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## **Výroční zpráva České národní banky za rok 2004**

Česká národní banka  
2005

Dostupný z <http://www.nusl.cz/ntk/nusl-42864>

Dílo je chráněno podle autorského zákona č. 121/2000 Sb.

Tento dokument byl stažen z Národního úložiště šedé literatury (NUŠL).

Datum stažení: 18.04.2024

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ANNUAL REPORT

4

2004



# ANNUAL REPORT

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In many respects, the period covered by this Annual Report saw significant changes for the Czech Republic and the Czech National Bank. In May 2004, the Czech Republic became a Member State of the European Union and the Czech National Bank joined the European System of Central Banks. This marked the culmination of a whole phase of efforts for integration into European structures. In my opinion, we coped successfully with the new conditions.

Membership of the European System of Central Banks means that many CNB employees are directly involved in its activities. Before accession, we were acquainting ourselves with the activities of the European Central Bank, but now we are contributing actively to their realisation. The CNB's representatives work in various committees and assist in the preparation, evaluation and implementation of documents. Our aim is to develop systematically the CNB's position as a respected member of the European System of Central Banks, building on our past achievements.

The year 2004 also brought positive results in relation to the fulfilment of the CNB's primary objective. This objective remains unchanged: stabilisation of inflation at a low level near the inflation target. For most of 2004, inflation was successfully kept within the target band, despite the additional risks connected with EU accession, which resulted in increased *ex ante* uncertainty regarding its possible structural and price impacts. We also improved our prediction processes, the organisation of those processes, and the technical procedures we use.

The current monetary policy challenge is to make low inflation a permanent feature of the Czech economy. In line with this intention, an inflation target was set in 2004 for the period from January 2006 until adoption of the euro, which obliges us to keep annual inflation near 3%. This level meets the needs of a converging economy and reflects the requirements for future fulfilment of the Maastricht criterion on inflation. Implementation of this clearly defined monetary strategy is the CNB's contribution to maintaining a stable macroeconomic environment and sustainable economic growth.

In 2004, major progress was also made in the area of banking supervision and regulation. The banking sector recorded very good results and operated smoothly, chiefly thanks to the completed restructuring process. The quality of banks' risk management and control mechanisms moved to the centre of attention of banking supervision. The regulatory area was dominated by efforts to achieve full compatibility with international standards. The main challenge for the future is the implementation of the new capital adequacy framework (Basel II) and the related establishment of comprehensive assessment of banks' risk profiles.

The debate on the future arrangement of financial market supervision continued in 2004. The Czech National Bank declared its support for integration in two stages. In the first stage, the Czech National Bank will take over supervision of credit unions and the Czech Securities Commission will take over supervision of insurance companies and pension funds. This strategy will enable us to prepare for the necessary convergence of the regulators' standards, procedures and internal cultures. The second step will be the creation of a single institution responsible for the regulation and supervision of the whole Czech financial market. In 2004, the CNB's formerly independent departments responsible for banking supervision and banking regulation merged, which resulted in other institutional changes.

The banking sector remains the core of the financial system. However, the weight of other, non-bank financial institutions and products competing with traditional banking services is steadily growing. Over recent years, the analysis of financial stability, the risks thereto and the resilience of financial systems to shocks has moved to the centre of attention of international institutions and central banks. The Czech National Bank had already responded to this trend by defining economic research priorities so as to establish an analytical base in this area, and we made further progress in 2004. At the decision of the Bank Board, a specialised financial stability unit was formed within the Economic Research Department. Its task is to analyse systematically the issue of financial stability and prepare and submit a Financial Stability Report every year drawing on information from other CNB units. The first of these reports was discussed and approved by the Bank Board in December 2004. The report was then made available to the general public.

As in previous years, the CNB recorded a loss in 2004 due to the appreciation of the koruna's exchange rate. A stronger koruna results in a lower koruna value of the international reserves and an exchange rate loss on the CNB's accounts. The ways of reducing the loss involve investing the international reserves efficiently, gradually optimising their volume and, last but not least, economising and reducing the CNB's operating expenses. We were successful in this also in 2004. We must expect, however, that it will take longer to reduce the accumulated loss and eventually fully cover it from the central bank's profits.

Last year was important for the Czech National Bank also with regard to its strategy. The bank's units assessed the fulfilment of the tasks set out in the strategic documents *Challenges for the CNB* and *Medium-Term Plan for 2002–2004*. We can say that this period was successful and the tasks were fulfilled. Therefore, I would like to thank all the CNB's employees, who contributed with their professional attitude and everyday work.

It is also obvious that the conditions in which the central bank will continue to fulfil its mission and objectives have changed significantly. Therefore, we have prepared entirely new documents for the period 2005–2010. After being discussed and approved by the Bank Board in 2004 H2, these documents became binding guidelines and criteria for the activities of all units until the adoption of the euro. Their fulfilment will determine the future shape of our central bank, its institutional culture and its success. The full versions of both new materials (*Challenges for the CNB in 2005–2010* and *The Czech National Bank's Medium-Term Plan for 2005–2010*) are available on the CNB's website.

The year 2004 was also specific in that shortly after it ended the six-year terms of office of four Bank Board members expired. The Bank Board in its old composition achieved much in those six years, for which I want to thank all its members. This is confirmed not only by the results presented in this Annual Report, but also by the Czech National Bank's generally favourable image in the eyes of Czech and international public. At the time of these changes within the Bank Board, the Czech National Bank is a well-functioning and credible institution.



Zdeněk Tůma  
Governor



The CNB's mission is defined in the Constitution of the Czech Republic and in the Act on the CNB<sup>1</sup>. The Act defines the CNB's primary objective as the maintenance of price stability. It also stipulates that without prejudice to the primary objective, the CNB shall support the general economic policies of the Government and economic policies in the European Community. In line with this mission, the Act authorises the CNB to perform specified activities, defines the instruments of monetary regulation and sets out the powers of its supreme governing body, the Bank Board.

Price stability is defined by the inflation target. The CNB endeavours to hit the target by changing its policy interest rates and using other policy instruments and measures specified by the Bank Board.

The fulfilment of this mission – to maintain low and stable inflation – is the foundation of every credible and stable currency. However, a good currency is also characterised by reliable legal tender, smooth circulation thereof, and trouble-free operation of the payment system. Therefore, the CNB has the exclusive right to issue banknotes and coins and the obligation to manage the circulation of currency, the payment system and clearing between banks.

A currency's credibility depends heavily on the stability of the financial system, which derives from the reliability of its individual components and the functioning of its segments. These also determine its overall resilience to individual business failures and economic fluctuations. The CNB therefore engages in detecting the weaknesses and threats to the stability of the financial system: it performs banking supervision, analyses information on the conduct of non-bank financial intermediaries, and assesses the economic situation, the economic outlook and the developments in financial markets also from the viewpoint of risks to the domestic financial system, examining their impact and extent should they materialise. The CNB's mission also includes activities aimed at mitigating such risks. Besides regulatory activities vis-à-vis banks (or other entities carrying on banking business), which have the decisive weight in the domestic financial sector and financial intermediation, these include bolstering the financial infrastructure and the safety and soundness of domestic and cross-border payment and clearing systems. In exceptional cases, the CNB can support the liquidity of a banking institution by providing short-term collateralised credit.

Since the Czech Republic's accession to the European Union, the CNB has been part of the European System of Central Banks (ESCB). As a member of the ESCB and other international organisations, it is obliged to participate in their activities and contribute to the improvement of European and international monetary systems.

The CNB fulfils its mandate in accordance with the principles of an open market economy; without prejudice to its primary objective, it supports the general economic policies of the Government leading to sustainable economic growth and co-operates with other domestic institutions, foreign central banks, banking and financial market supervisory authorities abroad and international institutions active in this area.

<sup>1</sup> The Constitution of the Czech Republic of 16 December 1992, Constitutional Act No. 1/1993 Coll., as amended by Act No. 347/1997 Coll., Act No. 300/2000 Coll., Act No. 448/2001 Coll., Act No. 395/2001 Coll. and Act No. 515/2002 Coll. Act No. 6/1993 Coll., on the Czech National Bank, as amended by Act No. 60/1993 Coll., Act No. 15/1998 Coll., and Act No. 442/2000 Coll., the ruling of the Constitutional Court No. 278/2001 Coll., Act No. 482/2001 Coll., Act No. 127/2002 Coll. and Act No. 257/2004 Coll.

The Czech National Bank provides information on its activities by issuing a number of periodical publications. These include, for example, quarterly Inflation Reports and annual Banking Supervision Reports and Financial Stability Reports. All CNB publications are available in electronic form on the CNB website ([www.cnb.cz](http://www.cnb.cz)).

Under the Act on the CNB, the CNB is obliged to submit periodical reports on monetary developments to the Chamber of Deputies (the lower house) of the Czech Parliament. These periodical reports are the Inflation Reports and, starting 2004, also the Financial Stability Reports. The reports are submitted by the CNB Governor, who participates in the debate in the Chamber of Deputies and responds to questions.



As with private/commercial banks, the CNB's accounts are checked by external auditors. Moreover, the Supreme Audit Office is entitled to carry out inspections in the CNB in the areas of asset acquisition and the bank's operations. The Czech National Bank submits an annual financial report for discussion in the Chamber of Deputies, which includes the external auditor's report.

In addition, financial data can be found in the CNB's Annual Report, which also contains basic information on organisation, monetary developments and the bank's activities in other areas.



# MANAGEMENT AND ORGANISATION



### **THE BANK BOARD**

The Bank Board is the supreme governing body of the CNB and decides as a collective body. It has seven members: the Governor (who chairs the Board), two Vice-Governors and four Chief Executive Directors. The Bank Board takes decisions by a simple majority of the votes cast.

The Bank Board sets monetary policy and the instruments for implementing this policy. It approves key measures arising from the supervision of the banking sector and the performance of other activities, and rules on appeals in administrative proceedings. The Bank Board also sets the CNB's overall development strategy, approves its budget and budgetary rules, and defines the types, amounts and uses of the CNB's funds. It decides the bank's organisational structure and approves the CNB's Organisational Statute and revisions thereto. It appoints and dismisses senior officers of the CNB and conservators.

The members of the Bank Board supervise the main activities performed by the CNB's departments and branches (executive management areas) in line with the Bank Board's decisions.

### **SENIOR MANAGEMENT**

The executive directors of the CNB's departments and branches are responsible – subject to the CNB's overall strategy, approved medium-term plans and annual work programmes – for effective performance of the tasks falling within their areas of competence as set out in the Organisational Statute. Their competencies and responsibilities include in particular: management activities, methodological activities, preparing proposals and solutions to issues of fundamental significance and presenting them at Bank Board meetings, carrying out the decisions adopted by the Bank Board, and setting targets for the staff under them.

They also perform the employer's rights and duties under labour law in respect of the employees, and propose appointments and dismissals of senior employees in their areas of competence. They are responsible for co-ordinating with other units of the bank and with domestic and foreign partner institutions.

### **HEADQUARTERS**

The CNB's organisational structure consists of a headquarters in Prague and regional branches. The fundamental organisational units of its headquarters are departments, which are responsible for methodological management in specific areas defined by the Organisational Statute. The headquarters performs the bank's main activities, branch management, and ancillary and service activities. Co-ordination of activities, which in many cases covers the areas of competence of several departments and depends on close co-operation between them, is provided for by standing advisory bodies, committees and project teams.

The main objectives in the area of management and organisation are to maintain a transparent and relatively simple organisational structure, to enhance the internal control system and its mechanisms (e.g. by using internal auditing and control and by ensuring that the CNB's activities are compliant with legal rules, internal rules and general ethical principles), and to improve the risk management system and create conditions for effective management of activities and processes, while maintaining flexibility enabling project-oriented management and targeted rotation of employees.

A number of changes were made in 2004. Two departments merged to form the Banking Regulation and Supervision Department. This change was intended to facilitate closer integration of regulatory procedures, to make use of the experience acquired through the application of those procedures in inspections, to unify management and to enhance co-ordination. The areas of competence and activities of the department's divisions were redefined.

Organisational changes were made in the Monetary and Statistics Department, reducing the number of divisions and redefining and regrouping some activities. The objectives of the changes

were to link analytical and statistical activities where applicable, to increase the compatibility of the work within divisions, and to enhance communication with the ECB.

The area of competence of the Economic Research Department was extended with the creation of a financial stability unit, which was given the task of preparing and co-ordinating analyses and forecasts on financial stability and drawing up regular Financial Stability Reports.

The responsibilities of some organisational units were updated in connection with, among other things, the entry of the Czech Republic into the EU and the CNB into the ESCB. The CNB's legal obligations in the fight against money laundering by non-banks were enlarged, and the instruments of the internal management system were extended.

## BRANCHES

The CNB's branches represent the bank in the regions and are its contact points for relations with bank representatives, state and local authorities, financial authorities, the Czech Statistical Office, selected clients and other legal and natural persons that have dealings with the CNB under the relevant legal rules. The CNB's branches are responsible mainly for managing money reserves, maintaining accounts of the Treasury and other CNB clients, making cash and non-cash payments, operating safe deposit boxes and conducting the accounting of the branches. In a specified scope the branches also conduct administrative proceedings, perform foreign exchange supervision, inspections of anti-money laundering measures and crisis management work within their fields of competence, and collect and process data on exchange office operations and regional data for business surveys.

### Branches and their regional jurisdictions



In order to streamline its operations, the CNB last year cut back activities in the České Budějovice and Ústí nad Labem branches associated with money reserves management in relation to commercial banks, and concentrated the processing of foreign exchange statistics for all regions in the Ústí nad Labem branch.



### The Bank Board



1. Pavel Racoča, 2. Michaela Erbenová, 3. Jan Frait, 4. Pavel Štěpánek,  
5. Oldřich Dědek, 6. Zdeněk Tůma, 7. Luděk Niedermayer



### Executive Directors of Departments



1. Vladimír Kolman, 2. Miloš Hrdý, 3. Jana Báčová, 4. Ota Kaftan, 5. Zdeněk Vírúš,  
6. Marian Mayer



### Executive Directors of Departments



1. Leoš Pýtr, 2. Jan Hampl, 3. Tomáš Kvapil, 4. Kateřina Šmídková,  
5. Tomáš Holub, 6. Jan Schmidt, 7. Tomáš Hládek

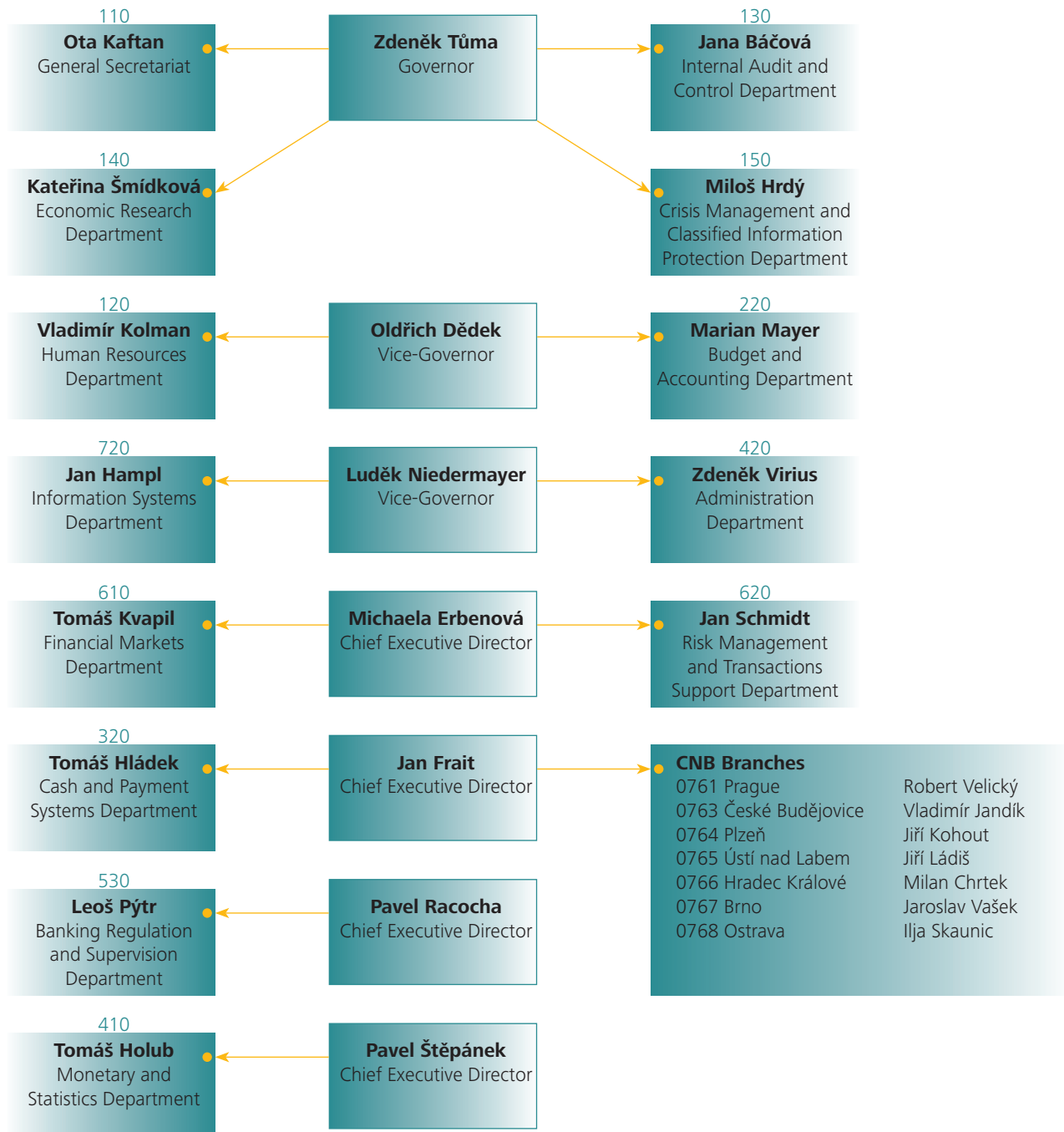


### Executive Directors of Branches



1. Ilja Skaunic (Ostrava branch), 2. Jiří Ládiš (Ústí nad Labem branch),  
3. Jiří Kohout (Plzeň branch), 4. Jaroslav Vašek, (Brno branch),  
5. Vladimír Jandík (České Budějovice branch), 6. Robert Velický (Prague branch),  
7. Milan Chrtěk (Hradec Králové branch)

## ORGANISATIONAL CHART



## Notes:

The Bank Board manages the organisational units presented in the organisational chart as a collective body

● denotes the Bank Board member's powers of supervision over particular organisational units





# THE CNB'S OBJECTIVES AND TASKS AND THEIR FULFILMENT

2

The CNB's medium-term objectives and tasks are set out in the CNB's Medium-Term Plan. The first document of this type, governing the CNB's activities in 2002–2004, expired in 2004. Its main points focused above all on:

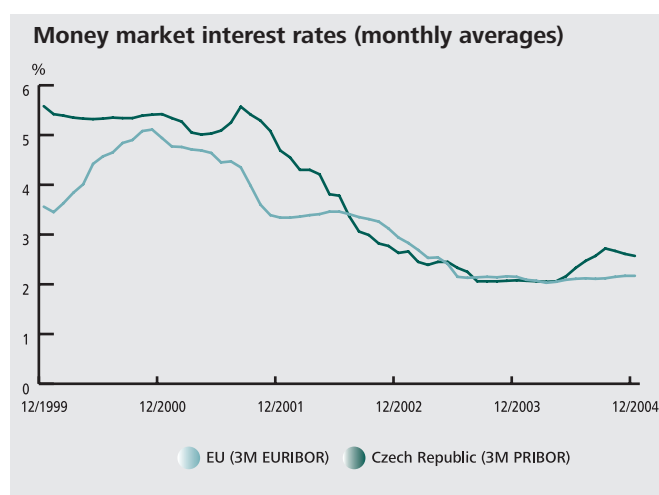
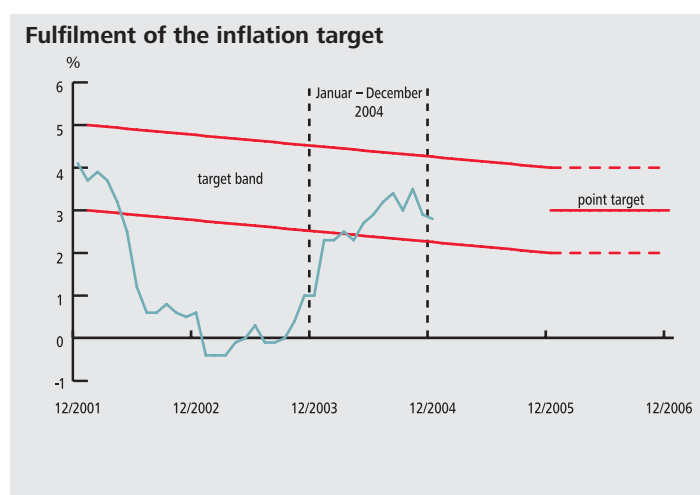
- stabilising inflation by refining the inflation targeting strategy, the application of that strategy, and analytical, research and forecasting activities;
- enhancing the research supporting the bank's monetary policy activities, increasingly covering the issue of monetary convergence, and being open to thinking in the European and global context;
- creating a harmonised regulatory framework and achieving full compatibility with EU countries in the performance of banking supervision by working more closely with foreign and other domestic regulators and paying increased attention to the stability of the financial system as a whole;
- achieving maximum returns on the international reserves, subject to sufficient safety and liquidity;
- developing co-operation with the Ministry of Finance in the field of national debt management, based on the CNB's range of related services, expertise and know-how;
- providing banking services to the public sector at an adequate technical and security level under terms and conditions acceptable both to the CNB and to its clients (with respect to rules, scope of services and prices); endeavouring, at the same time, to adopt a joint approach with the Ministry of Finance and a medium-term agreement on the scope of such services, not limiting the private sector where it is able to offer the services under better conditions;
- increasing the economic efficiency of activities related to the issuance, processing and distribution of money (narrowing the number of branches performing money management by one or two) and offering co-operation in this area to the private sector;
- preparing for the regulation of the entire payment and clearing area, and providing for the new Payment System Act and the CNB's role as an administrative authority in the area of electronic money instruments;
- refining the CERTIS, SKD and ABO systems;
- providing for the activities of the Financial Arbiter;
- completing the harmonisation of bank accounting and statistics with EU standards, and reducing the burden on respondents;
- ensuring a high level of information openness, going beyond the requirements of the Freedom of Information Act as well as beyond the practice common in most other central banks; intensifying communication with that segment of the public who do not concern themselves with economic developments in detail, putting more emphasis on topics relating to EU accession;
- harmonising the legislation with EU law and ensuring compliance of internal rules, standards and procedures with the rules effective in the ESCB and the ECB;
- maintaining the current high standard of human capital, developing it in the necessary directions and areas using a more flexible salary system and an effective training and staff policy system;
- safeguarding the operations of the central bank by means of information and communication technology enabling smooth operation and safe and reliable connection to external systems, while emphasising effectiveness and efficiency of investment;
- enhancing financial management and efficiency assessment;
- strengthening the CNB's internal audit function, including assessment of the potential financial and reputational risks in order to minimise those risks.

