at the London School of Economics), Andrew Blake (Bank of England), Martin Čihák (International Monetary Fund), Carsten Detken (European Central Bank) and Pierre Siklos (Wilfrid Laurier University). The President of the Committee was CNB Governor Miroslav Singer and its Chairman was CNB Board Member Kamil Janáček. The internal members of the Committee were the Executive Directors of the CNB's Economic Research Department,¹¹ Monetary and Statistics Department, Financial Market Supervision Department, Financial Market Regulation and Analyses Department and Risk Management and Transactions Support Department, together with the four research project coordinators.

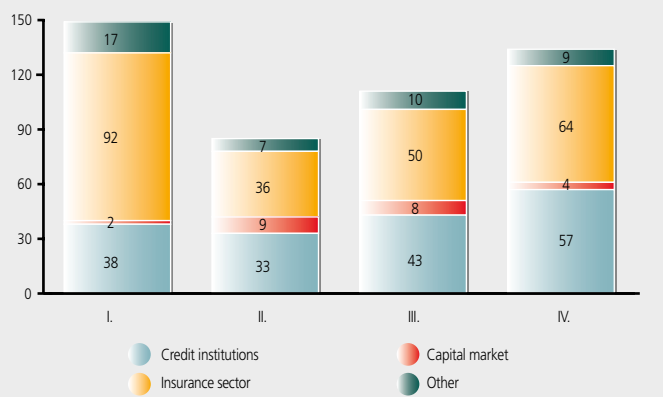
CONSUMER PROTECTION

The Consumer Protection Department (SAOOS) continued its work in 2010, which consists in receiving (at spotrebitel@cnb.cz) and investigating consumers' complaints in accordance with competences arising under the Consumer Protection Act. With effect from 1 January 2011, this competence was extended to include the consumer credit area, where the SAOOS supervises compliance with the statutory requirements for the offering of consumer credit among entities subject to CNB supervision. These requirements include the duty to provide mandatory information and explanations (including of how the APRC is calculated) and the duty to assess applicants' creditworthiness.

In 2010, the SAOOS received a total of 479 consumer complaints. Of this number, 171 related to shortcomings in credit institutions, 242 were against insurance companies and insurance intermediaries, 23 concerned shortcomings in the operation of the capital market and the remainder fell into none of the above categories.

¹¹ Until the end of September the Economic Research and Financial Stability Department.

Number of complaints received



In another important area – financial education – the CNB and the Ministry of Finance ran a joint project entitled *Measuring Adult Financial Literacy*. The project had its roots in the interdepartmental Working Group for Financial Education and is a key component of the National Financial Education Strategy approved by the government in May 2010. The results, published in December, showed that financial literacy is surprisingly low (the measurement results are available in the *Consumer Protection* section of the CNB website). The CNB also joined forces with the Ministry of Finance to put on a cycle of lectures entitled *The Financial Market and Us* for Universities of the Third Age in the second half of the year. Almost 500 people attended.

EUROPEAN AND INTERNATIONAL COOPERATION, FOREIGN TECHNICAL ASSISTANCE

European Central Bank, European System of Central Banks, European Systemic Risk Board

Since 1 May 2004, the CNB has been a member of the European System of Central Banks (ESCB), which comprises the European Central Bank (ECB) and the 27 national central banks (NCBs) of the EU. The CNB Governor regularly attends meetings of the ECB General Council – one of the ECB's three decision-making bodies, along with the Governing Council and the Executive Board.

The General Council meets four times a year. The governors of all the NCBs of the EU countries are represented in it. Two teleconferences of the General Council were held in 2010. The financial situation of Greece was discussed in February. The agenda in May included the approval of the regular ECB Convergence Report on the progress made in the fulfilment by the Member States of their obligations regarding the achievement of economic and monetary union. The report assessed the fulfilment of the economic and legislative criteria for euro adoption by these countries. The main items in the discussion concerned the sustainability of the fulfilment of the inflation criterion by Estonia, which became the 17th member of the euro area on 1 January 2011, and the financial independence of central banks. The regular items discussed at all General Council meetings in 2010 again included macroeconomic, monetary and financial developments around the world and in the EU. Issues relating to the reform of the European supervisory framework were discussed several times. At the end of 2010, the legislative process was completed and the relevant legal acts necessary for the establishment and commencement of activities of the new European System of Financial Supervision (ESFS) were adopted. Informal meetings relating to the European Systemic Risk Board (ESRB) and laying the groundwork for the inaugural ESRB General Board meeting in January 2011 were

held together with the ECB General Council meeting in December. Among other things, the General Council also discussed reports on public finance, the prohibition of monetary financing and the functioning of ERM II, a report on developments in the banking sector and the issue of exit strategies in relation to the previous crisis.

As in previous years, CNB representatives were involved in the ESCB's 14 committees and numerous working groups. The main items on the agenda were issues relating to the European and global economic situation, the new regulatory and supervisory framework for the financial sector and information on the current situation in the banking sectors of various countries. Other items included the problem of counterfeit euro banknotes and coins, preparations for the second series of euro banknotes, TARGET2 (Trans-European Automated Real-time Gross Settlement Express Transfer System) and SEPA (Single Euro Payment Area), and statistics.

More than 140 documents were prepared in ECB written procedures at the CNB in 2010. In 23 cases the CNB made comments in the form of a Governor's letter to the President of the ECB. Written consultations arise from the duty of the Member States and the EU to consult the ECB on any draft legislation falling within its fields of competence. The Czech Republic consulted the ECB on no legislation in 2010.

Relations with EU Council bodies

The CNB Governor regularly attends the informal meetings of the ECOFIN Council held twice a year in the country that holds the Presidency of the Council of the European Union. In 2010, these meetings took place in Madrid in April and in Brussels in late September and early October. A CNB Vice-Governor regularly attends the meetings of the Economic and Financial Committee (EFC), which acts in an advisory capacity to the Council of the European Union. The CNB is also actively involved in the work of the EFC Sub-Committee on International Monetary Fund Matters (SCIMF).

Besides the regular discussion of the current economic situation, the main topic of ECOFIN and of most EFC meetings in 2010 was the financial market area. In the first half of the year discussions were held about the possibility of introducing a bank tax, which the CNB flatly rejected. CNB representatives also repeatedly expressed their reservations about crisis management in the financial sector, and especially about the philosophy of asset transfers within bank groups and about the new powers of colleges of supervisors of parent companies and subsidiaries. Other areas of interest of ECOFIN and the EFC included the preparations for the activities of the new European supervisory authorities (ESAs), the effect of ratings of countries and financial institutions on the financial sector, stress testing of European banks, and enhanced management of the EU economy.

In connection with the Greek crisis, ECOFIN in May 2010 approved a rescue mechanism of up to EUR 750 billion to help euro area countries which, owing to potential debt problems, will not be able to obtain further financing on the market. The mechanism comprises funds from the European Financial Stability Facility (EFSF) and the European Financial Stabilisation Mechanism (EFSM). It also includes an IMF promise to provide further funds of up to 50% of the EU contribution. This rescue mechanism was applied in November 2010 in the case of Ireland, which was provided with an assistance package of EUR 85 billion. The December meeting of the European Council agreed to establish a permanent European Stabilisation Mechanism (ESM) to replace the temporary EFSF and EFSM instruments in 2013.

The G-20 continued its discussions in 2010. The top-level representatives of its member countries met at summits in Toronto (June) and Seoul (November). The most important issues discussed by the G-20 in 2010 were the creation of a framework for strong, sustainable and balanced growth (including monitoring of the economic policies of individual member countries), the reform of the International Monetary

Fund and its instruments, and the implementation of stabilisation measures in the financial sector area.

EU Committee

The EU Committee is the Czech Government's body for setting and coordinating the Czech Republic's positions in the EU. It meets at government level and at working level (high-level representatives of the state administration, usually deputy ministers). Its mandate is to formulate strategic interests regarding the Czech Republic's EU membership and to define the positions on fundamental issues discussed in EU bodies. Given its independence, the Czech National Bank enjoys the status of an associate member and informs the EU Committee twice a year about its relations with the ESCB and the ECB.