At the end of 2004, the Bank Board assessed the fulfilment of these objectives and declared that they had been achieved successfully. It also approved a new *Medium-Term Plan for 2005–2010* (see [www.cnb.cz](http://www.cnb.cz): *About the CNB – Mission and functions*).

### MONETARY POLICY AND ECONOMIC DEVELOPMENTS

The CNB's primary monetary policy objective is expressed as an inflation target, i.e. the level at which the CNB tries to keep inflation in the period in question. The inflation target for 2002–2005 was set in the form of a continuous band descending evenly from 3%–5% in January 2002 to 2%–4% in December 2005. In March 2004 a new inflation target of 3% was set for the period ahead. This target will apply from the beginning of 2006 until the Czech Republic's accession to the euro area (see [www.cnb.cz](http://www.cnb.cz): *Monetary policy* for details).

Compared to the previous period, inflation rose modestly last year and returned to the target band. It was below the centre of the band for most of the year.

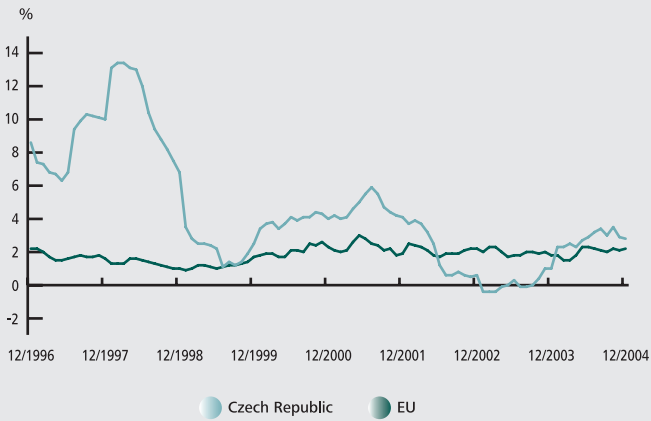


Annual consumer price inflation broke through the 2% level in January 2004 and approached 3% in June. It was above 3% in the four months that followed, reaching its peak (3.5%) in October and falling just below 3% in the remaining two months. Consumer price inflation was slightly higher than in the EU Member States throughout 2004. This was also reflected in domestic interest rates (as represented in the chart by 3-month interest rates).

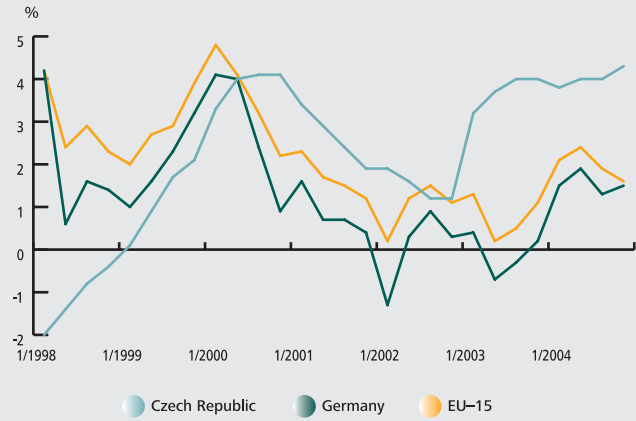
Inflation in 2004 was influenced above all by changes to indirect taxes (an increase in excise duties on cigarettes, alcohol and petrol, a shift of some services from the lower to the basic VAT rate, and a decrease in the basic VAT rate from 22% to 19%). The tax adjustments increased the prices of the items affected, and subsequently also influenced prices of other items. They also played a role in the growth of overall inflation expectations, which were also affected by broader public concerns regarding the price impacts of EU accession. The traditionally seasonally volatile food prices, which mostly reflected (the initially high) agricultural producer price inflation for most of the year, also contributed to the pick-up in inflation. High prices of energy-producing materials were offset throughout the year by appreciation of the koruna against the dollar. Demand-pull inflationary pressures remained subdued in the still strongly competitive environment on the retail market.

Inflation was broadly consistent with the inflation forecasts for this period prepared in 2002 H2 and 2003. The April 2003 forecast was an exception, suggesting a sharp rise in inflation in 2004 to just above the target band. However, this forecast did not materialise and was therefore adjusted downwards in July. The forecast was not fulfilled mainly because of lower-than-expected changes to indirect taxes and regulated prices and unexpected disinflationary external factors (especially lower demand and inflation abroad and stronger exchange rates of the euro and the koruna against the dollar). The forecasts that followed had already accounted for these facts.

Inflation in the Czech Republic and the European Union



Gross domestic product

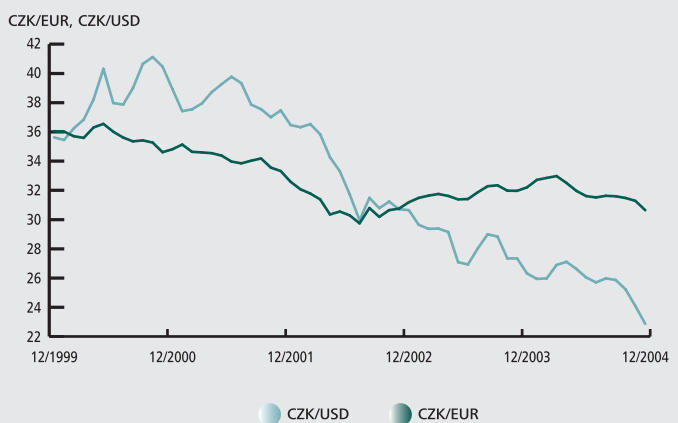


The growth of the Czech economy in 2004 was roughly the same as in 2003 H2 (around 4%). As in the previous three years or so, it was higher than in Germany and the "old" EU countries.

Economic growth was driven mainly by investment, whereas the influence of consumer demand, which dominated in the previous year, declined. In H2, growth was also supported by buoyant exports. GDP growth remained below its potential owing to incomplete, albeit growing, domestic capacity utilisation. Consequently, no demand-pull inflationary pressures emerged.

The nominal exchange rate of the koruna appreciated against the dollar and, to a lesser extent, also against the euro during 2004. The stronger koruna made imports cheaper, especially in the case of goods paid for in dollars (most notably energy-producing materials). It thus helped to dampen the effects of high raw material prices on world markets and maintain a low level of inflation.

Nominal exchange rate of the koruna against the euro and dollar



The stronger koruna did not bring about a decline in the growth rate of exports. These were, moreover, boosted by accession to the EU, which led to a fall in the trade deficit. Conversely, the current account deficit decreased only slightly, as a result of a growing outflow of earnings in the form of dividends paid to foreign owners. The surplus on the financial account was up by almost one-tenth on a year earlier. Given that the inflow of direct investment remained similar, the increase was caused by a net inflow of portfolio investment (compared with an outflow last year), reflecting growth in the attractiveness of domestic investments (the interest rate differential vis-à-vis the euro, expectations of appreciation of the koruna, growth in the prices of domestic shares), and by the drawing of corporate credit abroad. Running

counter to this was a reduction in the foreign exchange liabilities of the banking sector. By the end of the year, the improving balance of trade, the bright prospects for the economy in 2005 and the outlook for new privatisations had started to influence market expectations, resulting in a stronger nominal appreciation of the exchange rate. No interventions were made in the foreign exchange market in 2004.

The inflation forecasts in 2004 (for 2005–2006 H1) initially suggested that interest rates would have to be raised to keep inflation within the target band, or more precisely, near its centre. This led to interest rate increases in July and August. These expectations, however, started to change slowly during H2.

As a result of a modest upward revision of the potential (non-inflationary) output growth rate and less expansive fiscal policy, the October forecast shifted the time of closure of the output gap to the end of 2005 H1. This put the risks to the forecast in balance, postponing the need for further interest rate increases. In the months that followed, the interest rate settings were consistent with the forecast, and the balance of risks to the forecast also indicated that no change was necessary.

More detailed information on economic developments and monetary policy can be found in the quarterly Inflation Reports available in the *Publications* section of the CNB website.

A document drawn up jointly by the CNB, the Ministry of Finance and the Ministry of Industry and Trade entitled *Assessment of the Fulfilment of the Maastricht Convergence Criteria and the Degree of Alignment of the Czech Economy with the Euro Area*, which analysed the current and expected situation in that area, was completed at the very end of 2004 and approved by the Government in mid-January 2005. Based on these analyses, the document recommended that the Czech Government should not attempt to enter the ERM II during 2005.

## FINANCIAL MARKET OPERATIONS

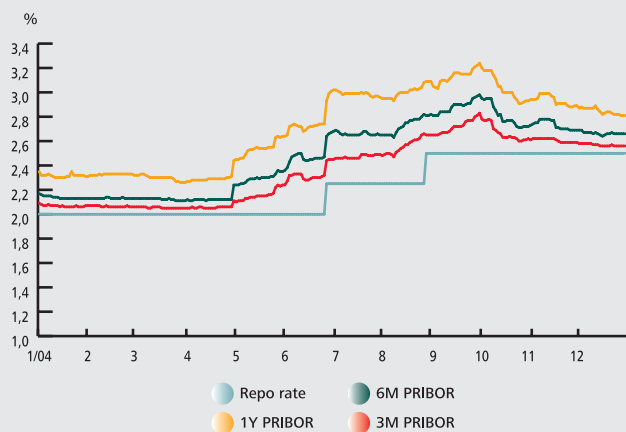
The CNB implements monetary policy by means of its operations on the financial market. The CNB Bank Board sets three interest rates: the two-week repo rate, the discount rate and the Lombard rate. The main monetary policy rate is the two-week repo rate. By setting this interest rate, the CNB influences the short end of the yield curve. 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) are accompanied by symmetrical changes in the discount and Lombard rates.

In 2004, the Bank Board decided to increase the two-week repo rate from 2.00% to 2.50%. This was done in two steps of 25 basis points, effective from 25 June and 27 August. Along with the two-week repo rate, the discount rate and the Lombard rate were increased from 1.00% to 1.50% and from 3.00% to 3.50% respectively.

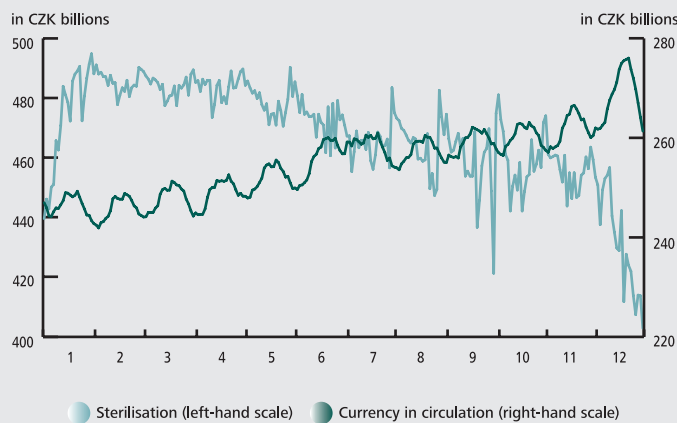
Using money market operations, the CNB daily influences the liquidity of the banking sector so that it is at the optimum level for compliance with the reserve requirement. This ensures that short-term interest rates are stable at the desirable level. The daily decision-making on the central bank's money market operations is based on an analysis and forecast of banking sector liquidity and on the money market situation.

In 2004, the main instrument for managing short-term interest rates was again the two-week repo. Owing to persistent and considerable excess liquidity in the Czech banking system, the CNB used these operations to absorb excess reserves (unlike the ECB, which provides liquidity). The liquidity absorbed is remunerated at the repo rate at maximum. Two-week repo tenders were announced daily and settled with same-day value. The volume of excess liquidity absorbed in monetary operations in 2004 varied between CZK 402 billion and CZK 494 billion, the average being CZK 467.9 billion, a decrease of around CZK 22.1 billion compared to the 2003 average.

Interest rates in 2004



Excess liquidity in 2004



This decrease was due to steady growth in currency in circulation (see the chart). Another factor reducing the volume of sterilisation was the sell-off of a portion of the returns on the international reserves. The Bank Board took this step in April 2004, since it did not regard continuous growth of the international reserves (due to realisation of returns at their current volume) as desirable. The volume of returns sold was roughly CZK 13.9 billion at the end of the year. A fall of around CZK 54 billion in excess liquidity absorbed at the end of the year was due mainly to a rise in government deposits with the CNB (of around CZK 19 billion) and a rise in off-budget funds deposited with the CNB by state organisations and state funds (of around CZK 35 billion). The traditional seasonal growth in currency in circulation in the run-up to Christmas was only around CZK 1.5 billion in 2004. These seasonal factors are short-term and closely linked with the end of the calendar year. During January their effect usually wears off. Interest paid to banks as a result of monetary operations totalled around CZK 10.45 billion in 2004.

The CNB's instruments also included two "automatic" facilities – the marginal lending facility and the deposit facility. Under the lending facility, the CNB lends funds overnight to banks against eligible collateral in the form of securities. Such loans are charged interest at the Lombard rate. The Lombard rate thus provides a ceiling for short-term interest rates. The CNB accepts T-bills, CNB bills and Czech Consolidation Agency bills as collateral. In connection with the Czech Republic's accession to the EU, securities issued by EU governments and selected multilateral issuers were added to the list of eligible collateral. This list is published and updated regularly on the CNB's website. The deposit facility gives banks the option of making overnight deposits with the CNB at the discount rate. The discount rate thus provides a floor for short-term interest rates. The minimum volume for these operations is CZK 10 million, increasing in multiples of CZK 1 million. Fine-tuning operations (ad hoc repos and reverse repos under market conditions) are used only rarely.

In 2004, the CNB continued issuing its own bills, which it used as eligible 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.

As banks are now entitled to operate on the Czech market under the single European licence following the Czech Republic's entry into the European Union, a change was made to the reserve requirements in 2004. This change dealt primarily with the issue of the accounts on which the required reserves can be maintained. Besides the primarily used interbank payment system accounts and cash withdrawal accounts (where the banks have such accounts), a special account for reserve holdings was introduced. This account is intended for banks that do not participate in the payment system operated by the CNB.

### Management of international reserves

In managing the international reserves, the CNB aims to attain maximum and stable returns at a specified, low risk. The international reserves are invested so that the state's foreign exchange obligations and, if necessary, interventions in the foreign exchange market are secured. The volume of the reserves is regularly published in the *Financial Markets* section of the CNB website – [www.cnb.cz](http://www.cnb.cz).

The international reserves represent approximately 86% of the CNB's balance sheet, and the income from these reserves is one of the CNB's most significant revenues. The volume of the international reserves in the central bank's balance sheet is shown in the chart below. Given the importance of sterilisation operations to the CNB's financial results, we also present a chart showing the share of sterilisation in the CNB's liabilities.



The CNB's international reserves amounted to CZK 636 billion at the end of 2004, down by CZK 56 billion from a year earlier. The primary reason was the appreciation of the koruna against both reserve currencies: the euro and the dollar. The volume of the reserves was also affected by the sell-off of returns realised in the previous period and income on investment activities. The international reserves were not affected by foreign exchange interventions, since no interventions were made.

In euro terms, the international reserves amounted to EUR 20.9 billion (an annual decrease of EUR 0.4 billion), whereas in dollar terms they rose by USD 1.4 billion to USD 28.4 billion. Besides the aforementioned factors, the change in the international reserves (expressed in these terms) was also determined by the euro-dollar exchange rate.

At the end of 2004 the international reserves were allocated as follows: 58.66% EUR, 39.55% USD and 1.79% SDR and gold. One portfolio is defined in each of the reserve currencies. Foreign exchange risk may not be accepted when managing the portfolios. The parameters defining the interest rate risk assumed – portfolio duration in particular – are also set separately for each portfolio. The duration set in 2004 was based on the requirement that the portfolio should not record a loss in any twelve-month period. At the beginning of last year, the duration was set at 1.74 of a year for the euro portfolio and 0.85 of a year for the dollar portfolio. In addition to historical data, the methodology for determining the duration takes into account the situation on the financial markets. Consequently (given the general increase in interest rates on the US market), the duration for the dollar portfolio was extended during 2004 to 1.30 of a year. The duration for the euro portfolio remained unchanged.

Portfolio managers invest the international reserves in particular instruments in compliance with the principles of the CNB's reserve management policy and subject to investment opportunities and developments on the financial markets. The largest part of both portfolios is invested in securities issued by the governments of OECD countries, government-guaranteed securities, or securities issued by eligible agencies and multilateral institutions. The rate of return on the reserves portfolios is measured both in absolute terms and relative to benchmark portfolios. Measuring the relative



rate of return indicates how successful the investment strategies implemented by the portfolio managers were relative to the benchmark portfolios.

In 2004, the total return on the international reserves in koruna terms<sup>2</sup> was CZK 19.330 billion. This result chiefly reflects the evolution of interest rates in the euro area and the USA, which resulted in lower portfolio returns, especially in 2004 Q2. These were not fully compensated before the end of the year, owing to low interest income.

The rate of return on the euro portfolio was 3.68% and that on the dollar portfolio 1.47%. The relative rate of return (i.e. the difference between the rate of return on the actual portfolio and that on the benchmark) was 0.08% for the euro portfolio, which is around EUR 9.9 million in absolute terms, and 0.19% for the dollar portfolio, or USD 20.6 million in absolute terms. The overall rate of return on the international reserves<sup>3</sup> in 2004 was 2.81% (down by 0.05 percentage point compared to 2003).

### ECONOMIC RESEARCH

Research activities in the CNB are organised in projects, with the employees of various CNB units as well as external experts participating in the research teams. This arrangement creates an environment for effective application of the research results in the activities of specialised units and for the utilisation and development of human capital in the central bank. During 2001–2004, a total of 54 CNB experts and 21 external experts from domestic and foreign academic institutions participated in the projects.

The research projects are co-ordinated by experts from the Economic Research Department, which is responsible for drafting the research plan and organising the CNB's research activities in general. When defining research priorities, preparing economic research programmes and assessing individual research projects, the Economic Research Department works closely with other CNB units.

The Research Advisory Committee, which is an advisory body to the Bank Board, has special status in guiding the research work. The current external members of the Committee are Ignazio Angeloni (European Central Bank), Nicolleta Batini (International Monetary Fund), Aleš Bulíř (International Monetary Fund), László Halpern (Hungarian Academy of Sciences), Eduard Hochreiter (Oesterreichische Nationalbank) and David Mayes (Bank of Finland). The internal members are the Executive Directors of the CNB's Economic Research Department, Monetary and Statistics Department, Banking Supervision and Regulation Department and Risk Management and Transactions Support Department, together with the co-ordinators of the five research areas (monetary policy, macroeconomic modelling, financial stability, fiscal policy and the real sector). Chaired by the CNB Governor, the Committee met regularly to assess the economic research programme and the report on completed research work. The meetings of the Committee are followed by meetings of the Bank Board, which is responsible for final decisions on research priorities and individual programmes. At the last meeting in September 2004, 16 research projects were approved for the 2005–2006 period.

Great emphasis is placed on the transparency and quality of the research. The results of the projects are published as research papers made available to the public after a demanding review process involving external referees, often from abroad. More than 50 external referees participated in the review processes in 2001–2004.

The results of the projects are published in two research paper series: CNB Working Papers and CNB Internal Research and Policy Notes. In all, 32 research papers were published in 2002–2004, of which ten were published in the CNB WP series and four in the CNB IRPN series in 2004. This number is comparable to those published by other central banks in small open economies with inflation targeting. The Economic Research Department also publishes an Economic Research Bulletin, which provides the professional public with an overview of the results of the research projects in thematically focused issues.

<sup>2</sup> Exchange rates for the last working day of 2004 were used for the conversion.

<sup>3</sup> The weighted average of the rates of return on the individual portfolios (the rates of return of the dollar, euro and gold portfolios are weighted by their share in the overall volume of the international reserves).



### Numbers of research publications: comparisons for 2003 and 2004

Central banks in small open economies	Number of papers in 2003	Number of papers in 2004
CNB	14	14
New Zealand	10	8
Sweden	12	17
Poland	3	1
Hungary	12	12

Central banks of smaller euro area economies	Number of papers in 2003	Number of papers in 2004
Finland	35	31
Austria	6	6
Portugal	19	20
Greece	8	19
Belgium	5	22
Ireland	9	10
Spain	20	22

All research publications and current economic research priorities are available on the CNB website.

### Research papers published in 2004

CNB Working Paper Series		
10/2004	Aleš Bulíř Kateřina Šmídková	Exchange rates in the new EU accession countries: What have we learned from the forerunners
9/2004	Martin Cincibuch Jiří Podpiera	Beyond Balassa–Samuelson: Real appreciation in tradables in transition countries
8/2004	Jaromír Beneš David Vávra	Eigenvalue decomposition of time series with application to the Czech business cycle
7/2004	Vladislav Flek, ed.	Anatomy of the Czech labour market: From over-employment to under-employment in ten years?
6/2004	Narcisa Kadlčáková Joerg Keplinger	Credit risk and bank lending in the Czech Republic
5/2004	Petr Král	Identification and measurement of relationships concerning inflow of FDI: The case of the Czech Republic
4/2004	Jiří Podpiera	Consumers, consumer prices and the Czech business cycle identification
3/2004	Anca Pruteanu	The role of banks in the Czech monetary policy transmission mechanism
2/2004	Ian Babetskii	EU enlargement and endogeneity of some OCA criteria: Evidence from the CEECs
1/2004	Alexis Derviz Jiří Podpiera	Predicting bank CAMELS and S&P ratings: The case of the Czech Republic

**CNB Internal Research and Policy Notes**

4/2004	Aleš Bulíř	External and fiscal sustainability of the Czech economy: A quick look through the IMF's night-vision goggles
3/2004	Martin Čihák	Designing stress tests for the Czech banking system
2/2004	Martin Čihák	Stress testing: A review of key concepts
1/2004	Tomáš Holub	Foreign exchange interventions under inflation targeting: The Czech experience

**Economic Research Bulletin – topics of individual issues**

December 2003	Equilibrium Exchange Rate
May 2004	Inflation Targeting
October 2004	Fiscal Issues

The Economic Research Department also organises lectures by leading world economists jointly with domestic institutions, the Czech Economic Society and CERGE-EI (The Centre for Economic Research and Graduate Education of Charles University – The Economic Institute of the Academy of Sciences of the Czech Republic). These seminars provide an opportunity for specialised discussion on topics related to the central bank and are open to the public.

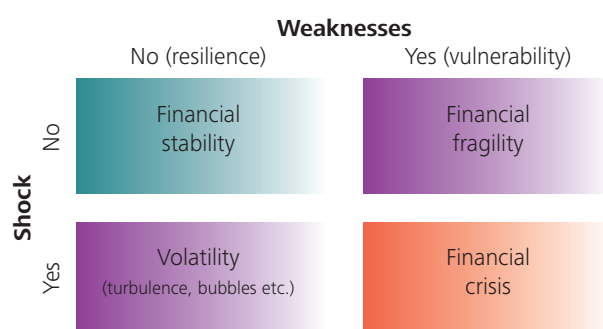
**Seminars organised in 2004**

William Poole (President, Federal Reserve Bank of St. Louis)	27 November 2004	Maintaining Financial Stability: A Central Banker's Perspective
Nicos Christodoulakis (Member of the Greek Parliament)	11 November 2004	Real and Nominal Convergence to EMU: Reforms, Harmonization and Transeuropean Initiatives
Neil Rankin (Professor, University of Warwick)	21 April 2004	Dynamic General Equilibrium Models in Macroeconomics

The economic research co-ordinators regularly deliver opinions on the situation reports on economic developments, which are the fundamental analytical input for the CNB Bank Board's decisions on the settings of policy interest rates. Related to this is the preparation of detailed transcripts and shorter minutes of the Bank Board meetings on monetary policy issues. The minutes are published 12 days after the meeting and the detailed transcripts six years after. Both documents are – together with press conferences and the Inflation Report – key communication tools that enhance the transparency of monetary policy.

## FINANCIAL STABILITY

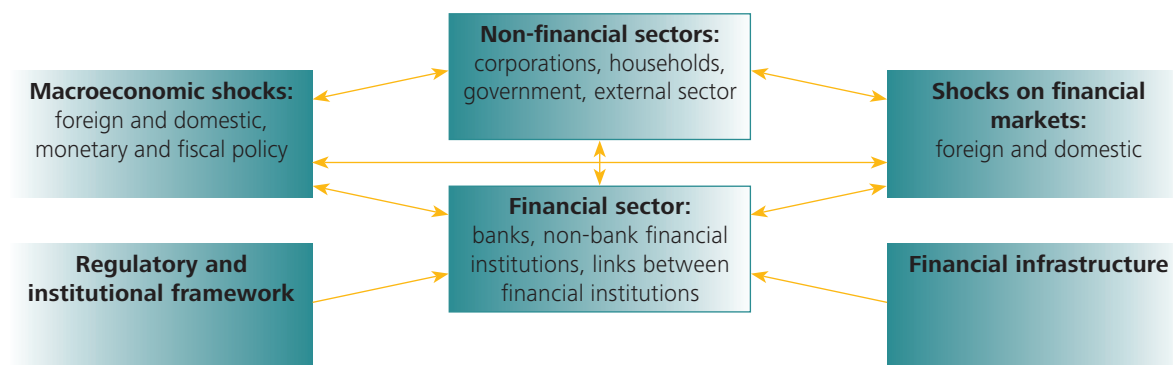
The term financial stability describes the situation where the financial system is sufficiently resilient (without significant weaknesses) to common exogenous shocks. In a less resilient financial system, the occurrence of shocks and weaknesses (see the chart) is not limited to greater volatility in its individual segments, but also makes it more prone to dysfunctions (financial fragility) and, in the event of a stronger shock, to the onset of a crisis. A higher number of – and more severe – weaknesses are typical of a financial system prone to financial crisis even in the event of relatively weak exogenous shocks.



Although financial stability has been successfully achieved in most countries over the past 20 years, this has not resulted in a lower frequency of financial crises on a global scale. Therefore, central banks have been paying increased attention to financial stability analysis in the last decade.

The CNB has been monitoring financial stability since 2004. Financial stability analysis differs to a large extent from the analyses performed by CNB Banking Supervision as well as the standard macroeconomic analysis related to the implementation of monetary policy.

In contrast with banking supervisory activities, which focus mainly on the analysis of individual institutions (the “micro-precautionary” approach), greater emphasis is placed on the analysis of systemic risks (the “macro-precautionary” approach). The analyses deal above all with the development of the financial sector as a whole, or with the responses of individual institutions to common shocks and the transmission of such shocks between those institutions. In addition to developments in the banking sector, other financial institutions (insurance companies, pension funds, etc.) are taken into account. The analyses also stress the link between financial sector developments and macroeconomic developments at home and abroad, the development of those economic sectors to which the financial sector is most exposed (above all non-financial corporations and households), developments in asset prices (financial assets, real estate, etc.) and the functioning of the financial infrastructure (payment and settlement systems).



Financial stability analysis also has some different features compared to the CNB's macroeconomic analysis and forecast, which serves as an input for decisions on monetary policy settings. A significant difference is that it does not attempt to model the most probable

development of the economy. Instead, it largely focuses on less likely, but possible, alternatives that could impact significantly on the financial system. It also deals with possible erratic transmissions of shocks in the financial system and the eventualities of ambiguous equilibria and erratic and unstable movements in asset prices over time.

Financial stability analysis in the Czech Republic as a developing post-transition economy is difficult, because the financial sector and financial structure are undergoing dynamic development. It is not easy to determine, for instance, to what extent the fast growth in the indebtedness of individual sectors of the economy or the related fast growth in asset prices are an indicator of future financial instability, as they often are in developed economies, and to what extent this is a reasonable trend consistent with the given phase of economic and financial development and economic convergence.

In 2004, the CNB prepared its first annual Financial Stability Report, which was published in January 2005. The Report concludes that the performance and stability of the financial sector strengthened further in 2004. The return on assets at 1.27% at the end of 2004 is much higher than in the EU-15 countries. The performance of the financial sector benefited from improved corporate financial indicators and lower credit risk.

The uncertainties and potential risks include fast growth in lending to households, which is leading to a gradual increase in their indebtedness. Growth in mortgage loans is particularly sharp. The interest burden on households is also rising.

The Report also takes into account international aspects of financial sector development connected with foreign ownership of financial institutions and cross-border provision of financial services. These are having positive impacts in the form of international transfer of financial and managerial know-how, improvements in risk management, restructuring and stabilisation of banks and greater competition, which should result in better financial services. There are, however, some risks, linked with the possibility of easier cross-border contagion of financial instability, the transformation of foreign banks' subsidiaries into branches, and outflow of earnings in the form of dividends abroad, which affects the external balance. Thus, there is a growing need for international co-operation between regulators and financial market supervisors.

The 2004 Financial Stability Report is available in the *Publications* section of the CNB website ([www.cnb.cz](http://www.cnb.cz)).



### THE BANKING SECTOR AND ITS REGULATION

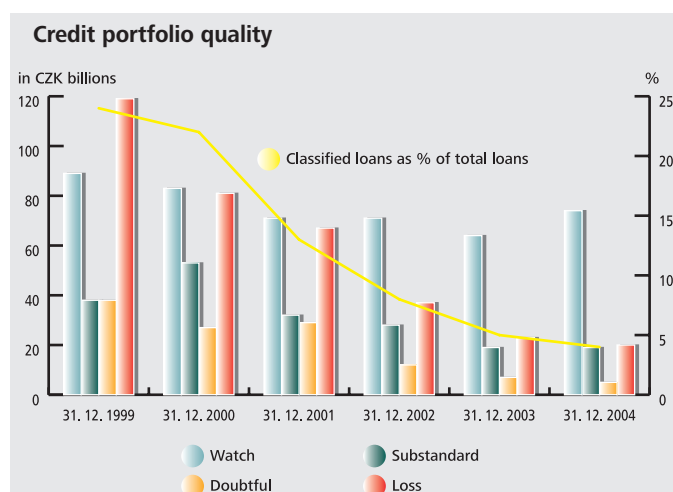
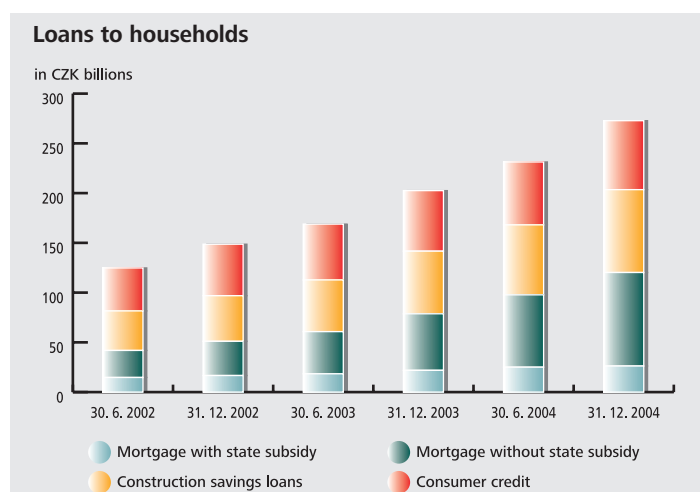
Banking supervision combines regulation (by setting prudential rules) and supervision (by reviewing compliance with these rules and other legal rules) of banks' activities. The performance of banking supervision takes the form of continuous off-site surveillance, whereby banks' activities and financial situation are monitored based on all available information, and on-site inspections, which give a better insight into the methods of risk and risk profile management in each bank. Another essential element of banking supervision is licensing and authorisation work, whereby entry into the banking sector and some activities of banks are regulated.

The Czech banking sector has undergone substantial restructuring over the past few years, and its current situation can be regarded as stabilised. Much of the sector is controlled by foreign banks, which act in the Czech Republic via subsidiaries or branches. The processes and standards applied in parent banks can thus be used to enhance their subsidiaries' management and control systems and internal rules and procedures.

The EU directive on the single licence has been valid in the Czech Republic since the country joined the EU in May 2004. The single licence principle means that banks from EU countries are entitled to carry on business for which they have a licence in their home country in another EU Member State without having to apply for consent in the host country. This means that any European bank can easily expand into other EU countries, either by establishing a branch, or by cross-border provision of services. However, banks with a single licence doing business in various EU countries are subject to regulation and supervision in the country where they have their registered offices. More information on the single banking licence is available on the CNB website.

As of 31 December 2004, 35 banks and foreign bank branches were active in the Czech Republic, the same number as at the end of 2003. All 9 foreign bank branches active in the Czech Republic automatically switched to the single licence regime. In addition, many foreign banks registered for cross-border provision of services in the Czech Republic under the single licence (i.e. without establishing a branch). As of 31 December 2004, there were 63 such entities.

In 2004, the total assets of the banking sector rose by CZK 108 billion to CZK 2,636 billion. This was due mainly to an annual increase in loans provided of CZK 77 billion and higher receivables from banks. The increase in loans provided was due to continuing growth in loans to households, which increased by 34.4% in 2004, as well as to an expansion of loans to corporations of 7.5%. The share of loans in banks' assets reached almost 41% at the end of 2004.



2004 saw continuing reduction of the volume of non-performing loans (i.e. loans classified by banks as substandard, doubtful or loss loans), which dropped by CZK 5.5 billion to CZK 44.5 billion, or 4% of total loans provided. At the end of the year the volume of watch loans increased, totalling CZK 74.2 billion on 31 December 2004. The coverage of classified loans by provisions and high-quality collateral is sufficient.

Client deposits rose by almost 4% year on year to CZK 1,732 billion at the end of 2004. Growth was recorded above all in demand deposits (an annual increase of CZK 52.4 billion). In contrast to 2003, time deposits rose as well (by CZK 13.4 billion).

The capitalisation of the banking sector remained sufficiently high throughout 2004. The regulatory capital used to calculate capital adequacy grew by CZK 4.3 billion to CZK 148 billion. However, there was an increase in the volume of risk-weighted assets and capital charges, connected with the growth in loans provided, which resulted in the capital ratio falling from 14.5% to 12.7% year on year. All banks met the minimum capital adequacy requirement of 8%.

The banking sector recorded a net profit of CZK 33.1 billion in 2004, up by CZK 2.9 billion on 2003. The profit was attributable mainly to an annual increase in profit from financial activities of CZK 13.1 billion to CZK 103.4 billion, which, in turn, was due above all to growth in net interest profit of CZK 5.5 billion and a rise in profit from fees and commissions of CZK 5 billion. Administrative expenses rose by 3% to CZK 48.9 billion. Write-offs and creation of provisions amounted to CZK 10.4 billion, compared to CZK 0.7 billion in 2003. However, the lower creation of provisions in previous years was influenced by the clean-up operations of some banks, connected with the dissolution of past reserves and provisions.

A total of 38,160 people were employed in the banking sector as of 31 December 2004, a decline of 844 from the end of 2003.

Detailed information on developments in the banking sector and supervisory activities is published in the CNB's annual Banking Supervision publications, which are available on the CNB website together with other analytical publications and the latest banking sector indicators.

### **What's new in regulation**

The "harmonisation amendment" to the Act on Banks, which deals above all with the single licence principle, became fully effective on the date of the Czech Republic's accession to the EU. Later in 2004, the Act on Banks was further amended in relation to the adoption of the Capital Market Undertakings Act and the amendment to the Act on the Protection of Personal Information.

In February 2004, the CNB issued a Provision on the Internal Control System of a Bank, which unified the previous provisions on individual risk types. In addition to the risks already covered, this provision included requirements for operational risk management, information systems risk management and internal auditing.

In September 2004, an amendment to the Czech National Bank Provision stipulating Rules for the Assessment of Financial Receivables and the Creation of Provisions and Reserves, and Rules for the Acquisition of Certain Types of Assets, was adopted. The amendment responded to developments in accounting and the obligatory use of international accounting standards by banks that are issuers of registered securities. The banks use the same method to determine provisions for compliance with the prudential rules as they do for keeping their accounts and compiling their financial statements. This prevents the occurrence of parallel records and discrepancies.

In connection with the new Act on Bonds, which empowered the CNB to monitor compliance with specific obligations by banks that issue mortgage bonds, the CNB issued a provision stipulating the content, method of keeping and requisites of the records of coverage of mortgage bonds.

### **Development of the Central Register of Credits**

The Central Register of Credits, operated by the Czech National Bank, has been offering its services to banks and branches of foreign banks operating in the Czech Republic for three years. In all, 241,000 clients and 260,000 claims were registered in the database as at the end of 2004. A total of 1,916 users work with the data in banks. Information on the credit exposure and debt repayments of clients from the business sector has become an important component of credit risk management in banks. In 2004, banks sent a total of 2,423,661 enquiries regarding the total credit exposure of present and future clients. At the same time, 85 extracts were issued during the year at clients' request.

Another development phase of the Central Register of Credits, aimed at enhancing data utilisation efficiency, was launched in 2004. This should above all make aggregated data available for analytical purposes, strategic decision-making, assessment of credit exposure in individual industries and economic sectors, etc.

### **Integration of financial market supervision**

The co-operation between the CNB, the Ministry of Finance and the Czech Securities Commission, based on a trilateral memorandum of understanding signed in February 2003, continued in 2004. In May 2004, the Government adopted a resolution on the gradual integration of the existing state regulatory and supervisory authorities in the financial market area. Supervision of banks and supervision of credit unions will be integrated within the CNB during 2005. By the end of 2005, state supervision of the capital market should also be integrated with state supervision of insurance companies and pension schemes within the Czech Securities Commission. The integration process will continue in the years ahead.

### **Introduction of the new capital framework**

In June 2004, the Basel Committee on Banking Supervision published the final version of the new capital framework, often referred to as Basel II. Given the Czech Republic's accession to the EU, Basel II – in the form resulting from its transformation into Community law – is and will continue to be crucial for the Czech Republic. It is expected that the relevant directives will be adopted by the European Parliament during 2005 and become effective in 2007.

At home, the CNB continued to implement the new capital framework in partnership with banks and within the joint trilateral project of the CNB, the Czech Banking Association and the Chamber of Auditors of the Czech Republic. This co-operation stepped up a gear in 2004 with the creation of ten working groups focusing on various aspects of the implementation of the new framework. The Czech Securities Commission and the Ministry of Finance also became involved.

CNB Banking Supervision also conducted bilateral talks and established direct contacts with selected foreign supervisory authorities on this issue and on the forging of ties between home and host supervisors. The CNB's progress with, and approach to, implementing the new capital framework is published and regularly updated in the *Banking Supervision* section of the CNB website.

### **International co-operation**

The Czech Republic's membership of the European Union has significantly altered the character and forms of banking supervisory co-operation within European structures. The nation's observer status has changed into Member State status, with all the related rights and obligations. The CNB participates actively through its representatives in committee and working group meetings within the structures of the European Commission and the ECB. There is continuing co-operation in the Basel Committee on Banking Supervision, with the IMF and the World Bank, and within the Group of Banking Supervisors from Central and Eastern Europe. As for bilateral relations, memoranda of understanding were signed with the central banks of the Netherlands and Italy in 2004. The CNB has so far concluded a total of eight bilateral memoranda of understanding.



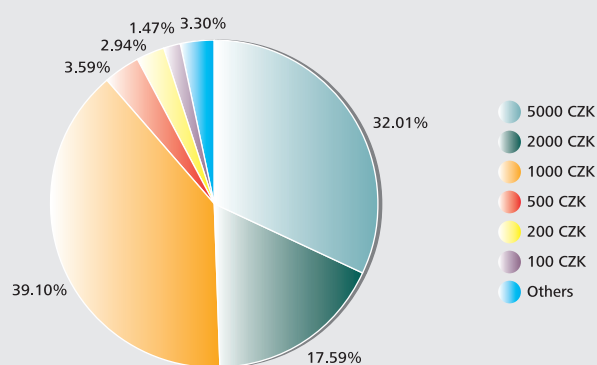
### Inspection and licensing activities in figures

- 15 on-site inspections were carried out in banks; 4 were comprehensive inspections and 11 partial inspections directed at selected areas of risk management. 10 information-gathering visits were made in order to acquire additional data.
- 13 remedial measures were imposed to eliminate shortcomings.
- The re-licensing of banks, launched at the end of 2002 in connection with the process of harmonisation of the Act on Banks with the European banking directive, was completed in the first half of 2004 with the granting of banking licences to the remaining 15 banks. In addition, 16 administrative decisions were issued in the area of licensing and authorisation relating to banks' applications for the extension of licences, consents to acquire qualifying holdings in banks, prior approvals for mergers, plans to establish a branch in an EU Member State, etc.
- In 2004, CNB Banking Supervision conducted no penalty proceedings directed at revoking licences or imposing fines for violations of the Act on Banks.
- 95 decisions were issued relating to the approval of external auditors, shareholder structures prior to general meetings, the inclusion of subordinated debt in a bank's capital, etc.
- Opinions on nominees for managerial posts were delivered in 22 cases.

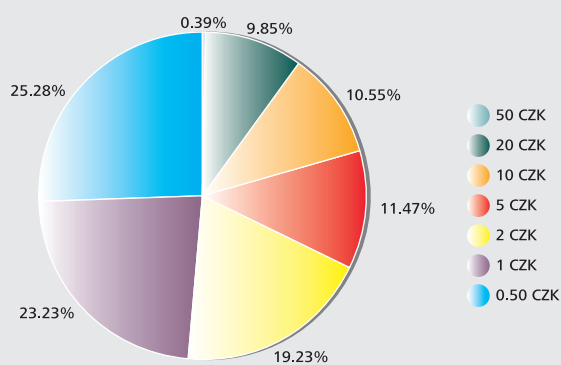
### CURRENCY IN CIRCULATION AND THE PAYMENT SYSTEM

The value of currency in circulation increased by 5.9% year on year and amounted to CZK 263.3 billion at the end of the year, with the rate of growth slowing compared to 2003. The number of banknotes in circulation reached 282.4 million, up by 4.4% on a year earlier. The denomination structure of banknotes in circulation did not change significantly. More than 20 million twenty-heller coins and almost 30 million ten-heller coins were destroyed during the course of the year. Although these coins keep gradually returning, records suggest that 1.1 billion remained unwithdrawn at the end of 2004.