In 2010, the CNB regularly participated in EU Committee activities, particularly the preparation of documents and comments on materials for European Council and EU Council meetings (particularly ECOFIN meetings) in areas relating to its fields of competence – economic policy, macroeconomic and financial stability and financial services. Here, too, the preparation of the new framework for financial market supervision in the EU was one of the most important tasks of 2010. At the initiative of the CNB, the Czech Republic won a dispensation relating to the future introduction of a levy/tax on financial services at the European Council meeting in June 2010. The CNB was involved in formulating the Czech position on the creation of European rescue mechanisms (the EFSF, the EFSM and the ESM) and on the new economic management rules amending and extending the existing provisions of the Stability and Growth Pact. However, these issues were not fully resolved in 2010.

International Monetary Fund

Further to the conclusions of the annual meetings of the International Monetary Fund and the World Bank held in Istanbul in 2009, the IMF focused in 2010 on:

- modernising macroeconomic and financial sector supervision in order to foster global stability;
- enhancing the creation and use of credit lines given the IMF's limited resources and the need to reduce the excessive accumulation of foreign exchange reserves;
- reform of IMF quotas and governance.

In August the Executive Board of the IMF approved reforms relating to crisis prevention. The new Flexible Credit Line (FCL) was enhanced (the duration of the credit was doubled to one year, the implicit cap of 1,000% of the quota was removed, and the protection of IMF funds was strengthened) and a Preventive Credit Line was established (for member countries with sound economic fundamentals who do not qualify for the FCL).

The reform of IMF quotas and governance was the most important topic in 2010. On 5 November, the Executive Board approved a proposal to increase the quotas in the 14th General Review of Quotas. Subsequently, on 15 December, the Board of Governors (the supreme body of the IMF) approved a resolution which will lead to an unprecedented doubling of member quotas and a shift of 6% of quota shares to dynamic emerging market and developing countries. The resolution includes also an agreement on a fundamental change in the Executive Board whereby the EU will give up two seats to the emerging economies and developing countries. This change affects the Belgian constituency, of which the Czech Republic is a member. The approval of the resolution is now subject to a ratification process in the individual member countries.

Part of a bilateral loan worth EUR 1.03 billion provided to the IMF by the Czech Republic was drawn in 2010.

Bank for International Settlements

In addition to banking services, the Bank for International Settlements (BIS) provides central banks with an expert discussion platform for exchanging information and opinions and for coordinating positions in areas concerning central banks' activities. The key topics discussed in 2010, which are also the subject of research work undertaken within the BIS, included the persisting risks to global financial stability, current monetary policy challenges and enhancement of financial market regulation and supervision.

The CNB Governor attended the regular meetings of central bank governors of BIS countries held every two months. The CNB was also represented at a regular meeting of vice-governors and at meetings of the Basel Consultative Group (BCG), which is part of the Basel Committee on Banking Supervision. At the expert level, the CNB was involved in the activities of the Working Party on Monetary Policy in Central and Eastern Europe.

The BIS Annual General Meeting, attended by the CNB Governor, took place in June 2010. The AGM decided to pay a normal dividend of SDR 285 per share for the financial year 2009/2010 and a supplementary dividend of SDR 400 per share. With its holding of 5,705 shares, the CNB thus received SDR 3,907,925. At the same time, the share of the CNB in the BIS increased by SDR 15.06 million to SDR 115.36 million thanks to an increase in the capital of the BIS and a subsequent revaluation of shares.

Organisation for Economic Cooperation and Development

The CNB regularly participates in the meetings of a number of OECD working bodies, particularly the Economic Policy Committee and the Committee on Financial Markets. This means it is involved in discussions on the latest findings and trends in the area of macroeconomic and structural policy with the most advanced countries of the world. The CNB contributed to the preparation of the OECD's regular economic review of the Czech Republic, which was discussed in Paris in January 2010 in the presence of a CNB Bank Board member. OECD Secretary-General Angel Gurría visited the Czech Republic in April for the official publication of the review.

European Bank for Reconstruction and Development

The Finance Minister is the Czech governor in the EBRD, with the CNB Governor acting as his alternate. The Czech Republic is currently involved mainly in technical assistance projects coordinated by the EBRD. This area looks promising as regards the potential involvement of the CNB in the future.

Foreign technical assistance

In virtually all its main areas of activity the CNB now has a strong position in the community of central banks that provide foreign technical assistance. In this way it achieves its strategic plan to pass on its experience of the process of economic transformation and integration into European and international structures to partner central banks in transforming economies seeking membership of the EU and central banks in the countries of the former Soviet Union and the Balkans. Demand for CNB know-how is constantly high. On the other hand, the feedback from participants in seminars and consultations organised both in Prague and in target countries is beneficial for CNB experts, too.

A total of 39 foreign technical assistance events were held in 2010. Ten seminars took place, attended by 165 experts from 29 central banks. There was also strong interest in consultations at the CNB; 20 of these were held for 66 participants from 15 central banks. CNB staff also provided expert assistance in the form of



consultations at recipient banks and lectures at foreign technical assistance events organised by foreign partners. The total amount spent by the CNB on such assistance under the relevant budget item was CZK 832,000 in 2010.

The CNB, together with other EU central banks, continued to implement an EU-funded banking supervision project for the central bank of Egypt. Together with the Deutsche Bundesbank the CNB participated in a twinning-light project organised by the European Commission for the central bank of Bosnia and Herzegovina in the field of human resources management. CNB experts also took part as usual in missions of the IMF, which finances such activities.

TECHNOLOGY AND SECURITY

Computing and communication systems

In the IS/IT area, the CNB continued to fulfil the strategic aims launched in previous years. The trend of cutting investment and operational costs while ensuring high-quality services and constant growth in the IS/IT technological level was maintained in 2010.

A total of 26 IS/IT development projects out of 54 projects under preparation were implemented last year. Of these, 33 projects supported activities in the areas of statistics, financial market supervision, banking transactions, currency issuance and management, interbank payments and settlements, and the CNB's internal accounting and management processes. The other projects involved system and user environment upgrades, with an emphasis on higher performance and accessibility, as well as rising security requirements and requirements for the support of other areas of CNB activities. Specifically, the data network access layer at CNB branches was upgraded in accordance with the CNB data network upgrade programme. Laptops for supervisory departments and dealer workstations were replaced. Conditions were also created for routine server virtualisation, and a continuous process of reducing the number of physical servers at the CNB was launched.

The CNB is continuing to cooperate within the ESCB and the information systems of the CNB and the ESCB are being interlinked (statistical reporting, data exchange

between national supervisors). The Information System Department put great emphasis on activities associated with the commencement of operation of the European Supervisory Authorities.

In the supervisory area, a unified register of regulated and registered entities was created. This allows basic data subject to mandatory disclosure to be presented on the CNB website.

In the security area, chip cards were introduced, allowing secure login to information systems and secure saving of certificates used, for example, for electronic signatures. Laptop security was enhanced by the use of full hard disk encryption software. The system for systematic search of known vulnerabilities for the server, client workstation and multifunctional device platforms was expanded. Following the introduction of a data box system, the possibilities for internal use of electronic signatures are being increasingly promoted.

Last but not least, the obsolete IT service development planning system was replaced by a new system that provides more effective support for the process of planning and managing the IS/IT project portfolio.

Crisis management system

The CNB's central position in the Czech financial market makes it an important and highly sensitive location on which the smooth running of the national economy crucially depends. The CNB therefore plans relevant measures to ensure the security and continuity of its activities and to enhance the resilience of the entire organisation in emergency situations. This process is formally laid down in the CNB's Crisis Plan and its implementing documentation.

Considerable attention is devoted to testing this documentation at the CNB. Among other things, regular business continuity tests were carried out in 2010 in order to verify the readiness and functionality of the back-up facilities of selected CNB organisational units.

The CNB took the unusual step of organising joint exercises with the Czech Police Service. These events focused on the resolution of emergency security situations, such as assaults on CNB employees and hostage-taking situations. The exercises were highly complicated, as they involved coordinating the activities of quite a large number of front-line and supporting police units. The purpose of the exercises was to verify and practice police procedures for taking action against dangerous perpetrators of particularly serious criminal acts. The CNB's internal testing plan combined with the above exercises with the Czech Police and the CNB's participation in the *Crisis 2010* exercise ensures that CNB employees are systematically prepared in the crisis management area on a long-term basis and can take successful action in the event of emergencies at both local and national level.