Structure of currency in circulation (in CZK)



Structure of coins in circulation (number of coins)



In 2004, branches accepted almost 730 million banknotes for processing, i.e. for sorting as fit or unfit for further circulation. Almost 106 million banknotes were sorted as unfit and destroyed.

Management of money reserves and cash operations for banks was terminated at the CNB's branches in České Budějovice and Ústí nad Labem on 30 June 2004. Both branches continue to carry out cash operations for the public (exchange of damaged money, exchange of invalid money, etc.) and cash operations for entities funded from the state budget or connected to the state budget in some other way. On the other hand, the management of money reserves was reinforced by gradual upgrades to outdated and worn-out banknote sorting

machines. The obsolete technology at the branches in Brno and Prague was replaced by a new generation of machines that are more reliable and have lower running costs. The Prague branch currently processes up to 2 million banknotes daily and has a new coin-sorting line that is able to check the genuineness and fitness of more than 300,000 coins in a single shift.

The number of counterfeit Czech and foreign currency seized in the Czech Republic was similar to that in previous years. A large quantity of counterfeits was seized before they were put into circulation thanks to two successful operations by the Czech police.

<b>Counterfeit banknotes</b>			
	Seized from circulation	Seized by the police	Total
CZK notes	3,273	3,107	6,380
USD notes	627	200	827
EUR notes	653	605	1,258
DEM notes	26	0	26
ITL notes	58	0	58
Other notes	8	63	71
Coins, all countries	288	3	291
Altered money	377	1	378
<b>Total</b>	<b>5,310</b>	<b>3,979</b>	<b>9,289</b>

In 2004, teaching programmes were finalised for courses leading to counterfeit recognition certification<sup>4</sup>. Such courses are intended for persons dealing in foreign currencies. The certification duty will apply to the full extent as of 1 September 2005.

### Commemorative coins

Several types of precious metal coins in various denominations were issued in 2004. Four silver 200 Kč coins were issued: in January to mark the 400th anniversary of the birth of Jakub Krčín of Jelčany and Sedlčany (founder of the system of South Bohemian fishponds); in May to mark the 250th anniversary of the construction of the lightning conductor by inventor Prokop Diviš; in June to mark the 150th anniversary of the birth of composer Leoš Janáček; and in October to mark the 450th anniversary of the first edition of the Kralice Bible. Two more gold coins were issued from the cycle *Ten Centuries of Architecture*: Empire – Kačina Castle (in April), and neo-Gothic – Hluboká Castle (in September).

A commemorative silver 200 Kč coin and bimetallic 2000 Kč coin were issued to mark the Czech Republic's accession to the European Union.



<sup>4</sup> An obligation arising under Article 4(2)(g) of CNB Decree No. 434/2002 Coll., implementing Article 9(3) of Act No. 219/1995 Coll., the Foreign Exchange Act.

Turning to the payment system, work started on an amendment to the Payment System Act<sup>5</sup> with a view to transposing Directive No. 2000/46/EC on the taking up, pursuit of and prudential supervision of the business of electronic money institutions. Electronic money institutions will be introduced into Czech law and the CNB will be authorised to give prior consent to the issuing of electronic money instruments to entities other than banks. Eight prior consents were issued in 2004, and four other cases are being dealt with. The CNB expects a growing number of such applications in the near future.

### **What's new in regulation and legislation**

Decree No. 62/2004 Coll., stipulating the manner of execution of payments between banks and settlement on accounts at banks, and the technical procedures to be used by banks for corrective settlement, came into effect in 2004. At the same time, Decree No. 51/1992 Coll., on payments and settlement between banks, was repealed, having become outdated over the previous ten years. The CNB was involved in drafting Act No. 554/2004 Coll., amending the Civil Code, the Civil Procedure Code, the Notarial Rules, the Commercial Code and the Act on the Management of Taxes and Fees, which came into effect on 1 January 2004. This completely overhauled the procedures of banks, account holders and persons authorised to dispose of funds on accounts relating to the death of an account holder. It modified probate proceedings and introduced the possibility for the testator to appoint the administrator of the property of the deceased. This means that, while still alive, the testator can decide who will be entitled to administer his estate after his death until such time as the estate is settled and distributed.

### **CERTIS**

The CNB operates CERTIS (Czech Express Real Time Interbank Gross Settlement System). This system processes all domestic interbank transfers in Czech koruna, checking in real time whether banks have sufficient coverage for such transfers. Processing of the data sent electronically by banks is fully automated. Banks have an information system at their disposal to monitor settlement in real time.

Further adjustments were made to the system in 2004. Alterations arising from Decree No. 62/2004 Coll. were implemented, and the format of the data provided by banks was modified slightly. On the technological side, a CERTIS 2 project was launched. In addition to introducing some new functions relating, among other things, to the preparations for joining TARGET 2, its objective is to replace the mainframe computer platform with a more cost-effective system environment.

### **SKD**

The CNB administers and operates the Short-Term Bond System (SKD). This system is used for issuing and registering all book-entry securities with maturities of up to one year, and for settling trades in these securities. T-bills, CNB bills and short-term bonds issued by the Czech Consolidation Agency are registered in SKD. The system enables the execution of sales of securities, repo operations and sell and buy operations, as well as pledges and exchanges of securities. It allows automated provision and repayment of intraday credit extended to banks by the CNB within CERTIS at any time during the accounting day.

In 2004, extensive changes were made to SKD in response to requests by participants. The aims of this process were to extend its functionality, to make it more user-friendly, to enhance the security of the system (a change to electronic signing of data) and to allow individual taxation of yields on securities applied in accordance with the legal status of each client. The new complete version of SKD was put into operation on 20 December 2004.

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<sup>5</sup> Act No. 124/2002 Coll., on Transfers of Funds, Electronic Payment Instruments and Payment Systems.

Following an assessment of SKD against the standards set by the European Central Bank for settlement systems for securities used as collateral for intraday credit extended by a central bank within the EU, detailed information was drawn up and published on the CNB website allowing users to examine and compare the systems used in various EU Member States (under the uniform disclosure framework required by the ECB and developed by the Committee on Payment and Settlement Systems and the International Organisation of Securities Commissions).

### **ABO**

The CNB is responsible by law for maintaining and administering the accounts of state organisational units and organisations connected to the state budget. This it does through the ABO (Automated Banking Operations) payment and settlement system. In addition, the ABO system is used to keep books on the central bank's own funds. Using data obtained from the ABO system, the CNB provides the Ministry of Finance with inputs for the national accounts. In 2004, work was launched on a new project aimed at greater rationalisation and centralisation of the system, the development of an Internet gateway for direct e-banking for CNB clients, and the preparation of new treasury support functions.

### **International co-operation**

In 2004, CNB representatives continued to participate in the meetings of EU bodies dealing with payment systems, particularly within the European Commission and the European Central Bank. Key topics included the preparation of the New Legal Framework (the drafting of a new payments directive), the development of the European TARGET payment system (the TARGET 2 project) and the co-ordination of payment system supervision.

### **THE CNB AS THE BANK OF THE STATE**

The CNB is authorised by law to perform banking services for the state and the public sector. It maintains the revenue and expenditure accounts of state organisational units connected to the state budget, revenue and customs offices (tax revenues), the Czech Social Security Administration (health insurance and pension contributions, pension payments), labour offices (employment policy), subsidised organisations, state funds, and business entities that receive subsidies from the state budget. The CNB is also responsible for the payment of state social benefits. For example, 12.6 million transactions relating to state social benefits, almost 9 million health insurance and employment policy contributions and 2 million operations connected with VAT administration were recorded on these accounts in 2004.

#### **Number and structure of accounts maintained as of 31 December 2004**

Treasury accounts	25,781
Extra-budgetary accounts of state organisational bodies	3,447
Subsidised organisations' accounts	833
State funds accounts	156
National Fund accounts	194
<b>Total</b>	<b>30,411</b>

The CNB also maintains accounts for the registration and use of National Fund money. Accession to the European Union necessitated the establishment of accounts in koruna and euro for the transfer of own funds to the EU budget.

### **Support for treasury liquidity management**

At the same time, the CNB provides the Ministry of Finance with daily consolidation of funds on the state budget revenue and expenditure accounts, state financial assets accounts, revenue offices' accounts and on the treasury liquidity management account into a single, aggregate treasury account so that free funds can be fully used to finance budget expenditures or to minimise debt service costs.

The accounts to be consolidated are specified in the Act on Budgetary Rules and in instructions issued by the Ministry of Finance. Current-day expenditures and their coverage by funds on these state accounts are continuously compared within the CNB's payment and settlement system in order to:

- ensure that all available free funds of the state are used to meet expenditures;
- determine the amount of credit (issuance of T-bills on the money market) needed to finance that part of the expenditure which lacks sufficient financial coverage on that particular day, and, at the same time, to keep the free balance of all funds on these accounts as low as possible after the use of such credit.

During the day, the CNB provides the Ministry of Finance with information on the liquidity on its accounts (including the aggregate account) and recommendations for daily borrowing or investment operations. At the end of the day it also provides detailed information on state budget revenues and expenditures (broken down by type and state budget chapter) and on other funds.

### **Support for state debt financing**

The Czech National Bank assists in the management of the Czech Republic's national debt. This it does by organising primary sales of government bonds and providing expert advice. In line with the Ministry of Finance's strategy of extending of the average maturity of the national debt, debt issued in the area of medium-term and long-term bonds grew by CZK 78 billion compared to 2003. Conversely, the volume of T-bill issues declined by CZK 5 billion. The Ministry of Finance moreover issued its first foreign bond, with a face value of EUR 1.5 billion. The income from the bond issue was hedged against exchange rate fluctuations.

In 2004, the CNB organised 35 T-bill auctions for the Ministry of Finance. These bills had maturities ranging from 3 months to 1 year and totalled CZK 359 billion. Of this volume, bills with a face value of around CZK 258 billion were purchased by direct participants in the auctions and the remainder (amounting to CZK 101 billion) were purchased by the issuer and placed in its portfolio. The bills were sold by Dutch auction. At the close of 2004, the outstanding volume of T-bills was around CZK 156 billion. The investors at T-bill auctions were particularly interested in bills with short maturities.

In 2004, the technique of reopening existing issues continued to be applied to government bonds with agreed maturity of over one year. This helped to increase the liquidity of the secondary market. In addition, the Ministry of Finance issued two new government bonds, with maturities of three and five years. The way in which the auctions are planned and organised is geared towards improving predictability and providing better information to participants. This was fostered by informative meetings between CNB and Ministry of Finance representatives and the direct participants in government bond auctions.

A total of 23 auctions of medium-term and long-term government bonds took place in 2004, with a total nominal value of CZK 117 billion. Last year, the Ministry of Finance also held 5 reverse auctions of government bonds in order to spread the repayment of the bond principal over time. However, only CZK 70 million worth were repurchased, out of a total demanded volume of CZK 10 billion. Three bond issues, with a face value of CZK 39 billion, were duly redeemed.

### **STATISTICS**

The Czech National Bank, together with the Czech Statistical Office, is the main producer of statistics for the needs of the Czech Republic and is a contributor to the statistics of the European Union. The division of responsibilities between these two institutions is similar to that in other European countries. The CNB is mainly responsible for monetary, banking and financial statistics and for the nation's balance of payments and related outputs. The CNB's representatives became full members of the statistical committees and working groups of European institutions upon the Czech Republic's accession to the European Union in May 2004. Co-operation between the CNB and the CZSO is very good. For example, the CNB co-

organised an international statistical conference held by the CZSO in September 2004 to mark the 85th anniversary of the establishment of statistics in the Czech Republic.



### **Monetary and financial statistics**

The first key area – now with standard outputs – is the balance sheet statistics of monetary financial institutions. Its best-known products are monetary and credit aggregates, providing information on stocks and effected transactions. In 2004, the CNB switched to standard compilation and publication of interest rate statistics, which is the second significant area of the monetary statistics. Interest rates on client deposits and loans, as well as the compilation and publication of long-term interest rates, were harmonised for convergence purposes. This laid the groundwork for the compilation of an interest rate indicator, which is one of the Maastricht criteria.

In 2004, the financial statistics focused on the launch of preparations for the harmonisation of the non-banking statistics. The legislative part of this process was completed by issuing a relevant decree requiring non-banking institutions (in particular, mutual funds and leasing companies) to report to the CNB.

### **Balance of payments statistics**

Regular outputs on the balance of payments and the international investment position were also compiled and published in this area. In addition to information issued quarterly, including a geographical breakdown of the current account, selected monthly balance of payments data are disclosed on a regular basis.

A methodological change to the monitoring and reporting of foreign trade with EU Member States was introduced in 2004, due to the abolition of the customs border on 1 May. Statistical monitoring of the structure of financial flows between the Czech Republic and the EU budget was introduced in May 2004.

The CNB is actively involved in the development of statistics within the EU. Last year, it held a conference of the new EU Member States on statistical monitoring of the economic activities of foreign-owned corporations.

### **Financial accounts statistics and government financial statistics**

This is one of the new statistics areas in the CNB. Its aim is the regular quarterly monitoring of stocks and flows of financial assets and liabilities of all economic sectors and the mutual consolidation thereof. This area was strengthened last year in order to achieve the usual standard in the EU countries before joining the euro area. The figures are to be used by

Czech and foreign analytical institutions and by the ECB for the euro area financial accounts statistics. These statistics are produced in close co-operation with the CZSO.

Given the critical importance of compliance with the Maastricht criteria in the fiscal area, the government financial statistics are also gaining in significance. The aim, above all, is to present as credible a picture of the public sector (deficit, debt) as possible, under ESA 95 methodology. Data and methodological issues relating to the standard and extraordinary operations of the state are being addressed in co-operation with the CZSO and the Ministry of Finance.

### **Publication of statistical outputs**

All statistical outputs are published in the *Statistics* section of the CNB website. This contains not only the data themselves, but also relevant methodological descriptions, national and European legislation, complete publications, a time series database, a data publishing schedule and information for respondents.

### **EUROPEAN AND INTERNATIONAL CO-OPERATION, FOREIGN TECHNICAL ASSISTANCE**

Upon the nation's accession to the EU, the CNB became a full member of the European System of Central Banks (ESCB), and CNB staff are now actively involved in the work of ESCB committees and bodies. The ESCB comprises the European Central Bank (ECB) and the 25 National Central Banks (NCBs) of the EU. The NCBs enjoy the status of separate legal entities within this system. Unlike the ECB and the NCBs, however, the ESCB does not have legal personality.

The CNB Governor regularly attends meetings of the ECB's General Council – a decision-making body that meets four times a year and where governors of all the NCBs of the EU countries are represented. Key issues discussed last year included the ECB's 2004 Convergence Report and the planned changes to the Stability and Growth Pact. The Council regularly discusses documents on macroeconomic, monetary and financial developments in the EU, the functioning of ERM II, financial stability issues and so on.

CNB representatives also participate in the work of the ECB's 12 committees and numerous working groups. Issues discussed, for example, in the International Relations Committee (IRC) and the Monetary Policy Committee (MPC) are often later discussed by the General Council. Last year, the CNB participated in the BANCO Committee, which deals with the issuance of euro banknotes, the counterfeiting of the single currency and the fight against this crime.

The CNB is also significantly represented in bodies linked either to the Council of the European Union or to the European Commission. The CNB Governor is invited as an observer to the enlarged informal meetings of the Council of Economics and Finance Ministers (ECOFIN). CNB representatives also attend the meetings of the Economic and Financial Committee (EFC) and the Banking Advisory Committee (BAC), which fulfil advisory functions for the Council of the European Union and the European Commission. Last year, the meetings of these committees were dominated by the issues of economic policy and financial services – the medium-term evaluation of the Lisbon Strategy, the reform of the Stability and Growth Pact, the implementation of a new organisational structure for the committees in the financial services area (the "Lamfalussy process"), etc.

In co-operation with the Ministry of Finance, the CNB participates in the work of the EFC sub-committee for issues of co-ordination of the EU Member States' policy towards the IMF. Last year this sub-committee chiefly discussed the role of the IMF in preventing and dealing with capital account crises.

The most important domestic platform for co-ordination of policies towards the EU is the EU Committee established by the Czech Government and run by the Ministry of Foreign Affairs. The CNB is involved in activities of this committee, which assists primarily in forming positions, instructions and mandates for the Czech Republic's representatives in the aforementioned working bodies of the Council of the European Union. Within the CNB, the "co-ordination meeting for EU issues", chaired by a vice-governor, is used to co-ordinate activities and discuss European issues.

### **Convergence Assessment**

On 20 October 2004, the European Commission and the European Central Bank published their regular Convergence Reports, prepared every two years. These documents set out to evaluate the state of preparedness of non-euro area Member States for the adoption of the euro. For the first time, the Reports covered the ten new Member States and Sweden. The countries with a permanent derogation (the United Kingdom and Denmark) were not evaluated. None of the aforesaid countries qualified for adoption of the euro in either economic or legal terms. The Reports contained a number of recommendations for achieving the desired level of economic convergence and improving the legal framework, these being necessary conditions for adopting the euro as the national currency.

### **The International Monetary Fund and World Bank Group**

CNB experts are involved in Europe-wide discussions on the international financial architecture and the future of the IMF. At the beginning of February, Prague hosted an international conference organised by the IMF and the CNB on the adoption of the euro in Central Europe, which focused on the pros and cons of adopting the euro, the political pre-conditions for a successful stay in the euro area, and the Maastricht convergence criteria.

On 12–25 May 2004, an Article IV consultation took place with an IMF mission, which positively assessed monetary policy. It was stated that the fiscal area had recorded little progress. In order to restore the credibility of the reforms, the IMF mission recommended reducing the public budget deficit by 0.25–0.5% of GDP in 2004, making the expenditure ceilings more effective and enhancing communications with the public. For the longer term, it proposed reducing the deficits below 2% of GDP by 2008–2009, accompanied by pension system and health care reforms. As regards structural issues, the emphasis was put on continuing privatisation.

In the context of technical assistance, the World Bank conducted two missions in the Czech Republic in the first half of the year. The first mission, devoted to evaluating corporate governance in the banking sector, resulted in a number of recommendations relating, for example, to increasing the role and responsibility of banks' supervisory boards and extending the scope of the data published by banks. Within the second mission, the World Bank made recommendations for enhancing the Czech bank insolvency legislation. These recommendations relate, for example, to bankruptcy procedures, official conservatorship, the restructuring of banks during bankruptcy and the liquidation of banks. The further recommendations of the World Bank will be further analysed and applied in banking supervisory practice once the final reports have been issued.

### **The Bank for International Settlements (BIS)**

In 2004, the CNB Governor attended the regular working meetings of central bank governors organised by the BIS. At these meetings, topical issues relating to world economic and monetary developments were discussed.

Co-operation with the BIS also continued in the Basel Committee on Banking Supervision. The Core Principles Liaison Group discussed, above all, selected issues relating to the implementation of Basel II and amendments to the core principles in line with international practice. The Working Group on Capital mainly discussed cross-border co-operation, national discretion and the implementation of the second pillar of the New Basel Capital Accord. Both working groups recorded further progress in achieving the final objective, namely to simplify the implementation of Basel II.

### **The Organisation for Economic Co-operation and Development (OECD)**

Among the most important objectives that the OECD focused on in 2004 were recommendations for high-quality regulation of stock and financial markets. Intensive discussions continued on the structural reform of the OECD and the reform of its budget process, including the search



for priority activities and the switch to results-based management. The CNB participated in these discussions in the areas of work plans and the future orientation of the work of committees and working groups on financial issues.

CNB representatives took part in the activities of key OECD committees dealing with topical global economic issues, financial issues and financial market developments. The CNB was involved in the preparation of an economic survey of the Czech Republic by the OECD secretariat. This survey, which was discussed in November 2004, contains relevant recommendations for fiscal consolidation, pension and health system reform, and compliance with the criteria for joining the euro area.

The OECD's Chief Economist Jean-Philippe Cotis met with the Czech Minister of Finance and the management of the CNB in Prague in April 2004. He took part in an expert debate on pension reform at the Ministry of Finance and a CNB workshop on the preparedness of the Czech Republic for the adoption of the euro.

The CNB helped to organise a seminar on liberalisation of capital movements organised by the OECD for non-member states in Istanbul in October 2004.

### **The European Bank for Reconstruction and Development**

In 2004, the EBRD signed nine projects in the Czech Republic – four of them regional projects – worth EUR 81 million in total (with purely Czech projects worth EUR 49 million). The largest investment was a capital investment in the holding company Raiffeisen International. The other investments went towards strengthening the financing of smaller and remote areas by means of joint regional funds in the countries of Central and Eastern Europe, and towards promoting exports. The EBRD's total investment in the Czech Republic since its launch up to the end of 2004 amounted to EUR 1.4 billion and involved 54 projects. The EBRD had also financed 32 technical assistance projects, worth EUR 5.4 million.

A presentation of the EBRD's 2004 Transition Report took place at the CNB – and for the first time in the Czech Republic – at the end of November 2004. This is a key annual report describing the current state of economic transformation in the countries where the EBRD operates.

### **Foreign technical assistance**

The CNB is one of the few central banks of the new EU Member States to provide technical assistance systematically. It continued in this activity in 2004. The main element of the plan was a programme of seminars intended primarily for central bank employees from the countries of the former Soviet Union and southern Balkans and Central and Eastern European countries.



Seven seminars were held last year, covering monetary policy, banking and preparation for EU accession, during which a total of 129 foreign experts visited the CNB. In addition to these seminars, plans were made for bilateral co-operation in the form of consultations. Nine bilateral consultations for 28 experts from the central banks of Belarus, Bulgaria, Botswana, Romania and Turkey took place at the CNB. There was an increase in the number of consultations and seminars organised either by international organisations or directly by the CNB and held at the recipient bank (Albania, Belarus, Botswana, Columbia, Moldova, Romania, Turkey and Ukraine).

The CNB became sought after as a systematic provider of assistance in the form of seminars and highly specialised consultations. This activity is valued not only by the seminar and consultation participants themselves, but also by the BIS in Basel, which monitors the technical assistance provided by central banks.

### Phare

A training project on payment systems for commercial banks, as well as twinning-light projects (expert assistance among partner institutions) for the CNB in the banking supervision and internal auditing areas, were implemented as part of the technical assistance received under the Phare and Transition Facility programmes in 2004 (total budget: EUR 1.45 million). In the period ahead, the CNB is to implement a twinning project for the development of a system for monitoring and analysing financial stability and a technical assistance project for Czech commercial banks and the CNB relating to the implementation of the New Basel Capital Accord (expected budget: EUR 2 million). A twinning project for the office of the Financial Arbiter of the Czech Republic is also in the specification phase (expected budget: EUR 0.5 million).

### THE CNB AS AN ADMINISTRATIVE BODY

In the foreign exchange area, the CNB carries on activities in accordance with the authorisation laid down in Act No. 219/195 Coll., the Foreign Exchange Act. These activities include issuing foreign exchange licences for certain types of foreign exchange transactions and overseeing compliance with the foreign exchange regulations by means of foreign exchange inspections. If these regulations are contravened, the CNB is authorised to impose penalties in administrative proceedings. The CNB may impose a fine or restrict, suspend or withdraw a foreign exchange licence, depending on the seriousness and nature of the infringement of the foreign exchange regulations.

The CNB granted 77 foreign exchange trading licences in 2004, roughly the same number as in previous years.

Valid foreign exchange licences				
	Total	Number of applications submitted		Valid foreign exchanged licences as of 31.12.2004
		Decisions to grant a foreign exchange licence	Decisions to refuse a foreign exchange licence	
Prague	31*	26	2	84
Č. Budějovice	10*	9	0	27
Plzeň	4	4	0	31
Ústí nad L.	7	7	0	34
H. Králové	3	3	0	12
Brno	12*	8	1	26
Ostrava	13	11	2	32
Headquarters	17*	9	4	71
<b>Total</b>	<b>97</b>	<b>77</b>	<b>9</b>	<b>317</b>

\* Figures include proceedings that had not been closed by a final and conclusive ruling as of 31 December 2004.

In 2004, the CNB issued 48 final and conclusive rulings on suspected foreign exchange offences and imposed fines amounting to CZK 2.8 million. These fines constitute revenues to the state budget.

Most of the sanctions were imposed for breaches of the conditions for foreign exchange trading (failure to make correct deductions for foreign currency sales and purchases, failure to identify clients in specified cases, failure to fulfil the reporting duty, etc.). However, combating unauthorised business remained a priority in this period. In all, 14 fines, totalling CZK 1.36 million, were imposed for such offences.

## **TECHNOLOGY AND SECURITY**

### **Computing and communication systems**

All the fundamental activities of the central bank are supported and safeguarded by information and communication systems interconnected within the CNB system environment. The aim set out in the CNB's IT development strategy is to maintain a reliable, adequately sized and efficient technological environment for such systems. Emphasis is put on functionality, cost-effectiveness and security corresponding to the security standards applied within the ESCB.

The biggest challenge of last year was the technological interconnection between the CNB and the ESCB's information systems and networks. A new ESCB network infrastructure was implemented, a teleconference system was put into operation, and selected applications used within the ESCB were installed and put into practice. In the context of these technological changes, new administration and support procedures were introduced for the new applications, including the necessary staffing (without increasing the number of CNB personnel).

The CNB system environment recorded further development in 2004. The most important change was the transfer of client workstations and all the software operated on them to a new version of the operating system. The transfer also covered elements of the system environment, which will help to enhance the stability of the system, provide greater convenience for users and improve the information security of the CNB. In order to reduce investment and operating expenses, the CNB continued to prepare for the use of less expensive technological platforms based primarily on commodity servers and open source standards.

### **The CNB and the crisis management system**

The crisis management system is an inherent part of the CNB's operations. It is built and maintained to eliminate potential security risks and to increase the organisation's resistance to such risks. The aim is to ensure effective co-operation with other central administrative authorities.

Last year significantly influenced the issue of security at the CNB. The CNB Crisis Plan was adopted in May 2004 and the related implementing documentation was elaborated before the end of the year in compliance with the Crisis Management Act. In the autumn, the Bank Board adopted a new crisis management policy for 2005–2010, with the concept of the security culture as its central theme. The policy is based on the assumption that preparedness for dealing with emergencies, along with protection of classified information and overall security, is a complex problem which cannot be reduced to the mere preparation of plans or regulations. In this respect, the potential vulnerability of an organisation is not only caused by nature or by technological failure or the ever-present human failure; it is a combination of technological, individual, group, organisational and social factors. Security incidents should therefore be understood as a failure of the organisation's security culture.

Protection of critical infrastructure has become a major task. The CNB, acting as both guarantor and co-ordinator in this area, was last year involved in defining the structure and extent of the critical infrastructure of the Czech banking sector. During 2004, selected critical infrastructure entities launched the development of contingency plans and set up an interbank crisis team for dealing with large-scale emergencies.

One of the CNB's strategic plans – the building of a back-up centre – was brought closer to fruition in 2004. This is one of the CNB's crisis management priorities. The contractor for the project was selected last year. The project is currently in the initial construction phase. The back-up centre is scheduled to go live in 2007.



# THE CNB AND THE PUBLIC



### EXTERNAL COMMUNICATIONS

The general aim of the CNB's communication policy is to provide information to individual target groups. Each of these groups requires a specific approach. Success is measured not only in terms of easy access to information, but also in terms of comprehensibility to the user. The CNB therefore employs various communication channels, allowing users to choose the one that best suits them.

In many respects, 2004 was a turning point for CNB communications. The Czech Republic's accession to the European Union and the CNB's entry into the European System of Central Banks brought a host of new tasks and opportunities. On joining the ESCB, the CNB undertook to translate all the statutory publications of the European Central Bank into Czech. In 2004, this involved the quarterly issues of the ECB Monthly Bulletin, the Convergence Report and the General Documentation on Eurosystem Monetary Policy Instruments and Procedures, all of which are available in the *Publications* section of the CNB website. Given the scope of the documents, their complex terminology and the complicated logistics of the process, this was quite a task.

As an ESCB member, the CNB gained the opportunity to contribute to the communications policy of the European Central Bank. Its membership in ECCO (External Communications Committee) and the related working group (ECCO WG) allows it to exchange information and experience with all 24 Eurosystem Member States and to assist in the preparation of joint communications strategies and activities.

The general public, journalists and specialists have become used to the CNB website as a source of a vast array of information. More than 15,000 visits to the website were recorded daily in 2004, almost two-thirds of which headed for the exchange rates section. The increasing quantity of information on the CNB website requires ongoing, mainly cosmetic adjustments. A complete overhaul of the website is planned for 2005. In 2004, the team responsible for the website prepared for the implementation of an editorial system. This will be launched in 2005 and will give users access to a better search engine (including an advanced search facility) and faster access to some sections of the CNB website.



As in previous years, the Czech National Bank also endeavoured to present its core activities in selected regions of the Czech Republic in 2004. One suitable opportunity for organising regional presentations is the *Ten Centuries of Architecture* project. Since 2001, the Czech National Bank has each year been issuing two gold commemorative coins bearing motifs of major architectural monuments in Bohemia and Moravia. The events held to unveil the coins are combined with presentations on current monetary policy issues and other CNB activities and are prepared in such a way as to directly involve the individual regions at the same time.

Another part of the CNB's communications strategy is the holding of conferences and seminars and also social events to mark special occasions. Their growing reputation is attested by the participation of numerous prominent guests from multilateral institutions and the finance ministries and central banks of EU Member States, as well as by the positive response they have received from the relevant experts.

### **PROVISION OF INFORMATION IN COMPLIANCE WITH ACT NO. 106/1999 COLL., ON FREEDOM OF INFORMATION**

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

Under the Act, the CNB provides information to applicants on the basis of applications or by way of public disclosure.

#### **Information provided in 2004 on the basis of applications:**

Number of applications for information under the Act:	None
Number of appeals against decisions:	None
Transcript of relevant parts of each court judgement:	None
Results of sanction proceedings for non-compliance with the law:	None

Other information relating to the application of the Act: The CNB provides the information referred to in Article 2(2) of the Act in cases where it makes decisions on the rights, legally protected interests or obligations of natural or legal persons in the area of public administration. The CNB has this legal obligation in respect of the administrative proceedings it conducts pursuant to the Act on the CNB, the Act on Banks and the Foreign Exchange Act. The CNB provides information on specific administrative proceedings where such proceedings have been closed by a final and conclusive decision. Most written, e-mail and telephone applications for information go beyond the legal framework of the Act. In 2004, the CNB answered 203 written and 1,537 e-mail enquiries from the public.

#### **Information provided by way of public disclosure:**

The CNB discloses and updates the information referred to in Articles 5(1) and 5(2) of the Act on notice boards at its headquarters and branches, in locations accessible to the public during working hours, and also on its website, <http://www.cnb.cz/en>.

### **EXHIBITION**

In the three years since it opened its doors, the CNB Exhibition has gained a prominent position among the information channels through which the public, and particularly the younger generation, is acquainted with the role and mission of the central bank of the Czech Republic. A permanent exhibition entitled "People and Money", which documents the economy past and present and the evolution of money within the Czech lands since the middle of the tenth century, was visited by around 14,800 people in 2004. About 60% of them were primary and secondary school pupils under the age of 18. However, the exhibition is visited not only by schools, but also by children's clubs such as scout troops and groups in the Czech Sokol Organisation.

The exhibition, set up in a former strong-room, is popular with adults as well. In its 65 showcases, the exhibition provides a comprehensive overview of the evolution of monetary policy and means of payment against the backdrop of the historical development of the Czech state. All the banknotes and coins exhibited can be also seen in digital form on touch screens where visitors can also find a wide range of more detailed information about the period when the note or coin was used as well as on the note or coin itself.





The aim of the exhibition is not only to acquaint visitors with the history of central banking, but also to provide them as far possible with the latest information. The sixth section of the permanent exhibition – “The Present” – was updated and extended in 2004. The accompanying texts, charts and tables in the relevant showcases were amended and supplemented to take into account developments up to 2004. The exhibition was expanded to include the silver commemorative coins issued between 2001 and 2004 and the gold coins from the cycle *Ten Centuries of Architecture*, celebrating major Czech architectural monuments from the Romanesque style up to the present day.

Special attention was also paid to the Czech Republic’s accession to the European Union. Visitors have the opportunity to watch a film entitled *The Czech National Bank and the European Union*, acquainting them in brief with the history of the European Union, the tasks that the Czech Republic had to perform before accession, how the Czech National Bank contributed to that process, and what conditions the Czech Republic will have to satisfy before it can join the euro area and adopt the euro. A separate showcase is devoted to the euro, where visitors can familiarise themselves with originals of the coins of all 12 euro area Member States.

An attractive new feature is a simulated dealing room acquainting visitors with movements in inflation, the koruna-euro exchange rate and the euro-dollar exchange rate since their introduction. Visitors can compare the historical figures with the real situation as documented on a Reuters online information terminal.



The exhibition is open to the public from Tuesday to Friday at two-hour intervals for groups of up to 34 people. Tours start at 9:00 a.m., 11:00 a.m. and 1:30 p.m., and on Thursday also at 4 p.m. One tour ends when the following one begins. Booking is recommended. A special infoline has been set up for this purpose: 224 41 626. More details are available in the *Exhibition* section of the CNB website.

### SPECIAL LIBRARY

The highly specialised collection of the CNB's special library comprises literature on economics, law, computer technology, politics and history, as well as encyclopaedias, language textbooks and biographies of prominent personalities. The library, which is open to the general public, gives visitors access to information that is not available anywhere else in the Czech Republic. Overall, the library maintains and provides access to more than 46,000 books and research reports and 1,500 periodicals, daily newspapers and items of grey literature, representing about 200,000 copies in total. In 2004, the library acquired about 4,000 books and research reports and about 9,000 periodicals and grey literature items. The incorporation of the older collection into an electronic catalogue was also completed. Users also have access to a whole range of electronic information sources in the reading room.



The library's public opening hours were extended by 13 hours a week in September 2004. The library is open Monday to Thursday from 9 a.m. to 5 p.m. and Friday from 9 a.m. to 3 p.m. The range of user services (lending, reference, bibliographic and research services) was extended to include an automated lending system. Users can use an electronic reading room to search for information from all available sources. People can also obtain information through the library's website or directly from its online catalogue (<http://sd.ruk.cuni.cz/tinweb/cnbanka/k6>), and can reserve the books they need or extend the borrowing period, etc. by e-mailing [lib@cnb.cz](mailto:lib@cnb.cz).

The expansion and the improved service quality have met with a favourable response from the public, as reflected in further growth in the number of visitors and borrowings. In 2004, the library registered 2,119 active readers, who made 14,154 visits and borrowed 17,264 publications.

### CONGRESS CENTRE

The Czech National Bank's Congress Centre, located in the neo-Renaissance palace of the former Commodity Exchange, does not just serve the needs of the central bank, but is also open to the public. As well as the special library, it houses classrooms and lecture halls.



Last year, the Czech National Bank held a number of major international conferences and seminars here on financial market regulation, banking supervision, public administration and staff training in partnership with leading international institutions such as the International Monetary Fund, the World Bank and the BIS. The most significant events included *Working Party on Monetary Policy in Central and Eastern Europe*, *Euro Adoption in the Accession Countries – Opportunities and Challenges*, *Practical Experience with Inflation Targeting* and *Working Group on Public Finance*. The international conference *Statistics: Investment in the Future*, organised in co-operation with the Czech Statistical Office and the University of Economics to celebrate the 85th anniversary of the establishment of the Czech Statistical Office, received a warm response from experts in the field.

The Congress Centre, however, is not solely a venue for specialist conferences and seminars; it is also used for important social events. Its excellent acoustics have made the Large Congress Hall popular with music lovers. Concerts of the Prague Spring and Young Prague international music festivals and the Prague Chamber Music Festival are also performed here regularly.



A tradition that is now well-established is the exhibitions of photographs in the foyer of the Congress Centre acquainting CNB employees and guests with the work of young photographers and trends in contemporary Czech photography. Last year, the Congress Centre exhibited works by students of the College of Art and Design at Jan Evangelista Purkyně University in Ústí nad Labem, and works by graduates of the Hradec Photographic Conservatory. An exhibition of pictures by Margita Titlová-Ylovsky, entitled *Garden of Vision*,

was held in the CNB passage in the summer and attracted considerable attention from the public. More information about activities at the CNB Congress Centre is available on the CNB website under *About the CNB – Headquarters*.



# THE CNB AND ITS PEOPLE

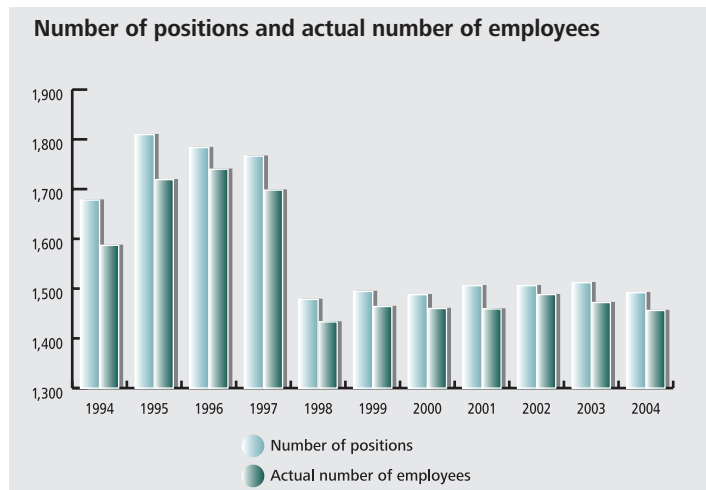


The basis of the CNB's success is human capital, which the CNB strives constantly to improve:

...The human resources area is of key significance, since successful fulfilment of the challenges in the period ahead will depend on the quality, knowledge and motivation of each member of staff. Up until now, personnel work has focused on acquiring people with the required qualifications in areas of central banking in the market economy. It has also been necessary to stabilise central bank staffing in the competitive environment of the developing commercial banking sector. The target for the future is to develop the professionalism of CNB staff members and motivate them to cope with a qualitatively different period of CNB operation. *Challenges for the Czech National Bank in the Years Ahead*

### Number of employees

At the end of 2004, the CNB had 1,456 employees, down by 141 compared to ten years ago. The number of positions has stabilised since the reorganisation in 1998.



In 2003, a total of 67 new employees were taken on and 72 people terminated their employment. In 2004, the respective figures were 77 and 97, of whom 32 retired. The recruitment of new employees generally takes the form of headhunting and written job applications, or of directly approaching selected students in their final years at university, and to a lesser extent of job advertisements, tenders and selection procedures. Employment is preceded by a demanding interview with the applicant to verify his or her professional qualifications and personal attributes.

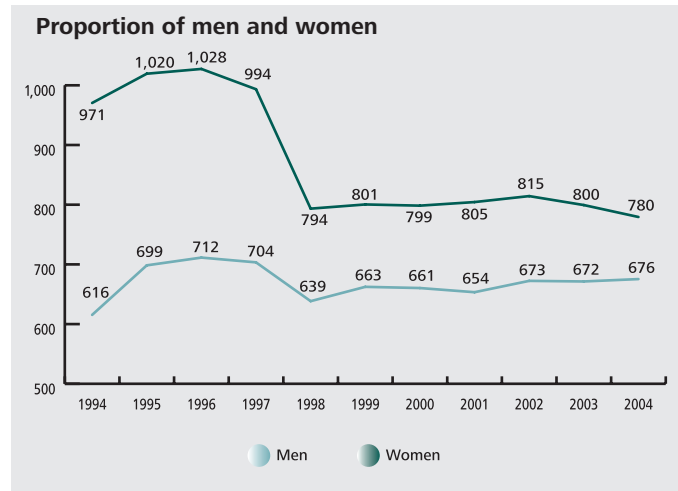
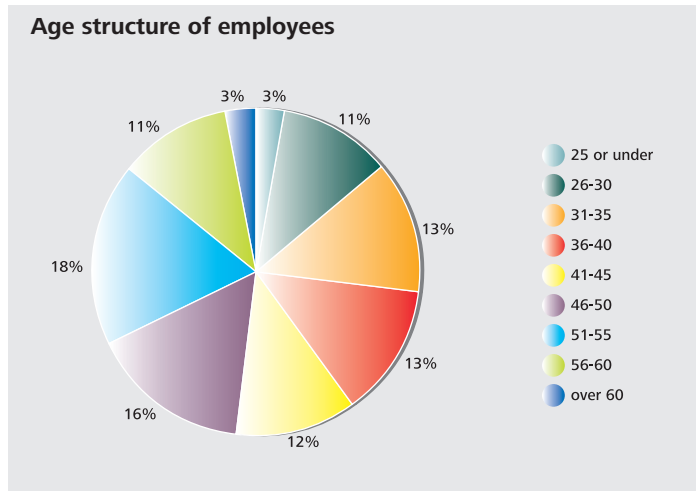
### Level of education of employees

As of 31 December 2004, university graduates made up 41% of the total CNB workforce, while employees with secondary school education (ending with a school leaving exam) and higher vocational training recorded a 45% share. The remaining 14% had basic education or vocational training (without a school leaving exam).

**Age structure of employees, proportion of men and women**

Disregarding the extreme age ranges (i.e. 25 years or under, and over 60 years), the age structure of CNB’s employees is balanced, with all age groups evenly represented.

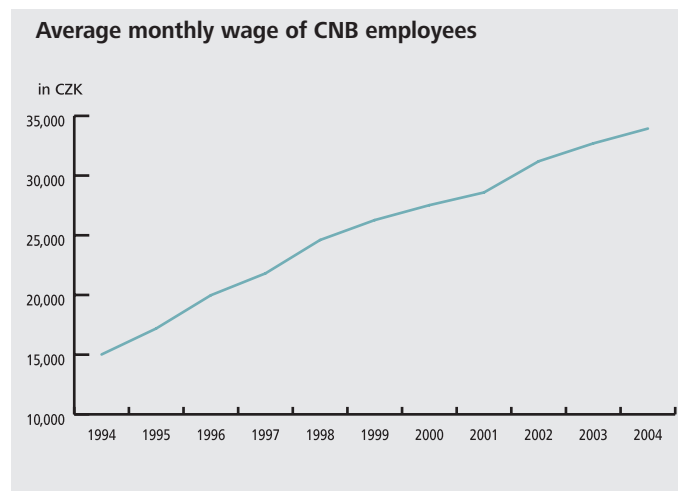
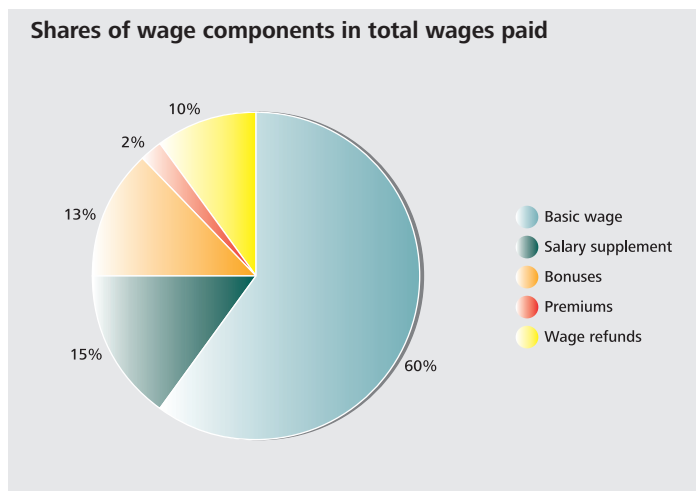
The ratio between men and women employed at the CNB has gradually been equalising and has stabilised at approximately 45:55 since the fundamental reorganisation of the CNB in 1998.