THE CNB AND THE PUBLIC



EXTERNAL COMMUNICATIONS

The Czech National Bank's objective in the communication area is to maintain and promote the CNB's reputation as a generally respected, credible and competent institution not only at home, but also abroad. The latest STEM survey showed that 77% of Czechs trusted the CNB. This was the highest figure since 1999, when the first such survey was conducted.

In 2010, the CNB's communication activities continued to focus on enhancing explanatory aspects and familiarising both experts and the general public with the wider context of the topics being communicated and presented. The CNB's main communication tool is its website www.cnb.cz. The *Financial market supervision* section of the site was overhauled in 2010. A website called www.cnbprovsechny.cz focusing on topics for the general public, in particular financial education, was created last year. In 2010, the CNB website had 7,000 visitors a day, who downloaded 79,000 pages on average. The CNB also continued to update its profile on the microblogging and social networking service Twitter, which provides the CNB with an alternative channel for sending the latest information to foreign observers.

As regards the communication of monetary policy topics, the main event was the lowering of interest rates to an all-time low in May 2010. To increase transparency, the CNB adopted the global standard in monetary policy communication and set a fixed time for announcing the Bank Board's interest rate decisions. Since the start of 2010, monetary policy decisions have been announced at 1 p.m. on the day of the Bank Board meeting. The press conference given by the CNB Governor, who explains the monetary policy decision, starts regularly at 2.30 p.m. The CNB announces the attendance of Bank Board members at monetary policy meetings in advance. The votes cast by the individual board members are disclosed one week after the monetary policy decision. The CNB releases audio recordings, and starting from 2010 also video recordings, of its press conferences. Both are available on



the CNB website. At the end of 2010, the CNB and the Ministry of Finance, in line with general expectations, recommended not to set a target date for adopting the euro yet.

The personal decision by CNB Governor Zdeněk Tůma to resign as of 30 June 2010, i.e. more than seven months before his regular six-year term of office ended, generated an unplanned area of communication activity. The President of the Czech Republic appointed current Vice-Governor Miroslav Singer as Governor with effect from 1 July 2010.



In 2010, for the first time in four years, the public had an opportunity to view the otherwise strictly guarded interior of the CNB headquarters on Na Příkopě Street. The CNB Open Day in June attracted a record number of visitors (more than 4,000). The visitors were able to view, for example, the Governor's office, the dealing room and the CNB Exhibition, which is located in a former strong-room. The event also included thematic presentations by Bank Board members, financial knowledge tests, examples of counterfeits and demonstrations of printing techniques. For the first time in its history, the CNB shared information about the Open Day preparations on Facebook, where it presented the individual stops of the tour in advance.

There was continued public and media interest in issues relating to financial stability and financial market regulation and supervision. With respect to supervision, the dominant topic was the emphasising of the CNB's positions on the newly established supervisory institutions in both the domestic and foreign media. In 2010, the CNB started on a quarterly basis to publish the results of bank stress tests



in reaction to the increased need for up-to-date information about the risks faced by the banking sector in the wake of the financial crisis. The tests showed that banks remained resilient to strong shocks.

Turning to currency in circulation, the CNB stressed that counterfeits of Czech money remained a low-risk issue. It announced in advance that the CZK 50 banknote would be withdrawn from circulation on 1 April 2011 and publicised the deadlines for exchanging them for valid money at commercial banks and at cash counters at CNB branches. The last two issues of gold coins from the five-year cycle *Industrial Heritage Sites* and in particular the issue of a commemorative silver coin to mark the 700th anniversary of John of Luxembourg's marriage to Elizabeth of Premyslides, attracted the attention of collectors and the general public alike. This CZK 200 silver coin and a similar 700 euro-cent coin issued by the Central Bank of Luxembourg were unveiled by the governors of the two banks Miroslav Singer and Yves Mersch in September in the Royal Hall of Křivoklát Castle.



The long-running upward trend in the number of enquiries from the public relating to the CNB's activities continued into 2010. The public can contact the CNB by calling the toll-free Green Line on 800 160 170, by e-mailing info@cnb.cz, or in writing. The number of e-mails dealt with rose to 3,861 (from 3,303 in 2009), the number of telephone calls answered increased to 3,757 (from 3,222) and the number of written submissions handled increased to 456 (from 404).

EXHIBITION

The permanent exhibition "People and Money" celebrated its 9th birthday in 2010 and the total number of visitors exceeded 136,000 during this period. The exhibition is still in high demand. This is confirmed not only by the number of visitors during the Open Day in June, but also by the fact that visits are being booked two years in advance. As the CNB exhibition provides a unique set of information about the history of money and monetary policy in the Czech Republic, concentrated in one location, it was, as in previous years, visited mostly by secondary school and university students seeking information for their dissertations and theses. The concept of the CNB exhibition remains unchanged. The showcases describing "The Present" are regularly supplemented with new exhibits (silver and gold commemorative coins), and all relevant texts, charts and tables were updated on for the Open Day. The exhibition's audio-visual equipment was also upgraded. The hardware and software of the screening room's control system were replaced and the outdated traditional touch screens were replaced by modern industrial LCD monitors. Some changes were also made to the introductory audio-visual programme.



The CNB Exhibition is used not only for reservation-based “standard tours” throughout the year, but also for one-off tours for groups and schools and as a film or photo set for TV programmes and magazine articles. Its unique character also makes it an interesting venue for meetings with official domestic and foreign visitors. Further information is available in the *Exhibition* section of the CNB website.

SPECIAL LIBRARY

In 2010, the special library continued to perform its main tasks of collecting and maintaining information and making it accessible to users – both CNB employees and outside specialists. To this end, the library offers lending, advisory, reference and bibliographic information and research services (searches for information from all available information sources). Its highly specialised collection and access to numerous electronic sources allow users to obtain various information in the fields of banking and economics in general, law and computer technology and to some extent in other areas as well. The library maintains and provides access to more than 61,000 publications and 800 periodicals. In 2010, the library acquired 2,408 books, 1,702 study texts, research reports and annual reports and about 7,000 periodicals and other publications (bank documents, brochures, etc.).



The number of printed publications from central banks and important international institutions is decreasing every year as such documents become available in electronic form only. In 2010 the library continued to provide access to bibliographic, full-text and numerical databases.

In line with the strategic plans for the further development of the library, the process to digitise the historical book collection and other publications continued in 2010. More than 300 unique titles were converted into full-text PDF files and made available in the library's local network. A major project to catalogue the non-periodical archive collections, which in many cases have been stored in the library since its creation, was completed in 2010. These archives contain all sorts of documents from domestic and foreign banks and economic documents which are often quite unique in the Czech library system. More than 5,000 titles have been catalogued and made accessible. The special library will undertake a similar project in the coming years, this time focused on its periodical collections.

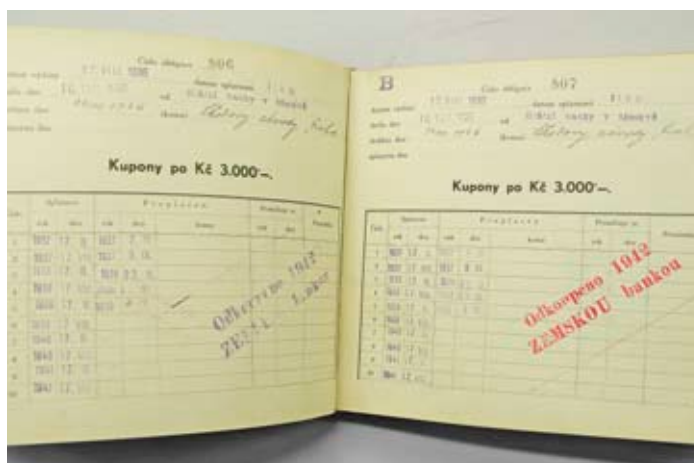
All information can be obtained by visiting the library in person, by going to the *CNB special library* section of the CNB website (http://www.cnb.cz/cs/verejnost/knihovna_cnb/), by directly accessing the online catalogue (<http://sd.ruk.cuni.cz/tinweb/cnbanka/k6>) or by e-mailing lib@cnb.cz.

CNB ARCHIVE

The Czech National Bank Archive is a public specialised archive. Its primary mission is to care for the archive documents produced by the CNB and its legal predecessors. These documents form part of the National Archive Heritage and are professionally processed by CNB archivists so that they are available to the general public. One of the long-term aims of the Archive is to broaden awareness of continuity and discontinuity in the history of the Czech financial market.

At the end of 2010, the CNB Archive had 59 archive collections with a total length of 6,714 metres. The archive documents date from 1819–1999. To study them, researchers can use archive tools in both book and electronic form. New electronic search tools are made accessible to researchers via the VadeMeCum application. At present, researchers can search for documents in two extensive databases containing 252,525 detailed records.

In 2010, the Archive's research room was visited by 44 researchers, who spent 244 research days there. The visitors were mostly university students specialising in economics or history, as well as university teachers and researchers. The most studied topics were the history of the banking system in the Czech lands, the lives



of prominent personalities in Czechoslovak banking and the history of important Czechoslovak companies, particularly from the period of the First Republic. Other topics studied included the history of Czechoslovak foreign trade and the evolution of global economic regions from the Czechoslovak perspective. The research room's work includes consulting activity provided to all researchers.

Background research is an integral part of the Archive's work. The most frequent topics in 2010 were the historical exchange rates of the Czechoslovak currency and the history of Czech and Central European banking. Property issues are another important area of work.

As in previous years, the Archive organised educational visits, mainly for university students, who were able to view the archive documents of Czech banks. The visits are always tailored to the field of study of the participants.

An exhibition entitled *Life of TGM at the Prague Castle* organised by the Office of the President took place in 2010. A video document from the large collection administered by the CNB Archive was put on show there.

The CNB Archive is also involved in specialised and scientific activities. Its employees participate actively in professional meetings of domestic and foreign scientific societies specialising in the history of banking, economic thinking and archiving methodology. The CNB Archive is a member of the European Association for Banking and Financial History (EABH) and since 2009 has also been represented in its statutory bodies (Academic Advisory Council). It is also involved in the activities of the EABH's Corporate Culture Memory Task Force, which aims to protect the archive heritage of financial institutions.

Anyone interested in studying in the CNB Archive or in obtaining historical economic information should visit the *Archive of the CNB* section of the CNB website or e-mail archiv@cnb.cz.

CONGRESS CENTRE

The CNB Congress Centre is a venue for meetings between the CNB's top management and representatives of central banks of other states, deputies and senators of the Parliament of the Czech Republic, financial market representatives, staff associations and trade unions, financial analysts and journalists. The CNB's specialised units hold conferences, lectures, research open days, presentations, quarterly insurance intermediaries' examinations and press conferences there. The most significant events held last year were undoubtedly the *Inflation Targeting and Market Consistent Embedded Value* seminars. The Congress Centre also hosted working meetings of the committees and working groups of the European Central Bank and the European System of Central Banks, for example the ECB WGs Meeting and the Basel Consultative Group.

The Congress Centre was used not only by the CNB, but was also offered to universities, non-profit institutions and other organisations. For example, the *18th European Banking and Financial Forum* organised by the Pan-European Society for Culture, Education and Scientific and Technical Cooperation, the AFIZ conference *Threats and Opportunities of the New European Financial Market Legislation* and conferences of various universities were held there. Other events included corporate presentations and gala evenings, including a concert to mark World Water Day, the CIO Network annual conference, the *Best of Realty* award ceremony and the Commerzbank Christmas Party.

The Congress Centre is used not only for conferences and seminars, but also for cultural events. In 2010, the Large Congress Hall hosted eight classical music

concerts. The start of the year was devoted as usual to Frederyk Chopin. This event was followed by the opening concert of the 10th season of the Berg Orchestra under Peter Vrabel, a concert by the Hradec Králové Philharmonic Orchestra, two Prague Spring International Music Festival concerts and two concerts by the Pavel Haas Chamber Orchestra. The music year concluded with a *Young Czech Talents* concert in which promising young performers played pieces by the great composers.



The CNB also continued its tradition of hosting exhibitions of photographs in the foyer of the Congress Centre. The first exhibition, entitled *Golden Collection – Part VI – Portrait*, comprised photographs lent by the National Museum of Photography in Jindřichův Hradec. This was followed by *Between Reality and Super-reality*, an exhibition showcasing a selection of work by students of the Department of Applied and Advertising Photography, Faculty of Art and Design, Jan Evangelista Purkyně University in Ústí nad Labem. The last exhibition was entitled *Prague through the Lens of the Secret Police*, prepared in partnership with the Institute for the Study of Totalitarian Regimes.

Further information is available on the CNB website (*About the CNB – Headquarters – Congress Centre*).

THE CNB AND ITS PEOPLE

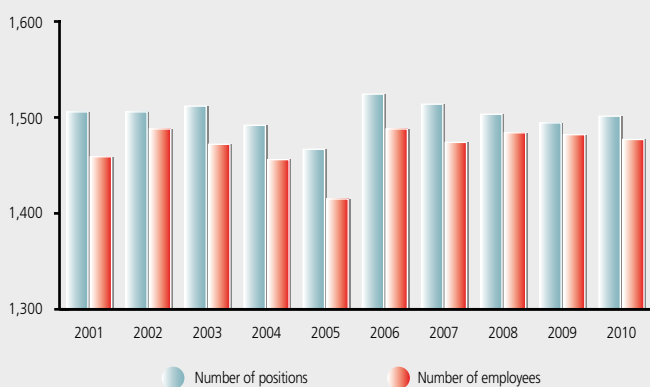


The CNB motivates its employees to develop their knowledge and skills. Its objective is to increase the efficiency and productivity of their work. In managing human resources, it also seeks to align the interests of its employees with its long-term objectives and tasks.

Number of positions and employees

As of 31 December 2010 the CNB had 1,477 employees, down by 5 from the end of 2009. The total labour turnover rate, including employees whose positions were eliminated due to organisational changes, was 6.8%. As of 31 December 2010, the average length of employment at the CNB was up slightly on previous years to 13.4 years (compared to 12.9 years as of 31 December 2009). The number of positions increased by 7 year on year. This rise was due chiefly to the strengthening of CNB supervision of entities and persons providing financial intermediary services.

Number of positions and actual number of employees

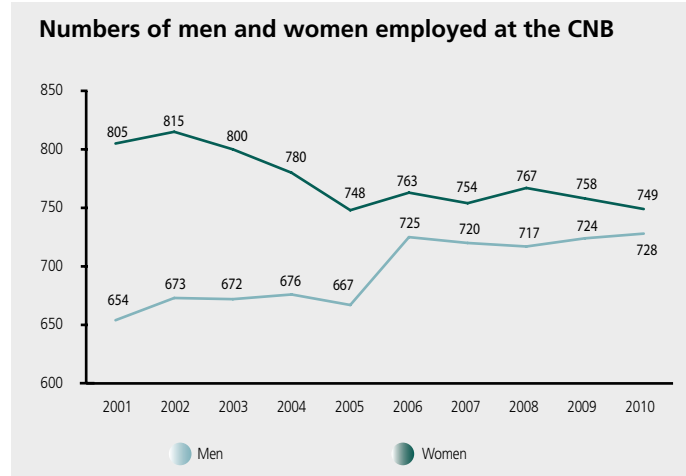
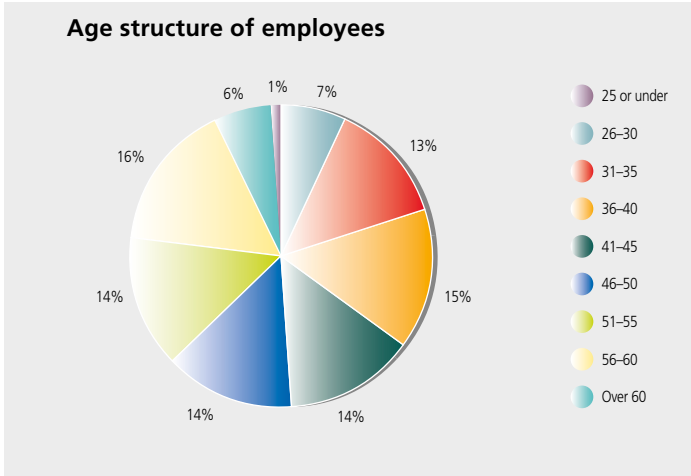


Recruitment and selection of employees

It is crucial for quality performance of the CNB's tasks going forward that the CNB seeks and recruits high-quality staff who will responsibly perform tasks in their field of work and will be extraordinarily motivated to perform at the highest level. The 27 most important positions were filled on the basis of external selection procedures in which 1,953 persons submitted applications. Vacancies are advertised internally on the CNB intranet and externally on the CNB website, on internet job sites and in the daily press. The CNB also finds new staff by directly approaching selected students in their final years at university. In order to select applicants of the highest quality and to use funds effectively, the CNB also maintains a database of applicants, who are contacted if a vacancy arises and invited to participate in the selection process.