**Salary system**

The main component of the CNB’s salary system is the basic wage, which is based on a sliding scale. Another component is the salary supplement, amounting to 25% of the basic wage, which is intended to compensate CNB employees in part for the increased duties and limits imposed on them by the Labour Code. Employees can be given performance-related bonuses.

Personnel expenses totalled CZK 860 million in 2004, up by 4.5% on a year earlier. A total of CZK 599 million was paid in salaries, i.e. 3.2% more than in 2003. The average monthly wage was CZK 34,045. The average annual wage increase was 3.8%.





**In 2004, the salaries of Bank Board members were as follows:**

	Gross CZK <sup>1</sup>	Net CZK <sup>2</sup>
Zdeněk Tůma	3,574,880	2,195,149
Oldřich Dědek	2,873,954	1,766,511
Luděk Niedermayer	2,876,408	1,763,200
Michaela Erbenová	1,556,777 <sup>3</sup>	994,378 <sup>3</sup>
Jan Frait	2,415,130	1,505,098
Pavel Rácocha	2,418,555	1,507,135
Pavel Štěpánek	2,426,404	1,511,806

<sup>1</sup> The gross salary comprises the basic wage, the salary supplement (25% of the basic wage), holiday pay, performance-related bonuses and bonuses for working on non-working days.

<sup>2</sup> The net salary is the gross salary net of state health insurance contributions, social security contributions, state employment policy contributions and income tax (calculated from adjusted gross income, i.e. total monthly gross salaries less deductible items for the taxpayer and dependent children).

<sup>3</sup> Affected by maternity leave from 1 January 2004 to 16 May 2004.

Statutory insurance payments amounted to CZK 212 million. Other social costs totalled CZK 17 million. The largest part of these costs comprised life insurance and pension scheme contributions provided to employees, which were included in this item for the first time in 2004 (having formerly been paid from the social fund).

**Staff training**

Staff training is one of the priorities of personnel work and encompasses a wide range of opportunities, from internal training organised within the CNB through training provided by domestic external organisations, including university studies and language tuition, to training provided in other countries. Spending on employee training amounted to CZK 32 million.

Language training was focused on preparing employees for prescribed standardised language exams. A total of 418 employees were meant to have fulfilled this duty by the end of 2005. At the time of writing, 61% of them had proved their language qualification. Regardless of the duty to prove a language qualification, the CNB employs more than 460 people with a proven language qualification at level 1 or above within the meaning of Government Resolution No. 1088 of 6 November 2002.

As for foreign training, the CNB works mainly with partner central banks. Top-level training includes courses and seminars run by international banking and financial institutions and training events organised within the ESCB.

The bulk of the internal training events held in 2004 consisted of specialised banking courses (offered in the CNB's annual catalogue of training events) and computer courses (linked with the changeover to the new MS Windows XP operating system). The internal training courses are led not only by external trainers, but also by CNB staff.





# FINANCIAL REPORT



## REPORT OF INDEPENDENT AUDITORS

### TO THE BANK COUNCIL OF THE CZECH NATIONAL BANK

We have examined whether the financial information presented in the section V. of the Annual Report entitled Financial report (hereinafter "the Section") of the Czech National Bank (hereinafter "the CNB") for the year 2004, which does not form part of the audited financial statements, is consistent with the audited financial statements of the CNB as at 31 December 2004 and for the year then ended. In our opinion, the financial information included in the Section is consistent with the accounting records of the CNB maintained in support of the audited financial statements in all material respects.

Our audit report on the financial statements as at 31 December 2004 and for the year then ended which do not form part of the accompanying Annual report of CNB for the year 2004 was as follows:

"We have audited the accompanying balance sheet of the Czech National Bank (hereinafter "the CNB") as at 31 December 2004, the related income statement and notes for the year then ended (hereinafter "the financial statements"). The financial statements, which include a description of the activities of the CNB in accordance with the Act on the Czech National Bank as amended, and underlying accounting records are the responsibility of the management of the CNB. 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. Those auditing standards require that we plan and perform the audit to obtain reasonable assurance as to whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by the management of the CNB, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion the accompanying financial statements give a true and fair view, in all material respects, of the assets, liabilities and equity of the CNB as at 31 December 2004, and the results of its operations for the year then ended in accordance with the Act on Accounting and other relevant legislation of the Czech Republic."

Czech National Bank  
Report of independent auditors

The maintenance and integrity of the CNB's website is wholly the responsibility of the management of the CNB. The work undertaken by us does not include consideration of these matters and, accordingly, we accept no responsibility for any changes that may have occurred to the annual report since they were initially presented on the CNB's website. Legislation in the Czech Republic governing the preparation and dissemination of the annual report may differ from legislation in other jurisdictions.

31 March 2005



PricewaterhouseCoopers Audit, s.r.o.  
represented by



Paul Cunningham  
Partner



Eva Loulová  
Auditor, Licence No. 1981

## INCOME STATEMENT AND BALANCE SHEET

<b>Assets</b>		
(in CZK millions)	31.12.2004	31.12.2003
1. Gold	825	833
2. Receivables from International Monetary Fund	31,611	32,193
3. Receivables from foreign countries including securities	645,830	677,158
3.1. Deposits at foreign banks	44,021	75,773
3.2. Loans provided to foreign banks	21,235	641
3.3. Securities	580,448	600,654
3.4. Other receivables from foreign countries	126	90
4. Receivables from domestic banks	70	96
5. Receivables from clients	12,856	13,609
6. Receivables from the state	22,435	23,858
7. Fixed assets	6,319	6,739
7.1. Tangible fixed assets	6,211	6,582
7.2. Intangible fixed assets	108	157
8. Other assets	4,231	7,346
8.1. Prepayments and accrued income	20	34
8.2. Other	4,211	7,312
<b>Total assets</b>	<b>724,177</b>	<b>761,832</b>
<b>Liabilities</b>		
(in CZK millions)	31.12.2004	31.12.2003
1. Currency in circulation	261,430	247,361
2. Liabilities to International Monetary Fund	22,159	19,790
3. Liabilities to foreign countries	23,551	3,089
3.1. Loans from foreign banks	23,145	2,665
3.2. Other liabilities to foreign countries	406	424
4. Liabilities to domestic banks	428,337	470,311
4.1. Bank monetary reserves	20,311	21,237
4.2. Repo operations	402,997	439,609
4.3. Other liabilities	5,029	9,465
5. Deposits from clients	57,573	29,249
6. Domestic treasury bills issued	0	0
7. Liabilities to the state	37,507	45,708
8. Reserves	4,781	5,881
9. Share capital	1,400	1,400
10. Funds	8,075	8,109
11. Accumulated losses from previous periods	-71,953	-53,780
12. Loss for the accounting period	-53,717	-18,173
13. Other liabilities	5,034	2,887
13.1. Accruals and deferred income	0	0
13.2. Other	5,034	2,887
<b>Total liabilities</b>	<b>724,177</b>	<b>761,832</b>
<b>Off Balance Sheet</b>		
(in CZK millions)	31.12.2004	31.12.2003
1. Guarantees issued	166,102	170,440
2. Receivables from spot, term and option transactions	129,599	122,293
3. Liabilities from spot, term and option transactions	118,764	118,516
4. Guarantees received	165,535	180,500

### Income Statement

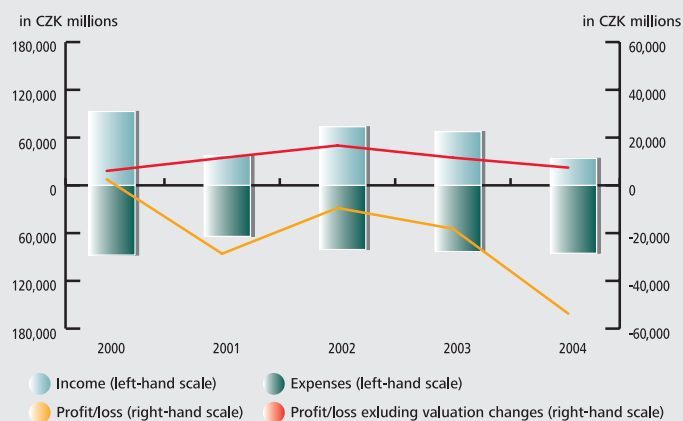
(in CZK millions)	31.12.2004	31.12.2003
<b>1. Interest income and similar income</b>	<b>13,744</b>	<b>19,192</b>
1.1. Interest from fixed income securities	12,243	16,530
1.2. Other	1,501	2,662
<b>2. Interest expense and similar expense</b>	<b>11,597</b>	<b>12,598</b>
2.1. Interest from fixed income securities	0	0
2.2. Other	11,597	12,598
<b>3. Income from securities with variable income</b>	<b>46</b>	<b>43</b>
<b>4. Fee and commission income</b>	<b>419</b>	<b>447</b>
<b>5. Fee and commission expense</b>	<b>37</b>	<b>41</b>
<b>6. Loss from financial operations</b>	<b>-55,104</b>	<b>-23,232</b>
<b>7. Other income</b>	<b>112</b>	<b>120</b>
7.1. Income from money issue	40	23
7.2. Other	72	97
<b>8. Administration expenses</b>	<b>1,919</b>	<b>2,042</b>
8.1. Personnel expenses	808	785
8.1.1. Wages and salaries	596	579
8.1.2. Social and health security	212	206
8.2. Other operating expenses	1,111	1,257
<b>9. Other expenses</b>	<b>541</b>	<b>655</b>
9.1. Expenses for issuing bank notes and coinage	261	285
9.2. Other	280	370
<b>10. Charge for specific and general provisions for loans and guarantees</b>	<b>477</b>	<b>33</b>
<b>11. Release of specific and general provisions for loans and guarantees and write-offs of loans</b>	<b>1,598</b>	<b>576</b>
<b>12. Charge for other specific and general provisions</b>	<b>1</b>	<b>10</b>
<b>13. Release of other specific and general provisions and write-offs of other receivables</b>	<b>40</b>	<b>60</b>
<b>14. Ordinary loss</b>	<b>-53,717</b>	<b>-18,173</b>
<b>15. Extraordinary profit</b>	<b>0</b>	<b>0</b>
<b>16. Loss for the period</b>	<b>-53,717</b>	<b>-18,173</b>

The notes to the financial statements are available on the CNB website, on the attached CD-ROM and from the CNB's Budget and Accounting Department, Na Příkopě 28, Praha 1

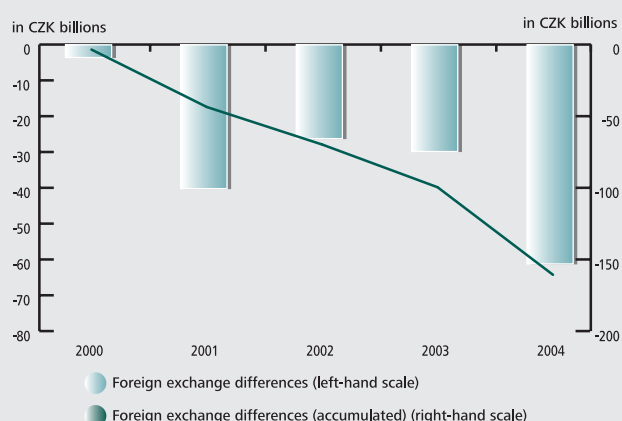
With income of CZK 33,811 million and expenses of CZK 87,528 million, the Czech National Bank made a loss of CZK 53,717 million in 2004.

In the past few years, the CNB's performance has been fundamentally affected by appreciation of the domestic currency against the currencies in which the international reserves of the central bank are allocated. The significance of this factor is evidenced by the fact that over the past four years the koruna has strengthened against the dollar from 37.80 CZK/USD to 22.40 CZK/USD, or in other words that the dollar has lost 41% of its value against the koruna. A similar trend has also been recorded against the euro, with the koruna strengthening

#### The CNB's performance 2000–2004



#### Development of foreign exchange differences 2000–2004





from 35.10 CZK/EUR to 30.50 CZK/EUR. Given the current volume of the CNB's international reserves, a change of CZK 0.10 in the koruna's exchange rate affects the CNB's bottom line by CZK 2.3 billion in the form of valuation changes. As the CNB by definition has an open foreign exchange position (that is, a significant excess of foreign exchange assets over foreign exchange liabilities due to its reserve holdings), an appreciation of the koruna generates an exchange rate loss. Conversely, a depreciation of the koruna would generate a foreign exchange profit.

In the CNB balance sheet, the crucial factors determining the level of valuation changes are the volume of foreign exchange assets and liabilities and the exchange rate at the end of the previous year compared to the rate at the end of the financial year, i.e. as of 31 December of the relevant year. Due to interest rate trends and the volume of the CNB's foreign exchange assets and liabilities at the end of 2004, the CNB recorded a total exchange rate loss of CZK 61,135 million. During the course of the year, the volatility of the exchange rates between the reserve currencies and the koruna was fairly high. The koruna depreciated against the reserve currencies at the beginning of the year, but then gradually appreciated until the end of 2004. The koruna's exchange rate appreciated by 6.0% year on year against the euro and by 12.8% year on year against the dollar, i.e. by CZK 3.30 in absolute terms.

The total net return on the international reserves was CZK 19,330 million in 2004<sup>6</sup>. This result chiefly reflects the evolution of interest rates in the euro area and the USA, which resulted in a sharp fall in portfolio returns on the CNB's international reserves, especially in 2004 Q2. In connection with rising interest rates (especially in the USA), the CNB realised capital losses which could not be fully compensated owing to low interest income. In 2004, the weighted average return<sup>7</sup> in the portfolios managed was 2.81% p.a., down by 0.05 percentage point compared to 2003.

The CNB's international reserves amounted to CZK 636 billion at the end of 2004, down by CZK 56 billion from a year earlier. The main source of the change was the exchange rate loss of the koruna value against both reserve currencies, i.e. the euro and the dollar. Another factor was the sell-off of returns realised in the previous period and market income on investment activities. As in 2003, the international reserves were not affected by the CNB's foreign exchange interventions during 2004. The international reserves totalled EUR 20.9 billion at the end of 2004, an annual decrease of EUR 0.4 billion. This decline was due to the appreciation of the euro's exchange rate against the dollar and the aforementioned sell-off of returns on the reserves.

The CNB employed the same monetary policy instruments as in previous years. Its main monetary instrument was the repo rate, which it used to steer interest rates in the economy. Owing to the systemic liquidity surplus in the Czech banking sector, repo tenders are also used for absorbing liquidity. An average of CZK 468 billion was sterilised in 2004, with the bank's total costs amounting to CZK 10.5 billion, down by around 4% from a year earlier.

The CNB's performance was also affected to a minor extent by the gradual termination of several cases relating to the consolidation of the banking sector. The potential costs of the banking sector consolidation process had already been covered by provisions and reserves and by a state guarantee. In its Resolution No. 51 of 22 January 1997, the Czech Government approved the issuing of a state guarantee of CZK 22.5 billion to the CNB for claims, guarantees issued and assets assumed in connection with the banking sector consolidation and stabilisation process for a period of 10 years. This state guarantee applies to the consolidation programme as a whole and not to losses on individual activities. The Czech Ministry of Finance made a partial payment of CZK 0.5 billion from this state guarantee in 2004, so the outstanding amount at the end of 2004 was CZK 22 billion.

<sup>6</sup> Exchange rates for the last working day of 2004 were used for the conversion.

<sup>7</sup> The average of the rates of return on the individual dollar, euro and gold portfolios, weighted by their share in the overall volume of the international reserves.

Under an agreement on the settlement of operating costs and losses from assumed assets in relation to the consolidation programme, the CNB paid Česká finanční costs of CZK 134 million for 2004. Based on a preliminary quantification of the unrealised losses from assumed assets, another part of the reserve created to cover the losses of Česká finanční was released, which meant that the balance of this reserve was CZK 4,176 million at the end of 2004. Specific loans to Česká finanční totalling CZK 4,427 million were recorded. The CNB accepted interest paid on these loans totalling CZK 110 million.

In connection with the sale of IPB, the CNB signed an Agreement and Letter of Indemnity undertaking irrevocably and unconditionally to cover certain losses incurred by ČSOB in relation to the takeover of IPB. In this context, the Czech Government adopted Resolution No. 622 of 15 June 2000, issuing a guarantee to the CNB to indemnify the strategic investor for losses ensuing from the Letter of Indemnity. On 6 November 2002, the CNB received a unilateral obligatory declaration from ČSOB according to which all ČSOB's claims for compensations from the CNB under the Agreement and the Letter of Indemnity will have been asserted and settled by the CNB by 31 December 2016 and the total amount of the compensation will not exceed CZK 160 billion. Based on this declaration, the CNB expects the potential compensation under the guarantee to be on equal or a smaller amount. On 28 June 2004, the CNB received a Binding Representation from ČSOB, enclosed with which was the final list of potential claims under the Letter of Indemnity. The receipt of the Binding Representation by the CNB on 28 June 2004 does not mean, however, that the individual claims in the enclosure have been confirmed or approved. Nevertheless, ČSOB may not bring any other claims under the Agreement and the Letter of Indemnity unless these are included on the final list of potential claims under the Agreement and the Letter of Indemnity. The CNB has not created a provision for the potential claims under the Agreement and the Letter of Indemnity, as no claims not covered by the guarantee have been raised so far under the Agreement and the Letter of Indemnity. The CNB is not currently able to determine the final volume of potential ČSOB claims arising from legal proceedings or the amount of damages which may be incurred by ČSOB which are not covered by the guarantee and which might thus be borne by the CNB.

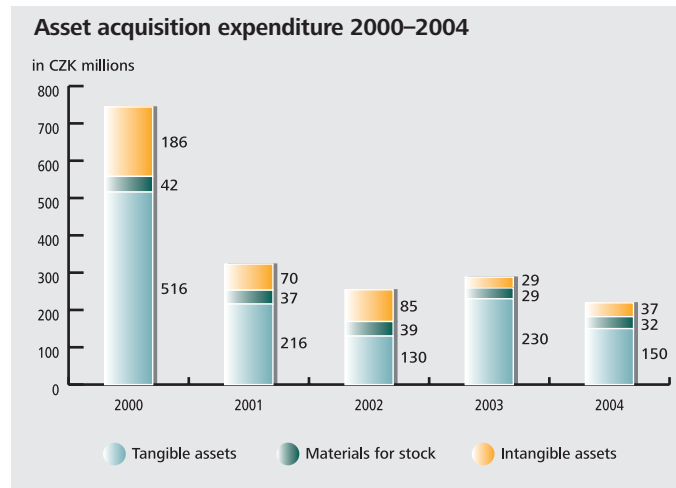
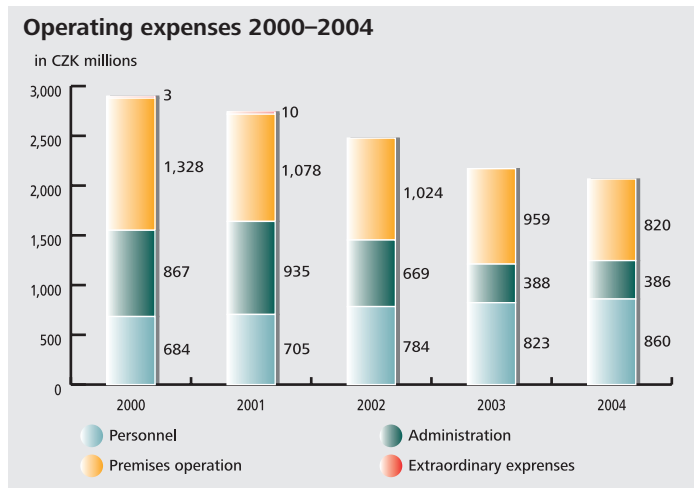
In connection with the Agreement and the Letter of Indemnity, the CNB paid advance payments to ČSOB totalling CZK 2,744 million and a final claim of CZK 38 million. No provisions were created in respect of the advance payments, as the CNB had classified them as items covered by the guarantee issued by the Czech Government. In this regard, the CNB received an advance payment of the aforementioned amount from the Czech Ministry of Finance for payments under the guarantee and the final claim under the guarantee.

In 2004, the Czech Consolidation Agency (CCA) made repayments on a redistribution loan provided to fund a co-operative housing scheme. The loan is repayable in annual instalments based on payments received from clients. Its final maturity has not been specified, but is being discussed as part of the plan to wind up the CCA. In 2004, the CNB received interest on this loan totalling CZK 216 million.

In 2004, the CNB purchased a total of 111 million banknotes from a domestic supplier at a cost of CZK 179 million. A total of 48 million base metal coins and silver and gold commemorative coins were supplied. The CNB purchased these for CZK 81 million. These amounts include costs for the preparation and protection of banknotes and coins (the development of new security features). Total banknote and coin costs gradually declined by comparison with previous years. Compared to 2003, the total costs fell by CZK 24 million. This was due partly to the fact that there were sufficient reserves of some denominations, hence it was not necessary to order their production in the same volumes as in previous years, and partly to the decision to withdraw small coins. Income in the area of currency circulation and management was CZK 42 million, linked primarily with the sale of numismatic material.

The last few years have seen a downward trend in overall operating expenses. In 2004, these expenses were down by 4.8% year on year and by 28.3% compared to 2000 (i.e. by CZK 816 million in absolute terms). In addition to increased cost-effectiveness, this trend was due to the winding-down of activities – and hence lower costs – relating to the reconstruction

of the CNB's headquarters and branches. A larger volume of written-off assets was also apparent. However, personnel expenses (salaries and insurance contributions) are gradually rising, recording a share of 42% in total operating expenses in 2004. This growth, however, was offset by reduced premises and equipment running costs and administration expenses.