Structure of employees in terms of education, age and ratio of men to women

The CNB is an equal opportunity employer, as its employee structure shows. The nature of the CNB's objectives and tasks reflects the percentages of employees in individual education categories. In 2010, university graduates made up 51% of the total CNB workforce, while employees with higher vocational training or secondary school education ending with a school leaving exam (including vocational training ending with a school leaving exam) accounted for 37.8% and employees with vocational training without a school leaving exam or with basic education recorded a 11.2% share.

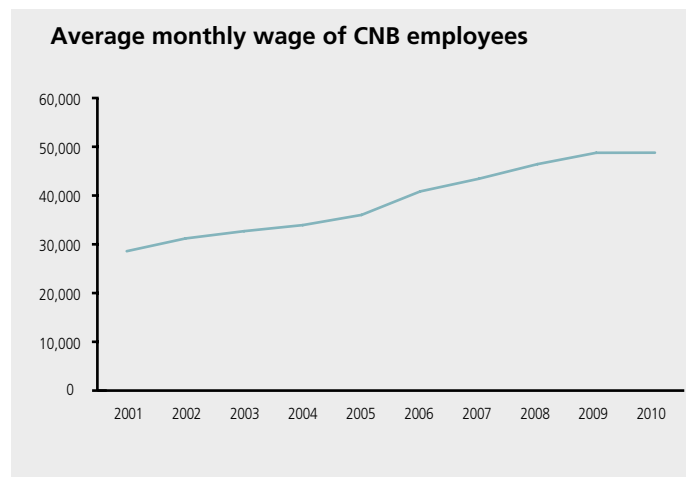
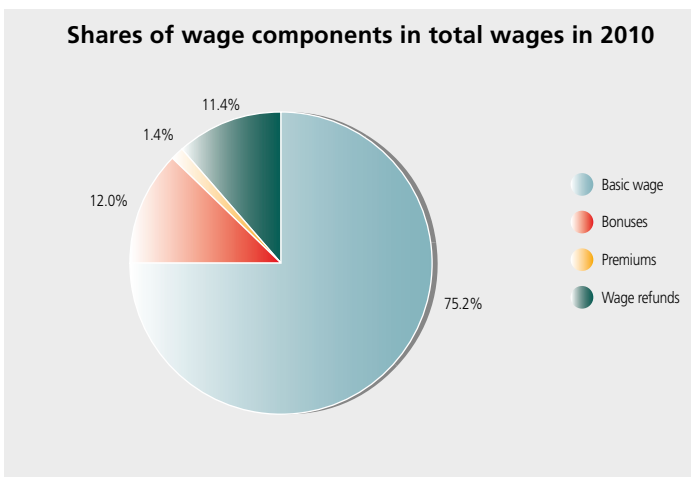


The changes in the CNB's age structure were minimal compared to 2009. All age groups are evenly represented. This ensures that working teams have optimal composition and the bank does not face risks arising from generational turnover. The average age of the CNB's workforce as of 31 December 2010 was 44.9 years (compared to 44.8 years in 2009).

The representation of men and women is balanced, too. At the end of 2010, the ratio of men to women was approximately 49:51.

Incentive system

The salary system and the two-phase staff appraisal system linked to performance-related bonuses are the main pillars for influencing employee performance. Regular feedback provided by managers within working teams is another integral part of the incentive system. Managers – as salary administrators of their divisions and departments – are motivated within the system to assess the workload, composition and number of members of the team.



Personnel expenses totalled CZK 1,261 million in 2010, up by 3.9% on a year earlier. A total of CZK 871.5 million was paid in salaries, i.e. 0.1% more than in 2009. Statutory insurance payments amounted to CZK 297 million. Other social costs, including employee benefits, totalled CZK 59.4 million. The largest part of these expenses (CZK 19.8 million) comprised life insurance and pension scheme contributions provided to employees.

The salaries of Bank Board members were as follows:		
	Gross salary in CZK ¹⁾	Net salary in CZK ²⁾
Zdeněk Tůma	2,743,021 ³⁾	2,095,111
Miroslav Singer	4,051,406 ⁴⁾	3,216,908
Mojmír Hampl	3,567,307	2,805,424
Vladimír Tomšík	3,336,552 ⁵⁾	2,561,234
Robert Holman	3,069,624	2,375,625
Pavel Režábek	3,090,915	2,377,283
Eva Zamrazilová	3,038,030	2,367,143
Kamil Janáček	1,605,957 ⁶⁾	1,131,344

1) The gross salary comprises the basic wage, wage refunds, performance-related bonuses and bonuses for working on non-working days.

2) The net salary is the gross salary net of "capped" state health insurance contributions, social security contributions, state employment policy contributions and income tax and tax discounts for the taxpayer and dependent children.

3) Zdeněk Tůma resigned from the post of CNB Governor as of 30 June 2010 and left the CNB on 31 July 2010.

4) Miroslav Singer was appointed CNB Governor as from 1 July 2010.

5) Vladimír Tomšík was appointed CNB Vice-Governor as from 1 July 2010.

6) Kamil Janáček was appointed CNB Bank Board member as from 1 July 2010.

As part of the CNB's cost-cutting measures and at the decision of the CNB Bank Board, the basic wages and performance-related bonuses of all the Bank Board members were reduced by 4% in 2010.

Professional development

Systematic professional development is an integral part of effective human resource management. The training system encompasses internal training organised by the CNB, training provided by domestic external organisations (including university studies) and training provided in other countries. Spending on CNB employee training totalled CZK 33 million in 2010.

Specialised courses focusing on enhancing skills in individual CNB business areas accounted for a large part of the internal training event structure. In addition to courses acquainting them with the central bank's main functions, new employees had access to an e-learning introductory course and various forms of internships in individual departments of the bank. Managerial training – focused mainly on communication techniques, change management and team building and leadership – was another key part of in-house training. A major training project entitled *Development of corporate culture and soft skills of CNB staff*, which was launched in 2009, continued into 2010. The project is being financed by the European Social Fund within Operational Programme Prague Adaptability. A total of 20 seminars were held and an individual coaching programme was launched as part of this project in 2010. Short-term external training events organised in the form of seminars and workshops were used to acquire information on new employment legislation and practices. Training of IT specialists also took the form of external training.

As for training abroad, cooperation between the CNB and partner central banks, the International Monetary Fund, the Joint Vienna Institute and the Financial Stability Institute played a major role. The most frequently used training events were seminars and workshops in the fields of financial stability, economic modelling and

the financial markets. There was a further increase in the number of financial market regulatory and supervisory staff attending seminars organised by the CEBS, CESR and CEIOPS. Extension of knowledge and experience in the form of consultations and short-term exchange study visits between central bank staff and financial market regulatory and supervisory institutions in the EU was an important element of specialised training.

The CNB's active involvement in education within the European System of Central Banks continued not only in the form of participation in training events, but also in the form of seminars organised at the CNB for employees of other EU central banks.

Language training took the form of long-term or intensive tuition focusing mainly on enhancing knowledge of specialised terminology and communication skills. Regular complementary e-learning also continued in 2010. The language skills requirements for managerial positions and specialised professions are met by all CNB employees for which such requirements are prescribed (in many cases at a higher level than required). A total of 51% employees proved their language skills by passing standardised language examinations.

FINANCIAL REPORT



(Translation of a report originally issued in Czech.)

INDEPENDENT AUDITOR'S REPORT

To the Bank Board of Česká národní banka:

- I. We have audited the financial statements of Česká národní banka as at 31 December 2010 presented on the enclosed CD-ROM and our audit report dated 25 February 2011 stated the following:

"We have audited the accompanying financial statements of Česká národní banka, which comprise the balance sheet as at 31 December 2010, and the income statement for the year then ended, and a summary of significant accounting policies and other explanatory notes. For details of Česká národní banka see Note 1 to the financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the Czech Republic, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with the Act on Auditors and International Standards on Auditing as amended by implementation guidance of the Chamber of Auditors of the Czech Republic. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including an assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.


Opinion

In our opinion, the financial statements present fairly, in all material respects, the financial position of Česká národní banka as at 31 December 2010, and its financial performance for the year then ended in accordance with accounting principles generally accepted in the Czech Republic."

- II. We have also audited the consistency of the annual report with the financial statements described above. The management of Česká národní banka is responsible for the accuracy of the annual report. Our responsibility is to express, based on our audit, an opinion on the consistency of the annual report with the financial statements.

We conducted our audit in accordance with International Standards on Auditing and the related implementation guidance issued by the Chamber of Auditors of the Czech Republic. Those standards require that we plan and perform the audit to obtain reasonable assurance as to whether the information presented in the annual report that describes the facts reflected in the financial statements is consistent, in all material respects, with the financial statements. We have checked that the accounting information presented in the annual report in section 5 "Financial report" is consistent with that contained in the audited financial statements as at 31 December 2010. Our work as auditors was confined to checking the annual report with the aforementioned scope and did not include a review of any information other than that drawn from the audited accounting records of the Company. We believe that our audit provides a reasonable basis for our opinion.

Based on our audit, the accounting information presented in the annual report is consistent, in all material respects, with the financial statements described above.

A stylized signature of the Ernst & Young firm, written in black ink.

Ernst & Young Audit, s.r.o.
License No. 401
Represented by Partner

A handwritten signature in black ink, appearing to read 'Magdalena Soucek'.

Magdalena Soucek
Auditor, License No. 1291

25 February 2011
Prague, Czech Republic

FINANCIAL STATEMENTS

ASSETS			
in CZK millions		31 Dec. 2010	31 Dec. 2009
1.	Gold	770	782
2.	Receivables from the International Monetary Fund	48,499	47,665
3.	Receivables from abroad, including securities	761,500	733,233
3.1.	Deposits at foreign banks and financial institutions	11,749	15,784
3.2.	Loans provided to foreign banks	44,222	39,306
3.3.	Securities	705,450	678,035
3.4.	Other receivables from abroad	79	108
4.	Receivables from domestic banks	1,500	0
5.	Fixed assets	4,692	4,933
5.1.	Tangible fixed assets	4,657	4,892
5.2.	Intangible assets	35	41
6.	Other assets	6,689	7,336
6.1.	Other financial assets	3,478	3,043
6.2.	Other	3,211	4,293
TOTAL ASSETS		823,650	793,949

LIABILITIES AND EQUITY			
in CZK millions		31 Dec. 2010	31 Dec. 2009
1.	Notes and coins in circulation	391,694	387,276
2.	Liabilities to the International Monetary Fund	41,358	42,658
3.	Liabilities abroad	6,180	2,413
3.1.	Loans from foreign banks	5,153	0
3.2.	Other liabilities abroad	1,027	2,413
4.	Liabilities to domestic banks	394,275	380,964
4.1.	Loans received	339,838	331,810
4.2.	Bank monetary reserves	40,256	43,260
4.3.	Other liabilities to banks	14,181	5,894
5.	Liabilities to the state and other public institutions	123,690	107,836
5.1.	Liabilities to the state	119,318	103,595
5.2.	Other liabilities	4,372	4,241
6.	Provisions	215	211
7.	Share capital	1,400	1,400
8.	Funds	8,050	8,050
9.	Revaluation reserve	8,667	6,633
10.	Accumulated losses from previous periods	-152,102	-170,555
11.	Net loss / profit for the period	-9,734	18,454
12.	Other liabilities	9,957	8,609
TOTAL LIABILITIES AND EQUITY		823,650	793,949

OFF BALANCE SHEET			
in CZK millions		31 Dec. 2010	31 Dec. 2009
1.	Guarantees issued	158,135	161,359
2.	Issued loan commitments	24,690	0
3.	Receivables from spot, term and option transactions	173,097	150,594
4.	Liabilities from spot, term and option transactions	174,542	151,028
5.	Guarantees received	156,952	156,952
6.	Collateral received	68,065	82,697
7.	Values taken into custody and values in own custody	292	684

INCOME STATEMENT			
in CZK millions			
		31 Dec. 2010	31 Dec. 2009
1.	Interest income and similar income	10,552	18,303
1.1.	Interest from fixed income securities	10,288	18,057
1.2.	Other	264	246
2.	Interest expense and similar expense	-4,024	-6,630
3.	Income from shares and other interests	1,232	601
4.	Fee and commission income	309	320
5.	Fee and commission expense	-74	-73
6.	Gains less losses from financial operations	-15,503	8,037
6.1.	Net foreign exchange gains / losses and foreign exchange spread	-16,386	-17,001
6.2.	Other	883	25,038
7.	Other operating income	262	694
7.1.	Income from money issue	124	256
7.2.	Other	138	438
8.	Other operating expense	-452	-893
8.1.	Expenses for production of notes and coins	-414	-538
8.2.	Other	-38	-355
9.	Administration expense	-1,640	-1,628
9.1.	Personnel expenses	-1,262	-1,215
9.1.1.	Wages and salaries	-872	-871
9.1.2.	Social and health security	-297	-285
9.1.3.	Training and employee benefits	-93	-59
9.2.	Other administration expenses	-378	-413
10.	Depreciation and amortisation of fixed assets	-398	-405
11.	Reversal of provisions for receivables and guarantees, income from receivables already written off	4,953	153
12.	Write offs, additions and utilisation of provisions for receivables and guarantees	-4,951	-25
13.	Net loss / profit for the period	-9,734	18,454

The full version of the financial statements of the Czech National Bank as of 31 December 2010, including the notes thereto, is available on the CNB website www.cnb.cz (About the CNB – Performance – Financial statements) and on the attached CD-ROM.

The structure of income and expenses used in the following text differs in some cases from the structure of the standard financial statements, but the overall sum of CNB income and expenses is the same. The difference in structure is due to the fact that from the perspective of the CNB's financial performance the individual income and expenses items are monitored and assessed according to the purpose of expenses (the income statement provides an overview of income and expenses primarily with regard to type). The database so defined creates relevant information which is then used in management of the main activities ensuing from Act No. 6/1993 Coll., on the Czech National Bank. In the following review of income and expenses, the individual areas of the central bank's financial performance in 2010 are broken down according to the purpose of expenses, including the year-on-year change in net income for the individual items.

in CZK millions

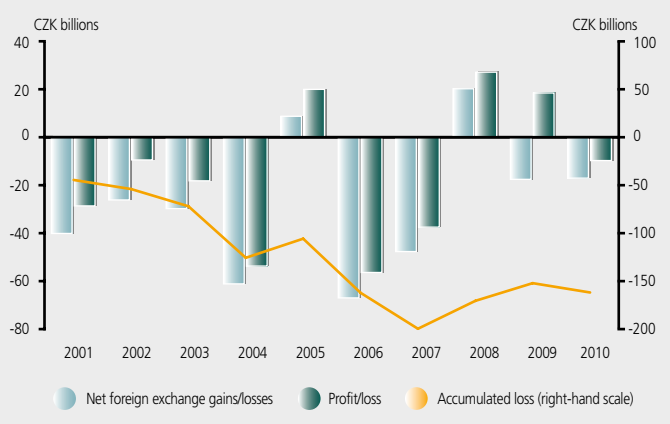
	expenses	income	net	y-o-y change
Monetary area	60,631	53,119	-7,512	-28,190
• monetary policy-making	3,490	22	-3,468	2,619
• international reserves management ¹²	21,692	34,158	12,466	-31,335
• valuation changes	30,033	12,977	-17,056	500
• client operations	469	1,005	536	154
• other operations	4,947	4,957	10	-128
Currency issuance and management	414	139	-275	-9
Operations	2,074	127	-1,947	11
Total	63,119	53,385	-9,734	-28,188

¹² The valuation differences arising from the revaluation of bonds in CNB portfolio to fair value rose by CZK 1.6 billion in the course of 2010. In line with accounting standards, unrealised profits or losses from revaluation of realisable bonds to fair value are not included in CNB income or expenses, but are reported as part of equity capital. They enter the profit and loss account only when the specific bond is settled.