The volume of asset acquisition expenditure at the CNB in 2004 was about 24% lower than in 2003. This decline was due to considerably lower expenditure on tangible assets, in particular computer hardware, security equipment and vehicles. In the period between 1999 (when the construction of the CNB's branches and the reconstruction of the CNB's headquarters were completed) and 2004, the total expenditure on asset acquisition gradually declined year on year (a slight increase was recorded only in 2003, due to higher year-on-year expenditure on cash storage, handling and processing equipment and on computers). However, some increase in expenditure on acquisition of tangible assets is expected from 2005 onwards, owing to the construction of the CNB's back-up centre and extensive upgrading of banknote counting and processing equipment.

Issued by:  
CZECH NATIONAL BANK  
Na Příkopě 28  
115 03 Praha 1  
Czech Republic

Contact:  
COMMUNICATIONS DEPARTMENT  
Tel.: ++420 22441 3494  
Fax: ++420 22441 2179

Layout, print:  
EURO AGENCY





CZECH NATIONAL BANK  
NOTES TO FINANCIAL STATEMENTS  
FOR THE YEAR ENDED 31 DECEMBER 2004

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2004

CZECH NATIONAL BANK  
NOTES TO FINANCIAL STATEMENTS  
FOR THE YEAR ENDED 31 DECEMBER 2004

**1 GENERAL INFORMATION**

The Czech National Bank (hereinafter the “Bank” or the “CNB”) is the central bank of the Czech Republic (hereinafter the “CR”). The Bank was established on 1 January 1993 following the dissolution of the State Bank of Czechoslovakia to form the Czech National Bank and the National Bank of Slovakia. The Bank was established on the basis of Act No. 6/1993 Col. as amended, The Czech National Bank Act. The Bank is a legal entity governed by public law and is not registered in the Commercial Register. The Bank operates from its headquarters in Prague and from seven branches around the CR (Prague, České Budějovice, Plzeň, Ústí nad Labem, Hradec Králové, Brno and Ostrava).

The primary objective of the Bank is to maintain price stability. Without prejudice to its primary objective, the Bank also aims to support the general economic policies of the Government which lead to sustainable economic growth. The Bank acts in accordance with the principle of an open market economy.

In accordance with its primary objective, the Bank sets the monetary rules, issues bank notes and coins, manages the money supply and clearing for interbank settlements, maintains the interbank settlement systems to ensure their fluency and efficiency, supervises the activities of banks and branches of foreign banks and sees to the safe functioning and development of the banking system in the CR. The Bank also performs other activities as defined by the CNB Act and by other legislation.

When pursuing its objectives, the Bank cooperates with the central banks of other countries, the authorities supervising the banks and financial markets of other countries, and with international financial organizations and international organizations involved in the supervision of banks and financial markets.

When carrying out its business, the Bank is independent of any instruction given by the President of the CR, the Czech Parliament, the Czech Government and administrative or other authorities and its relationship to the Chamber of Deputies of the Czech Parliament is defined by the law. The Bank and the Government communicate with each other about the principles and measures of monetary and general economic policy.

The highest-ranking management body of the Bank is the Bank Council of the CNB. The Bank Council has seven members. The members include the governor of the Bank, two vice-governors of the Bank, and four other Bank Council members. The members of the Bank Council are appointed and recalled by the President of the CR. The members of the Bank Council are appointed for a period of six years. The Bank Council sets the monetary rules and instruments for their implementation and decides about the primary monetary-political measures of the Bank.



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**1 GENERAL INFORMATION (continued)**

The members of the Bank Council as at 31 December 2004 and 2003 were as follows (including information regarding the end of their term):

Mr. Zdeněk Tůma	Governor	Until 12 February 2005
Mr. Oldřich Dědek	Vice-Governor	Until 12 February 2005
Mr. Luděk Niedermayer	Vice-Governor	Until 26 February 2008
Mrs. Michaela Erbenová	member	Until 30 November 2006
Mr. Jan Frait	member	Until 30 November 2006
Mr. Pavel Racoča	member	Until 12 February 2005
Mr. Pavel Štěpánek	member	Until 12 February 2005

On 12 February 2005, the term of four Banking Council members expired so that the president of the Czech Republic re-appointed the Governor and appointed the following new Banking Council members on 11 February 2005:

Mr. Miroslav Singer	Vice-Governor
Mr. Robert Holman	member
Mr. Pavel Řežábek	member

The statutory representative of the Bank is the Governor. In the event of the Governor's absence the Vice-Governor is appointed by him to represent the Bank.

The Bank uses its income to cover necessary operational costs of its operations. The Bank's profit, if any, is allocated to its reserve fund and other funds created from profit, and for other uses within the Bank's budget. Any remaining profit is transferred to the state budget. Accumulated losses are expected to be covered by future profits, however this depends on a number of factors, the outcome of which is not certain. The Bank Council is monitoring the situation so that appropriate action, consistent with the Bank's statutory objectives, can be taken should it be necessary.

The CNB submits its annual report on its operations to the Czech Parliament within three months after the calendar year end.

## **2 ACCOUNTING POLICIES**

### **(a) Basis of preparation**

The accounting records are prepared in compliance with the Act on accounting (Act No. 563/1991 Col. as amended), decrees and Czech Accounting Standards issued by the Ministry of Finance of the CR. The financial statements are prepared in compliance with the Act on accounting under the historical cost convention as modified by the revaluation of financial instruments held for trading and available-for-sale to fair values. The financial statements are prepared according to principles of presentation and disclosure determined by the management of the CNB to be appropriate, bearing in mind the needs and requirements for the reporting of a central bank. The financial statements are rounded to millions of Czech Crowns (hereinafter "CZK") unless otherwise stated. The Bank does not prepare consolidated financial statements, in compliance with the decree no. 501/2002 issued by the Ministry of Finance.

### **(b) Foreign currencies**

Transactions in foreign currencies are translated to CZK at the foreign exchange rate effective at the transaction date. Assets and liabilities denominated in foreign currencies (including Special Drawing Rights (Note 2(g)), including all unsettled committed spot or term purchases and sales of foreign currencies, are translated to CZK at the exchange rate effective at the balance sheet date. All resulting realised and unrealised foreign exchange gains and losses are recognised in the income statement in the loss from financial operations.

### **(c) Gold and other precious metals**

Gold and other precious metals are valued at historic cost. Deposits and securities denominated and payable in gold, that the CNB intends to hold to maturity, are included in the gold balance and valued at historical cost. Interest income resulting from the interest bearing securities and deposits denominated in gold is accrued.

### **(d) Securities**

The Bank classified all its fixed income securities as available-for-sale securities. Shares other than investments in subsidiary or associated undertakings are included in other assets.

Securities transactions are recorded on a settlement date basis.

Foreign securities are purchased in relation to foreign currency reserves administration, in accordance with predefined rules set by the Banking Council. They consist of money market and capital market securities.

## **2 ACCOUNTING POLICIES (continued)**

### **(d) Securities (continued)**

Treasury bills and other discounted securities are stated at fair value. Treasury bills and other discounted securities are originally recorded at cost which is further increased by related accrued interest income (amortised cost). Since 1 January 2004, interest income is accrued using an effective yield method. Until 31 December 2003, a linear interest rate was used as an approximation of the effective yield. Treasury bills and other discounted securities are subsequently re-measured to their fair value on a monthly basis.

Bonds are stated at fair value. Bonds are originally valued at cost, which is further increased by related accrued interest income consisting of coupon and the difference between the purchase price and the nominal value of bonds (amortised cost). Since 1 January 2004, interest income is accrued using an effective yield method. Until 31 December 2003 a linear interest rate was used as an approximation of the effective yield. Re-measurement of bonds to their fair value is performed on a monthly basis.

Effective interest rate is the rate that exactly discounts estimated future cash receipts through the expected life of the security to the net carrying amount of the security.

Transaction costs are not included in the cost of purchased securities.

The fair value of a security is determined as the market value quoted by a relevant stock exchange or other active public market. In other cases the fair value is estimated by:

- the share of the investee's equity for equities, in the absence of any other measure the historical cost less impairment;
- the risk adjusted net present value for debt securities and notes.

Changes in the fair values of securities are included in the loss from financial operations.

Dividends received are included in income from securities with variable income.

Disposals of securities are valued at the weighted average cost of the amortised costs.

During 2004 and 2003 the Bank does not have any investments in subsidiary or associated undertakings.

**2 ACCOUNTING POLICIES (continued)**

**(e) Securities financing arrangements**

Securities borrowed or purchased under agreements to resell (reverse repo agreements) are not recognised on the balance sheet. Securities lent or sold under agreements to repurchase (repo agreements) are retained in their original portfolio. The underlying cashflows are recorded as received or provided loans and borrowings, respectively, on a settlement date basis.

**(f) Currency in circulation**

Notes and coins in circulation represent the liability of the Bank from the issue of currency. The Bank recognises the amount of currency in issue, decreased by the cash in hand, denominated in CZK.

**(g) Membership quota at the International Monetary Fund**

The membership quota at the International Monetary Fund (hereinafter the "IMF") is denominated in Special Drawing Rights (hereinafter the "SDR") and is translated to CZK at the rate advised by the IMF on a yearly basis.

**(h) Issued securities**

The amount of treasury bills issued by the Bank is presented in the balance sheet after offsetting against treasury bills repurchased by the Bank. The Bank repurchases the whole issued amount of treasury bills and uses the treasury bills as collateral in repo operations with domestic banks.

**(i) Derivative financial instruments**

Derivative financial instruments including foreign exchange contracts, futures, currency and interest rate swaps and other derivative financial instruments are initially recognised on the balance sheet at cost and subsequently are re-measured at their fair value or market value (futures). Fair value as applied by the Bank approximates the market value through the calculation of foreign exchange differences and accrual of the difference between spot and forward rate. Fair values of derivatives are presented in other assets or in other liabilities when they are positive or negative respectively. The Bank does not apply hedge accounting. Changes in the fair value of derivatives are included in the loss from financial operations.

## **2 ACCOUNTING POLICIES (continued)**

### **(j) Interest income and expense**

Interest income and expense are accrued using a linear yield method for loans and deposits. Interest income for bonds available-for-sale is calculated using an effective yield method since 1 January 2004. The Bank used a linear interest rate as an approximation of the effective yield until 31 December 2003. Accrued interest is recorded together with underlying assets and liabilities.

Income on non-performing loans is also accrued and included in the related loan balance at the due date. Such amounts are considered in estimating the specific provisions for non-performing loans. Interest income also includes interest earned on securities. Penalty interest income recognition is suspended in case of a debtor's default and excluded from interest income until received.

Non-interest earning assets, such as long term receivables are not discounted.

Interest expense includes interest expense from loans and deposits received.

### **(k) Fee and commission income**

Fee income from the maintenance of current accounts and other activities is accrued. One-off fees are recognised immediately in the income statement.

### **(l) Specific provisions and reserves**

Reserves are created when the Bank has a present obligation as a result of past events, it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation, and a reliable estimate of the amount of the obligation can be made.

When creating reserves for issued guarantees related to the consolidation of the banking sector, the guarantee issued by the Czech Government that covers the related risks was taken into consideration (Note 30). The received and issued guarantees related to the consolidation of the banking sector are recorded in the off balance sheet of the CNB.

A specific credit risk provision for loan impairment is established to provide for the credit losses as soon as the recovery of an exposure is identified as threatened. The amount of specific provisions for loans and other assets at risk is based on appraisals of these assets at the balance sheet date. When creating specific provisions for assets at risk related to the consolidation of the banking sector, the guarantees issued by the Czech Government that cover these assets were taken into consideration (Note 30).

## **2 ACCOUNTING POLICIES (continued)**

### **(l) Specific provisions and reserves (continued)**

Specific provisions adjust the book value of individual assets at risk. Reserves for off balance sheet exposures and reserves for standard loans are included in liabilities. Specific provisions and reserves are not discounted for the effects of expected timing of cash flows.

When a loan is deemed to be not collectable, it is written off and the related provision for impairment is released. Subsequent recoveries are credited to the income statement if previously written off.

### **(m) Tangible and intangible fixed assets**

Tangible and intangible fixed assets are recorded at cost, which, with the exception of vehicles, excludes value added tax (hereinafter "VAT").

Tangible and intangible fixed assets are depreciated / amortised by applying the straight-line basis of depreciation over the estimated useful lives unless usage of intangible fixed assets is limited by contract; in such cases the intangible fixed assets are amortised over the contractual period. Low value tangible fixed assets with a unit cost of more than CZK 2,000 and less than or equal to CZK 40,000, as well as low value intangible fixed assets with a unit cost less than or equal to CZK 60,000, are treated as fixed assets and are fully depreciated / amortised upon the inception of use. Land, art and art collections are not depreciated.

Tangible and intangible fixed assets are depreciated as follows:

Buildings and constructions	30 years
Furniture and fittings	6 years
Motor vehicles	4 years
Office equipment and computers	4 years
Software	4 years

In the case of a change in the annual depreciation or amortisation rate or classification or valuation of the property, the depreciation charge is modified in the month of the change; depreciation or amortisation charged before that date are not adjusted.

Repairs and maintenance expenditures are charged to expenses as incurred. Improvement expenditures exceeding CZK 40,000 per unit in one year are included in the cost of the property.

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**2 ACCOUNTING POLICIES (continued)**

**(n) Value added tax**

The Bank is registered for VAT. In accordance with the VAT Act, the CNB claims the full amount of input VAT in respect of received taxable supplies used to affect taxable supplies liable to VAT; apart from this the allowance reduced by coefficient according to Paragraph 76 of the VAT Act is claimed.

**(o) Income tax and profit transfer to the state budget**

The Bank is exempt from income tax in accordance with Paragraph 17, Article 2 of the Act No. 586/92 Col. on Income Taxes as amended. As a result the Bank does not account for current or deferred tax. The income of the Bank is used to cover necessary operating expenses. Profit after allocations to funds and other budgeted usage is transferred to the state budget.

**(p) Pensions and social fund**

The Bank does not administer its own pension fund but operates defined contribution schemes for its employees, administrated by commercial pension funds. Regular contributions are made to the state budget to fund the national pension plan.

The CNB creates a social fund to finance the social needs of its employees and the employees' programme. In compliance with the Czech accounting requirements, the allocation to the social fund is not recognised in the income statement, but as a transfer between funds. Similarly, the usage of the social fund is not recognised in the income statement, but as a decrease of the fund.

**(q) Cash flow statement**

As the Bank is the central bank of the CR, the management of the Bank is of the opinion that inclusion of a cash flow statement would not provide further significant information to the users of these financial statements.

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**2 ACCOUNTING POLICIES (continued)**

**(r) Changes in accounting policy**

Since 1 January 2003, the effects of changes in accounting policies have been recognised in the equity.

The CNB's investments in the Bank for International Settlement (hereinafter the "BIS") were denominated in Gold francs until 30 March 2003. Under Czech accounting rules, all equity investments which are denominated in foreign currency have to be re-measured at the year end exchange rate. The revaluation of the shares for the foreign currency impact was not possible previously, as the foreign exchange rate for Gold francs was not quoted. As of 1 April 2003, the BIS shares are denominated in SDR and the CNB re-measured the shares using the current foreign exchange rate.

The impact of the re-measurement of CZK 219 million was recognised in the equity (Note 17) and decreased the accumulated losses from previous periods.

Since 2004, the Bank disclosed receivables from Česká konsolidační agentura within receivables from the state, previously they were recorded within receivables from clients. Comparable figures as at 31 December 2003 have been reclassified accordingly.

**(s) Subsequent events**

The effects of events which occurred between the balance sheet date and the date of signing the financial statements are reflected in the financial statements in the case that these events provide further evidence of conditions which existed at the balance sheet date.

Where significant events occur subsequent to the balance sheet date but prior to signing the financial statements which are indicative of conditions that arose subsequent to the balance sheet date, the effects of these events are disclosed, but are not themselves reflected in the financial statements.



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**3 GOLD**

	<u>31 December 2004</u> CZK million	<u>31. December 2003</u> CZK million
Gold in total	<u>825</u>	<u>833</u>

The gold as at 31 December 2004 includes a gold bond issued by the International Bank for Reconstruction and Development with maturity on 15 December 2007, in the book value of CZK 283 million (31 December 2003: CZK 283 million). The nominal value of the purchased bond was 150,115 oz of gold and the market value of this gold as at 31 December 2004 was CZK 1,460 million (31 December 2003: CZK 1,626 million).

The total market value of gold as at 31 December 2004 was CZK 4,254 million (31 December 2003: CZK 4,784 million).

**4 RECEIVABLES AND PAYABLES FROM/TO IMF**

	<u>31 December 2004</u> CZK million	<u>31 December 2003</u> CZK million
Membership quota at IMF	22,277	20,028
Deposits in IMF	<u>9,33</u>	<u>12,165</u>
Total receivables from IMF	<u>31,611</u>	<u>32,193</u>
Liability to IMF	20,009	19,653
Current account IMF	<u>2,15</u>	<u>137</u>
Total payables to IMF	<u>22,159</u>	<u>19,790</u>

The membership quota at IMF is denominated in SDR and financed by bills of exchange payable on any request issued by the Czech Government and co-accepted by the CNB.

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**5 RECEIVABLES FROM FOREIGN COUNTRIES INCLUDING SECURITIES**

	<u>31 December 2004</u> CZK million	<u>31 December 2003</u> CZK million
Current accounts with banks	30	37
Deposits	<u>43,99</u>	<u>75,74</u>
<b>Total deposits at foreign banks</b>	<b>44,021</b>	<b>75,773</b>
<b>Total loans provided to foreign banks</b>	<b>21,235</b>	<b>641</b>
Treasury bills and other discounted securities	209,064	217,879
Bonds and other coupon securities	<u>371,384</u>	<u>382,775</u>
<b>Total securities</b>	<b>580,448</b>	<b>600,654</b>
Cash in foreign currencies	<u>126</u>	<u>90</u>
<b>Total other receivables from foreign countries</b>	<b>126</b>	<b>90</b>
<b>Total receivables from foreign countries including securities</b>	<b><u>645,830</u></b>	<b><u>677,158</u></b>

Foreign banks are banks with residence abroad. Foreign banks do not include branches of foreign banks with residence in the Czech Republic.

**Loans provided to foreign banks**

Loans provided to foreign banks consist only of reverse repo operations. Securities used in reverse repo operations include state treasury bills, other short-term treasury bills and government and other coupon bonds. Their market value does not materially differ from the carrying value of the agreements.

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**5 RECEIVABLES FROM FOREIGN COUNTRIES INCLUDING SECURITIES  
(continued)**

**Geographic sector risk concentrations within receivables from foreign countries,  
excluding securities (Assets Balance sheet lines 3.1., 3.2., 3.4.)**

	31 December 2004		31 December 2003	
	CZK million	%	CZK million	%
Euro zone	20,415	31	35,110	46
Great Britain	22,534	35	40,637	53
Other European countries	22	-	99	-
USA	13,673	21	653	1
Japan	8,730	13	2	-
Other countries	<u>8</u>	<u>-</u>	<u>3</u>	<u>-</u>
	<u>65,382</u>	<u>100</u>	<u>76,504</u>	<u>100</u>

**Treasury bills and other discounted securities (Assets Balance sheet line 3.3.)**

Treasury bills and other discounted securities can be analysed as follows:

	Fair value 31 December 2004 CZK million	Fair value 31 December 2003 CZK million
Treasury bills	107,363	114,913
Other discounted securities	<u>101,701</u>	<u>102,966</u>
Total treasury bills and other discounted securities	<u>209,064</u>	<u>217,879</u>

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**6 RECEIVABLES FROM FOREIGN COUNTRIES INCLUDING SECURITIES  
(continued)**

**Geographic sector risk concentrations within treasury bills and other discounted securities**

	31 December 2004		31 December 2003	
	CZK million	%	CZK million	%
Euro zone	60,676	29	13,714	6
Great Britain	4,557	2	2,694	1
Switzerland	19,431	9	30,128	14
USA	46,336	22	60,671	28
Japan	68,233	33	99,570	46
Other countries	<u>9,83</u>	<u>5</u>	<u>11,1</u>	<u>5</u>
	<u>209,064</u>	<u>100</u>	<u>217,879</u>	<u>100</u>

**Bonds and other coupon securities (Assets Balance sheet line 3.3.)**

Bonds and other coupon securities can be analysed as follows:

	Fair value 31 December 2004 CZK million	Fair value 31 December 2003 CZK million
State bonds	223,890	179,405
Other foreign bonds (bonds issued by foreign financial institutions)	<u>147,494</u>	<u>203,370</u>
Total bonds and other coupon securities	<u>371,384</u>	<u>382,775</u>

Bonds and other securities with fixed income reported as at 31 December 2004 and 2003 include solely fixed income securities.

**Geographic sector risk concentrations within bonds and other coupon securities**

	31 December 2004		31 December 2003	
	CZK million	%	CZK million	%
Euro zone	246,094	66	266,327	70
Great Britain	4,902	1	11,815	3
USA	<u>120,388</u>	<u>33</u>	<u>104,633</u>	<u>27</u>
	<u>371,384</u>	<u>100</u>	<u>382,775</u>	<u>100</u>

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**6 RECEIVABLES FROM DOMESTIC BANKS**

	<u>31 December 2004</u> CZK million	<u>31 December 2003</u> CZK million
Non-performing loans	14	14
Loans provided from European Investment Bank (hereinafter the "EIB") funds (Note 12)	<u>70</u>	<u>96</u>
	84	110
Specific provisions against receivables from domestic banks (Note 18)	<u>(14)</u>	<u>(14)</u>
Total net receivables from domestic banks	<u>70</u>	<u>96</u>

**Non-performing loans**

Non-performing loans represent loans after maturity and loans that show violated contract terms in other respects, or which indicate a worsening financial situation of the debtor.