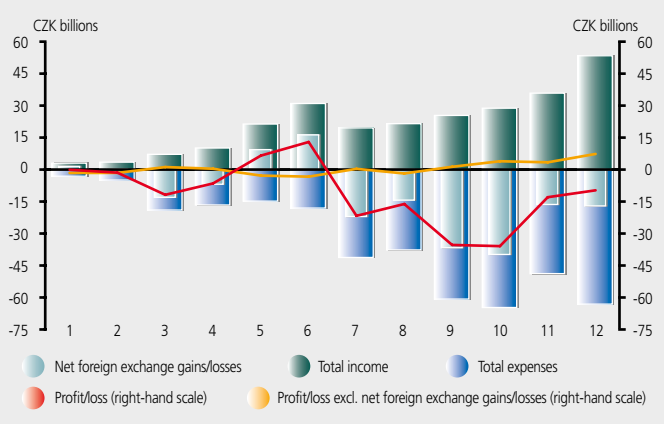
The CNB recorded a loss of CZK 9.7 billion in 2010. Valuation changes, which have fundamentally affected book profit for years, were the key factor. The total accumulated loss increased to CZK 162 billion after the 2010 performance was included.

The CNB continued to ease its monetary policy in 2010 H1. In May it lowered the key two-week repo rate, which it uses in transactions with banks, to 0.75% p.a. This change led to a decrease in the bank's expenses.

The CNB's performance 2001–2010



The CNB's performance in 2010



The primary objective of the CNB is to maintain price stability. Monetary policy making is fully subordinated to this, regardless of the amount of expenses and income.

In the pursuit of its objective, the CNB uses monetary policy instruments, mainly open market operations conducted in the form of repo operations. In such operations the CNB accepts surplus liquidity from banks. At maturity the CNB repays the principal of the loan plus agreed interest to the creditor bank. The basic maturity of such operations is 14 days. The two-week (2W) repo rate is therefore considered to be the key monetary policy rate. Free liquidity withdrawn through repo operations showed a modest annual increase of 4% in 2010. An average of CZK 362 billion was sterilised, with total costs of CZK 3,063 million. The decline in sterilisation costs in the last two years was due primarily to the lowering of interest rates. A more marked correction had occurred in 2009.

The minimum reserve requirement is another monetary policy instrument. In 2010, the CNB paid commercial banks interest totalling CZK 426 million on reserve holdings. The year-on-year decline was associated with the fall in the two-week repo rate, at which the minimum reserves are remunerated.

The CNB's monetary policy instruments also include automatic and extraordinary facilities. These facilities were used by commercial banks to only a limited extent in 2010 and so their effect on the CNB's performance was minimal.

In conducting monetary policy the CNB recorded a total loss of CZK 3,468 million, down by 43% year on year owing to the decline in interest rates.

At the end of 2010, the international reserves totalled EUR 31,980 million. This was a year-on-year rise of EUR 4,403 million, fostered by external flows into the portfolios stemming mainly from foreign exchange transactions with CNB clients, portfolio income, reserve currency exchange rate movements and by sales of part of the returns on the international reserves. The CNB decided in the past

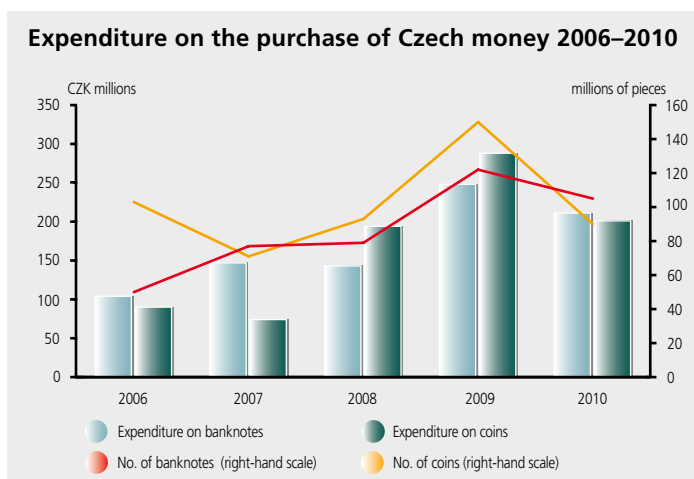
not to increase the volume of international reserves any further and thereby reduce the risk associated with the open foreign exchange position (international reserves denominated in foreign currencies account for more than 90% of all CNB assets, whereas the liabilities are mostly denominated in Czech koruna).

In absolute terms, international reserves management (adjusted for valuation changes) yielded the CNB net income of CZK 12,466 million. This was a significant decline compared to the previous year. It should be noted, however, that 2009 was exceptional as regards the impact on the CNB's financial results, as, owing to movements in prices on foreign markets, the market value of realisable bonds in the bank's portfolio increased. Their subsequent sale meant that the CNB recorded high capital gains, which could not be realised to such an extent in 2010. Thus, the most important contribution in 2010 came from interest income on bonds in the EUR and USD portfolios. Significant income was also generated by the CNB's shares portfolio.

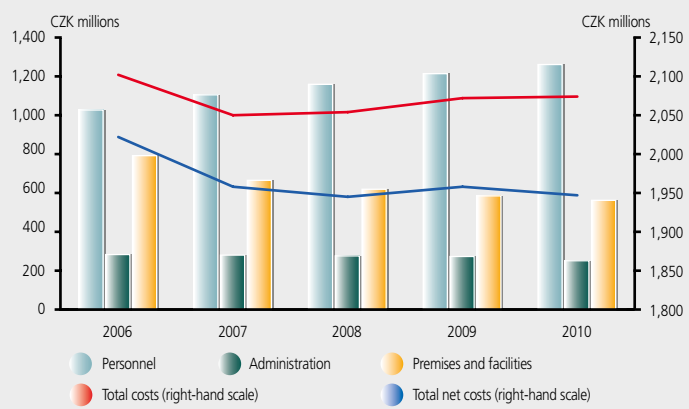
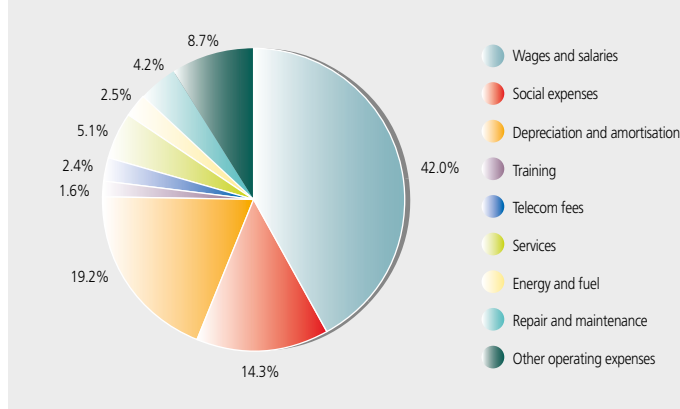
In accordance with the accounting legislation, the CNB revalues bonds in its portfolio to their market value. Owing to price movements on foreign markets, the valuation differences on these bonds increased by CZK 1,598 million year on year. Adjusted for the aforementioned increase in unrealised capital gains, the aggregate profit in the area of international reserves management would have been CZK 14,064 million.

Owing to the high proportion of foreign exchange assets, the CNB's performance is significantly affected by the nominal exchange rate of the koruna against the currencies in which the international reserves are allocated. The volatility of the koruna's exchange rate against the main reserve currencies (the euro and the dollar) was high in 2010, as it reflected foreign investors' decisions, which change depending on the risks in the USA and Europe. A number of significant fluctuations were recorded in particular against the dollar. As regards the koruna-euro exchange rate, the koruna followed a gradual appreciation trend, moderated by short periods of correction. Foreign exchange losses totalled CZK 17,056 million as of the end of the year.

Given their nature, client operations have a positive effect on the bank's performance. In 2010, the CNB recorded a profit of CZK 536 million. Most of the income came from international payment services, interbank settlement and services related to the registration and settlement of short-term bond transactions, and maintenance of Treasury accounts and extra-budgetary accounts. The cost side of client operations consisted mainly of interest on current and time accounts of clients.



The State Printing Office in Prague is the sole supplier of Czech banknotes. Base and precious metal coins are minted at the Czech Mint. In 2010, the total volume of banknotes and coins purchased decreased year on year, as the CNB had replenished the stock of Czech money to the required level in 2009. The CNB purchased 105 million banknotes of various denominations from the State Printing Office, for which it paid CZK 211 million. It also paid CZK 201 million for 90 million base metal coins and silver and gold commemorative coins, with base metal coins accounting for most of this sum (CZK 153 million). Income in the area of currency circulation and management was CZK 139 million. Sales of numismatic material accounted for the bulk of the income; a smaller proportion came from fees received from banks for cash operations and banknote and coin processing.

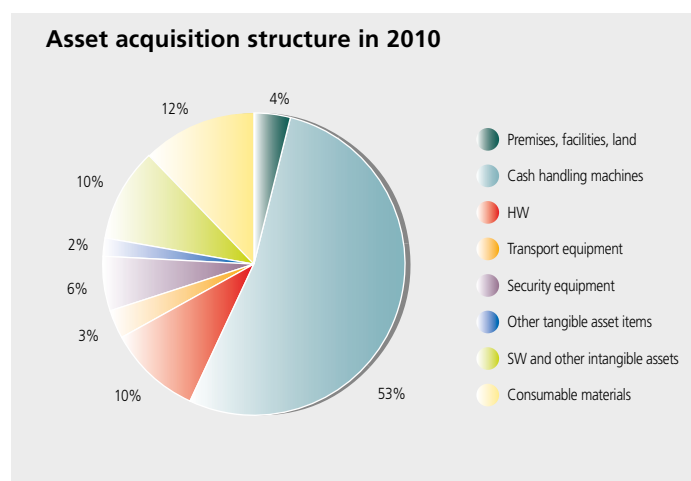
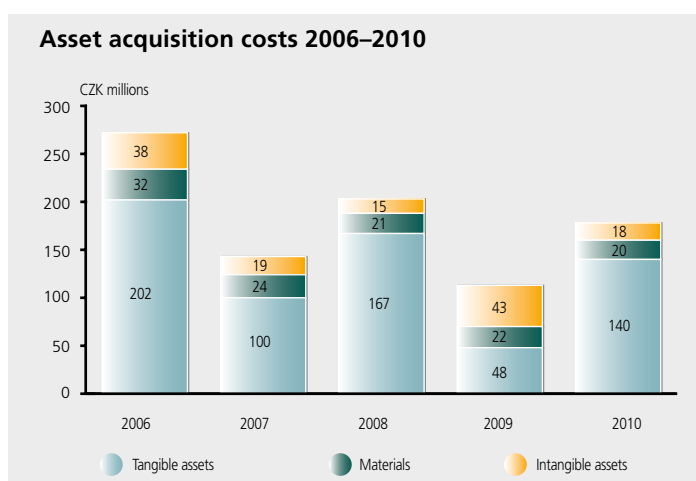
Operating expenses 2006–2010

Structure of operating expenses in 2010


The CNB strives constantly to spend efficiently in all its internal processes. This is a particular priority in the areas of operations and asset acquisition. The results of these efforts can be seen in the CNB's operating expenses over 2006–2010. The CNB has long succeeded in maintaining operating expenses at a stable nominal level, despite its widening activities in the areas of financial market supervision and consumer protection.

The CNB recorded a total loss of CZK 1,947 million in the area of operations in 2010, a decrease of CZK 11 million year on year. As in previous years, rising total personnel costs were offset by more efficient management of other areas of the bank's operations. It should be noted, however, that the increase in personnel costs in 2010 compared to 2009 was due to a methodological change to the items included in personnel costs, not to a rise in wage costs per employee.

Administrative expenses (e.g. purchased services, telecommunication fees, travelling expenses, canteen food services, membership fees, purchases of publications, representations) amounted to CZK 251 million. These expenses decreased by CZK 22 million compared to 2009, mainly because expenses in 2009 had included the acquisition price of technical equipment provided to the Czech police. In addition, the 2009 expenses had included the costs of arbitration proceedings before the International Court of Arbitration in Paris. By contrast, membership fees increased in 2010 in connection with the transformation of financial market supervisory committees into European agencies. The CNB's income from administrative activities totalled CZK 92 million, with fees levied during financial market supervision accounting for the largest part.

The CNB spent a total of CZK 562 million on the operation of premises and equipment. Expenditure on repair and maintenance of security equipment and information technology was reduced, and write-offs of tangible and intangible assets also decreased. Rising energy purchase prices acted in the opposite direction. The remaining expenses stayed roughly at the previous year's level. Income from the operation of premises and equipment was CZK 34 million and consisted mainly of rental income (mostly from non-residential premises).



Asset acquisition expenditure totalled CZK 178 million in 2010, of which CZK 140 million was spent on tangible assets, CZK 18 million on intangible assets and CZK 20 million on materials. This represented a rise of CZK 65 million (58%) compared to 2009.

The biggest expenditure item in the area of tangible asset acquisition was cash processing equipment (CZK 95 million). Most of the amount spent was used to expand or modify four existing banknote processing machines (at branches in Plzeň, Hradec Králové, Brno and Ostrava) to enable multi-denomination processing of banknotes irrespective of side orientation. In addition, coin checking and counting equipment was acquired and table cash handling equipment was partly modernised. CZK 17 million was spent on computer hardware, particularly on upgrading PCs, work-stations and laptops and on reconditioning or acquiring new servers, disc arrays, printers and multifunctional reprographic equipment. A total of CZK 11 million was used to upgrade the CNB's alarm, security and emergency systems and the system for recording digital images from the camera circuits at the CNB's headquarters and to modify and supplement camera circuits in the money operations premises at the branches in Brno, Plzeň and Hradec Králové in connection with a change in working practices in multi-denomination processing of banknotes irrespective of side orientation. Expenditure on buildings and premises totalled CZK 7 million. Major investments included the upgrading of audio and video systems in the Congress Centre and the elimination of security risks of lifts at the Brno and Ostrava branches. In addition, modifications were made to air-conditioning and cooling systems and electricity distribution systems at some branches and other minor projects were implemented as well. Expenditure on modernising a special cash transport vehicle and two cars amounted to CZK 6 million.

A total of CZK 18 million was spent on software. The biggest amount was spent as a result of a change in the database environment licensing policy for the acquisition of software licences for the Oracle Standard Edition database (the purchase of licences

will allow the CNB to reduce the total costs of Oracle SW operational support in future years). MS Windows software licences were purchased for new servers. Other purchases included licences allowing the use of reporting and online analysis of data from the CNB's information systems and licences for creating a virtual server environment and for monitoring capital market risks. The functionality of the record office information system was expanded, the editorial system of the CNB's external website was upgraded and the functionality of web forms was extended.

Almost half of the amount (CZK 20 million) spent on material acquisition was used to purchase banknote and coin packing materials. Further expenditure went on the purchase of office supplies, operating materials and computer parts and consumables.

PROVISION OF INFORMATION UNDER
ACT NO. 106/1999 COLL.



The Czech National Bank provides information pursuant to Act No. 106/1999 Coll., on Freedom of Information, as amended (hereinafter the "Act") by way of disclosure on the internet, primarily at www.cnb.cz, or to applicants on the basis of applications.

The Czech National Bank's procedure for complying with the duties ensuing from the Act, and in particular its procedure for accepting and dealing with applications for information in compliance therewith, is regulated by Czech National Bank Directive No. 55 of 13 December 2002, on the communication of the Czech National Bank, as amended.

A) Information provided in 2010 on the basis of applications:

1. Number of applications for information submitted in compliance with the Act:
12
2. Number of decisions refusing an application:
2
3. Number of appeals submitted against decisions:
0
4. Transcript of the relevant parts of each court judgement concerning the examination of the legality of an obliged entity's decision refusing an application for information and an overview of all expenses incurred by the obliged entity in connection with court proceedings on rights and obligations under this Act, including its own staff expenses and legal representation costs:
0
5. Number of exclusive licences granted, including justification of the necessity to grant exclusive licences:
0
6. Number of complaints submitted under Article 16a, reasons for their submission and a brief description of the manner in which they were dealt with:
0
7. Other information relating to application of the Act:
Most e-mail, telephone and written applications for information received in 2010 concerned information whose provision went beyond the scope of the existing legislation. In 2010, the CNB answered 3,861 e-mail, 3,757 telephone and 456 written enquiries from the public.

B) Information provided by way of public disclosure:

The CNB publishes information in a manner allowing remote access pursuant to Article 3 of the Act and provides information pursuant to Article 5(1) and (2) of the Act. The information is available on the CNB website www.cnb.cz and on notice boards at CNB headquarters and branches, in locations accessible to the public. Other information on the activities and responsibilities of the CNB is also published on the state administration web portal.

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