**7 RECEIVABLES FROM CLIENTS**

	<u>31 December 2004</u> CZK million	<u>31 December 2003</u> CZK million
Standard loans	4,539	5,166
Classified loans	<u>17,397</u>	<u>17,544</u>
	21,936	22,710
Specific provisions for classified loans (Note 18)	<u>(9,080)</u>	<u>(9,101)</u>
Total net receivables from clients	<u>12,856</u>	<u>13,609</u>

In 2004, receivables of CZK 23,858 million as at 31 December 2003 were reclassified from receivables from clients to receivables from the state (Note 8).

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**7 RECEIVABLES FROM CLIENTS (continued)**

**Classified loans**

Classified loans are categorised into four categories (watch, substandard, doubtful, loss) in accordance with the definitions issued by the Bank that are binding to commercial banks in the CR. They consist of the total outstanding principal and accrued interest receivable, and are overdue or show other defaults in contractual terms or financial performance.

	<u>31 December 2004</u> CZK million	<u>31 December 2003</u> CZK million
Loss loans	<u>17,397</u>	<u>17,544</u>
Gross classified loans	17,397	17,544
Specific provisions	<u>(9,080)</u>	<u>(9,101)</u>
Net book value	<u>8,32</u>	<u>8,44</u>

The net book value of classified loans reflects the guarantee received from the Czech Government (Note 30).

Classified loans include a portfolio of receivables from Agrobanka Praha, a.s., v likvidaci of total gross amount of CZK 5,204 million as at 31 December 2004 (31 December 2003: CZK 5,674 million). A specific provision of CZK 5,204 million as at 31 December 2004 was created against this receivable (31 December 2003: CZK 5,548 million).

Excluding specific provisions for classified loans, the Bank created a reserve for standard loans of CZK 348 million (Note 18) as at 31 December 2004 and 2003. The reserve must be utilised or released to income in compliance with Czech accounting rules for banks by 31 December 2005.

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**8 RECEIVABLES FROM THE STATE**

	<u>31 December 2004</u> CZK million	<u>31 December 2003</u> CZK million
Redistribution loans	8,752	9,675
Receivables from the state arising from an exercised state guarantee	<u>13,683</u>	<u>14,183</u>
Total receivables from the state	<u>22,435</u>	<u>23,858</u>

**Redistribution loans**

Long-term redistribution loans were provided to former Konsolidační banka Praha, s.p.ú. (now Česká konsolidační agentura) in 1990 and 1991. A redistribution loan, under special conditions, was provided to fund the cooperative housing scheme. It is repayable by annual instalments based on payments received from clients and its final maturity has not been specified.

**Receivables from the state arising from an exercised state guarantee**

As a result of the consolidation of the banking sector, the CNB had a receivable from a former bank covered by the state guarantee (Note 30). Since the liquidation of this former bank was finished and the bank was deleted from the Commercial register, this receivable does not exist any more and the CNB claimed it from the state guarantee. This claim is disclosed within receivables from the state. The CNB received a partial payment of CZK 500 million from the Ministry of Finance in 2004.

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**9 FIXED ASSETS**

**Tangible fixed assets**

	31 December <u>2003</u> CZK million	<u>Additions</u> CZK million	<u>Disposals</u> CZK million	31 December <u>2004</u> CZK million
<u>Cost</u>				
Land	176	-	(2)	174
Buildings	7,036	14	(219)	6,831
Technical equipment	2,552	330	(106)	2,776
Equipment	341	2	(11)	332
Other	445	21	(31)	435
Tangible assets in the course of construction	<u>40</u>	<u>239</u>	<u>(254)</u>	<u>25</u>
Total cost	<u>10,590</u>	<u>606</u>	<u>(623)</u>	<u>10,573</u>
<u>Accumulated depreciation</u>				
Buildings	(1,279)	(227)	38	(1,468)
Technical equipment	(2,047)	(231)	72	(2,206)
Equipment	(271)	(26)	10	(287)
Other	<u>(411)</u>	<u>(21)</u>	<u>31</u>	<u>(401)</u>
Total accumulated depreciation	<u>(4,008)</u>	<u>(505)</u>	<u>151</u>	<u>(4,362)</u>
Net book amount	<u>6,58</u>			<u>6,21</u>

The original cost of low value tangible fixed assets that have been fully depreciated when put into use in 2004 is CZK 21 million (2003: CZK 9 million).



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**9 FIXED ASSETS (continued)**

**Intangible fixed assets**

	31 December <u>2003</u> CZK million	<u>Additions</u> CZK million	<u>Disposals</u> CZK million	31 December <u>2004</u> CZK million
<u>Cost</u>				
Software	1,171	31	(36)	1,166
Other intangible assets	2	4	-	6
Intangible assets not yet put into use	<u>6</u>	<u>38</u>	<u>(35)</u>	<u>9</u>
Total cost	<u>1,179</u>	<u>73</u>	<u>(71)</u>	<u>1,181</u>
<u>Accumulated amortisation</u>				
Software	(1,020)	(87)	36	(1,071)
Other intangible assets	<u>(2)</u>	<u>-</u>	<u>-</u>	<u>2</u>
Total accumulated amortisation	<u>(1,022)</u>	<u>(87)</u>	<u>36</u>	<u>1,073</u>
Net book amount	<u>157</u>			<u>108</u>

The original cost of low value intangible fixed assets that has been fully amortised when put into use in 2004 is CZK 0.9 million (2003: CZK 0.9 million).

The Bank did not provide any fixed tangible or intangible assets as collateral and does not hold any fixed assets under finance lease contracts.

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**10 OTHER ASSETS**

	<u>31 December 2004</u> CZK million	<u>31 December 2003</u> CZK million
Accrued income	20	34
Advances in relation to the Indemnity letter (Note 30)	2,744	2,785
Other advances in relation to the consolidation of the banking sector	69	1,496
Other foreign financial assets	404	253
Other precious metals	18	21
Positive fair value of foreign currency forwards (Note 25)	877	4,122
Margin account including fair value of futures (Note 25)	18	19
Other	<u>655</u>	<u>628</u>
	4,805	9,358
Specific provisions to advances and other assets (Note 18)	<u>(574)</u>	<u>(2,012)</u>
Total other assets	<u>4,231</u>	<u>7,346</u>

The Bank discloses its share on European Central Bank's (hereinafter only "ECB") share capital within other foreign financial assets. The Czech Republic joined the European Union on 1 May 2004 and consequently the CNB became a member of the European system of central banks (hereinafter only "ESCB"). In line with the article 28 of the Statute of European central banks and European central bank (hereinafter only "Statute"), the CNB became a shareholder of ECB. The membership share is set in line with the Article 29.3. of the Statute and must be adjusted every 5 years. The share of the Czech Republic, 1.4584%, was calculated according to the Article 29 of the Statute based on the population and gross domestic product. The Czech Republic is not a member of the Euro zone, so transition provisions included in the Article 48 of the Statute are applied and the CNB paid the contribution of 7% from its share on subscribed share capital in the total amount of EUR 5.7 million. The residual part will be paid after the accession of the Czech Republic into the Euro zone.

The CNB's investments in BIS and SWIFT are also disclosed in other foreign financial assets. The shares of BIS and SWIFT are non-tradable and their holding results from the participation of the CNB in these institutions. In 2003, the accounting value of the shares of BIS increased due to the revaluation of shares upon re-denomination of these shares into SDR (Note 2 (r) and 17).

The shares in ECB, BIS and SWIFT are measured at cost less any impairment other than temporary.

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**10 OTHER ASSETS (continued)**

Within other assets, the Bank disclosed its shares in Agrobanka Praha, a.s. v likvidaci, Kreditní banka Plzeň, a.s. – v likvidaci and BH CAPITAL, a.s., transferred free of charge from Československá obchodní banka, a.s. (hereinafter “CSOB”) to the CNB, in compliance with the Agreement and Indemnity Letter (hereinafter the “Indemnity Letter”) in 2002 (Note 30).

Within other assets, the Bank also discloses its 99.98 % shares in EKOAGROBANKA, a.s. v likvidaci and COOP Banka, a.s. v likvidaci, purchased in 2004 from Česká finanční, s.r.o. (hereinafter “CF”) within the Consolidation programme under the conditions, which did not cause a financial loss to the CNB. These shares are not treated as investments in subsidiaries, because in the opinion of representatives of the Bank, it is the liquidator and not the general meeting who takes decisions about activities of these companies, and therefore the CNB cannot control the management of these companies.

The shares are measured at fair value and in the opinion of the representatives of the Bank the fair value of these shares is approximately nil.

**11 CURRENCY IN CIRCULATION**

	<u>31 December 2004</u> CZK million	<u>31 December 2003</u> CZK million
Notes in circulation	256,649	242,102
Coins in circulation	6,692	6,338
Cash in hand denominated in CZK	<u>(1,911)</u>	<u>(1,079)</u>
Total currency in circulation	<u>261,430</u>	<u>247,361</u>

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**12 LIABILITIES TO FOREIGN COUNTRIES**

	<u>31 December 2004</u> CZK million	<u>31 December 2003</u> CZK million
Repo operations	23,075	2,569
Loans from the EIB (Note 6)	<u>70</u>	<u>96</u>
Total loans from foreign countries	23,145	2,665
Other liabilities to foreign countries	<u>406</u>	<u>424</u>
Total liabilities to foreign countries	<u>23,551</u>	<u>3,089</u>

**Loans from the EIB**

From the loans received from the EIB, the Bank granted loans in foreign currencies to commercial banks in the CR (Note 6). Loans were received and provided in the same amount, have the same maturity date and are not secured. The CNB earns a margin on these loans.

**Repo operations**

State treasury bills and state bonds secure loans granted from repo operations. Their market value does not materially differ from the carrying value of the operations.

**Geographic sector risk concentrations within liabilities to foreign countries:**

	<u>31 December 2004</u>		<u>31 December 2003</u>	
	CZK million	%	CZK million	%
Euro zone	70	-	2,684	87
Other European countries	5	-	4	-
USA	<u>23,476</u>	<u>100</u>	<u>401</u>	<u>13</u>
	<u>23,551</u>	<u>100</u>	<u>3,089</u>	<u>100</u>

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**13 DUE TO DOMESTIC BANKS**

	<u>31 December 2004</u> CZK million	<u>31 December 2003</u> CZK million
Monetary reserves from banks	20,311	21,237
Repo operations	402,997	439,609
Other liabilities to domestic banks	<u>5,03</u>	<u>9,47</u>
Total liabilities to domestic banks	<u>428,337</u>	<u>470,311</u>

**Monetary reserves from banks**

Obligatory minimum reserves represent deposits of the banks in the CR held at the CNB. The CNB pays interest equal to the CZK two-week repo interest rate on these deposits. Obligatory minimum reserves are defined as 2% of received deposits and loans from non-banking clients or selected issued securities.

**Repo operations**

Repo operations as at 31 December 2004 include CZK 402,997 million (31 December 2003: CZK 439,609 million) of loans received from banks in the CR. Re-purchased treasury bills of the Bank guarantee these loans. Their market value does not materially differ from the carrying value of the operations.

**Other liabilities to domestic banks**

Other liabilities to domestic banks represent deposits for handling cash and deposits used for interbank money transfers.

**14 DEPOSITS FROM CLIENTS**

	<u>31 December 2004</u> CZK million	<u>31 December 2003</u> CZK million
Current accounts	19,199	9,836
Term deposits	1,912	2,020
Deposits of local government bodies	31,992	13,699
Other deposits	<u>4,47</u>	<u>3,69</u>
Total deposits from clients	<u>57,573</u>	<u>29,249</u>

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**15 DOMESTIC TREASURY BILLS ISSUED**

	<u>31 December 2004</u> CZK million	<u>31 December 2003</u> CZK million
Bank's treasury bills	700,000	700,000
from which:		
- held in the treasury bills portfolio	(297,145)	(267,867)
- in repo operations	<u>(402,855)</u>	<u>(432,133)</u>
Total domestic treasury bills issued	<u>-</u>	<u>-</u>

The treasury bills were issued at zero discount.

**16 LIABILITIES TO THE STATE**

	<u>31 December 2004</u> CZK million	<u>31 December 2003</u> CZK million
State funds' accounts	8,716	23,182
State assets denominated in CZK	19,959	19,025
State assets denominated in foreign currency	<u>8,83</u>	<u>3,5</u>
Total liabilities to the state	<u>37,507</u>	<u>45,708</u>

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**17 EQUITY**

Changes of equity during 2004 and 2003 were as follows:

	Share capital CZK million	Funds CZK million	Accumulated losses CZK million	Loss for the year CZK million	Equity CZK million
Balance at 1 January 2003	1,400	8,156	(44,531)	(9,468)	(44,443)
Transfer of accumulated losses	-	-	(9,468)	9,468	-
Revaluation of BIS shares (Note 2 (r))	-	-	219	-	219
Decrease of valuation fund upon sale of fixed assets acquired free of charge	-	(2)	-	-	(2)
Usage of social fund	-	(45)	-	-	(45)
Loss for the year 2003	-	-	-	(18,173)	(18,173)
Balance at 31 December 2003	1,400	8,109	(53,780)	(18,173)	-62,444
Transfer of accumulated losses	-	-	(18,173)	18,173	-
Usage of social fund	-	(34)	-	-	(34)
Loss for the year 2004	-	-	-	(53,717)	(53,717)
Balance at 31 December 2004	<u>1,400</u>	<u>8,075</u>	<u>(71,953)</u>	<u>(53,717)</u>	<u>(116,195)</u>

**Funds**

The major part of funds is represented by the General reserve fund of CZK 7,773 million existing in both reporting periods, which can be used to cover accumulated losses, increase share capital or for any other purpose approved by the Bank Council of the CNB, as well as the Special reserve fund.

The Social fund of CZK 3 million as at 31 December 2004 (31 December 2003: CZK 3 million) is used for coverage of the social needs of employees and the employees' programme of the CNB. Allocations to the Social fund are performed each year from the profit of the prior year. If the CNB achieved a loss in the prior year, the allocation to the Social fund is made from the Special reserve fund.

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**18 RESERVES, SPECIFIC PROVISIONS AND WRITE-OFFS**

The Bank created specific provisions and reserves for assets at risk:

	<u>31 December 2004</u> CZK million	<u>31 December 2003</u> CZK million
<b>Specific provisions</b>		
Non-performing loans due from domestic banks (Note 6)	14	14
Classified loans to clients (Note 7)	9,080	9,101
Other (Note 10)	<u>574</u>	<u>2,01</u>
Total specific provisions	<u>9,668</u>	<u>11,127</u>
<b>Reserves</b>		
Standard loans (Note 7)	348	348
Guarantee for CF (Notes 20 and 30)	4,176	4,770
Guarantees for the consolidation of the banking sector (Notes 20 and 30)	-	467
Guarantees for clients (Note 20)	<u>257</u>	<u>296</u>
Total reserves	<u>4,781</u>	<u>5,88</u>

Specific provisions for classified loans to clients include the provisions resulting from Consolidation programme of CZK 3,622 million as at 31 December 2004 (31 December 2003: 4,694) (Note 30).

**Write-offs and recovery of amounts written off previously**

The CNB wrote off receivables of CZK 1,400 million in 2004 (2003: CZK 75 million) and did not receive any payments on debts which had been previously written off in 2004 and 2003.

In 2004, receivables written off primarily represented advances of CZK 1,400 million, paid in the past within the consolidation of the banking sector. They were fully provided for. Impact of this write-off is disclosed net in line Release of other specific and general provisions and write-offs of other receivables.



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**18 RESERVES, SPECIFIC PROVISIONS AND WRITE OFFS (continued)**

**Specific provisions**

The movements in the specific provisions can be analysed as follows:

	<u>Amounts due from banks</u> CZK million	<u>Classified loans</u> CZK million	<u>Other</u> CZK million	<u>Total</u> CZK million
At 1 January 2003	14	9,389	1,988	11,391
Addition	-	9	27	36
Usage and release	-	(297)	(3)	(300)
At 31 December 2003	14	9,101	2,012	11,127
Addition	-	470	1	471
Usage and release	-	(491)	(1,439)	(1,930)
At 31 December 2004	<u>14</u>	<u>9,080</u>	<u>574</u>	<u>9,668</u>

**Reserves**

The movements in reserves can be analysed as follows:

	<u>Standard loans</u> CZK million	<u>Consolidation</u> CZK million	<u>Other guarantees</u> CZK million	<u>Total</u> CZK million
At 1 January 2003	348	5,51	348	6,21
Addition	-	-	7	7
Usage and release	-	(277)	(59)	(336)
At 31 December 2003	348	5,237	296	5,881
Addition	-	-	7	7
Usage and release	-	(1,061)	(46)	(1,107)
At 31 December 2004	<u>348</u>	<u>4,176</u>	<u>257</u>	<u>4,781</u>

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**18 RESERVES, SPECIFIC PROVISIONS AND WRITE OFFS (continued)**

**Reserves (continued)**

In 2004 usage and release of reserves to activities within the consolidation of the banking sector includes release of reserve created to cover the losses of Česká Finanční, s.r.o. incurred in relation to the implementation of the Consolidation programme in the amount of CZK 594 million (Note 30) (2003: CZK 146 million). In 2004 the Bank purchased from Česká Finanční, s.r.o. within the Consolidation programme shares of COOP Banka, a.s. v likvidaci (Note 10). Purchase price of these shares was netted off against the loans provided to Česká Finanční, s.r.o. (Note 30).

**19 OTHER LIABILITIES**

	<u>31 December 2004</u> CZK million	<u>31 December 2003</u> CZK million
Negative fair value of foreign currency forwards (Note 25)	1,121	586
Advance received in relation to the State guarantee (Note 30)	2,744	2,000
Liabilities to the European Communities	861	-
Other liabilities	<u>308</u>	<u>301</u>
Total other liabilities	<u>5,034</u>	<u>2,887</u>

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**20 CONTINGENCIES AND COMMITMENTS**

	<u>31 December 2004</u> CZK million	<u>31 December 2003</u> CZK million
<b>Issued guarantees</b>		
Clients	286	330
CF (Note 30)	4,176	4,770
Consolidation of the banking sector (Note 30)	<u>161,640</u>	<u>165,340</u>
Total issued guarantees	<u>166,102</u>	<u>170,440</u>
<b>Received guarantees</b>		
From the Czech Government for impaired assets taken over by the Bank within the Consolidation programme (Note 30)	8,317	22,500
From the Ministry of Finance in relation to the Indemnity Letter (Note 30)	<u>157,218</u>	<u>158,000</u>
Total guarantees received	<u>165,535</u>	<u>180,500</u>

The issued guarantees for the consolidation of the banking sector primarily include the Indemnity Letter and the Guarantee for deposits (Note 30).

The identified need for reserves for expected losses (Note 18) on the issued guarantees was as follows:

	<u>31 December 2004</u> CZK million	<u>31 December 2003</u> CZK million
Guarantees for clients (Note 18)	257	296
Guarantee for CF (Note 18 and 30)	4,176	4,770
Guarantees for the Consolidation of the banking sector (Note 18)	-	<u>467</u>
	<u>4,433</u>	<u>5,53</u>

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**20 CONTINGENCIES AND COMMITMENTS (continued)**

**Receivables and payables from unsettled transactions with securities**

	<u>31 December 2004</u> CZK million	<u>31 December 2003</u> CZK million
Receivables from unsettled transactions with securities	12,432	31,835
Payables from unsettled transactions with securities	<u>1,67</u>	<u>30,130</u>
Net position	<u>10,760</u>	<u>1,71</u>

All receivables and payables from unsettled transactions with securities matured in January of the following year.

**Legal suits**

The Bank is participating in a legal suit against Union banka, a.s. “v likvidaci” relating to compensation for an alleged claim of approximately CZK 1.8 billion resulting from a transaction performed by the CNB during the consolidation of the Czech banking sector. Based on the Bank’s own opinion resulting from cooperation with an external law firm, as well as the result of arbitration, the management of the CNB does not consider it to be probable that any compensation will have to be paid by the CNB and therefore has not created any reserve for such compensation.

The Bank is participating in a legal suit against INVESTMART B. V. resulting from a transaction performed by the Bank within the supervision activities over the banking sector. The amount of the suit is EUR 188 million. As at the date of preparation of the financial statements, the Bank is not able to reliably assess the outcome of this legal suit and therefore has not created any reserve for this legal suit.

**Other contingencies**

The Bank received a letter from administrator Union Banka, which states that the Bank did not pay an amount of CZK 20 million resulting from a transaction performed by the CNB during the consolidation of the Czech banking sector. Based on the Bank’s lawyers opinion the whole case is statute-barred and therefore no reserve has been created.

**Investment commitments**

The Bank has not entered into any contracts for the purchase of tangible and intangible fixed assets as at 31 December 2004 and 2003.

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**20 CONTINGENCIES AND COMMITMENTS (continued)**

**Assets held in custody**

The Bank has not received any assets from third parties to be held in custody in 2004 and 2003.

**21 INTEREST MARGIN**

	____ 2004 CZK million	____ 2003 CZK million
Interest income and similar income	13,744	19,192
Interest expense and similar expense	<u>(11,597)</u>	<u>(12,598)</u>
Interest margin	<u>2,15</u>	<u>6,59</u>

**Interest income and similar income**

	____ 2004 CZK million	____ 2003 CZK million
Treasury bills and other discounted securities	2,207	2,602
Bonds	<u>10,036</u>	<u>13,928</u>
Interest from securities with fixed income	<u>12,243</u>	<u>16,530</u>
Inter-bank deposits	1,000	2,165
Receivables from the clients	330	384
Other	<u>171</u>	<u>113</u>
Total other interest income	<u>1,5</u>	<u>2,66</u>
Total interest income and similar income	<u>13,744</u>	<u>19,192</u>

Based on the estimate of the Bank's management, the 2004 total income included CZK 0.5 million from interest income on classified loans (2003: CZK 1.0 million). Unpaid interest is accrued and is taken into account when calculating the amount of specific provisions.

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**21 INTEREST MARGIN (continued)**

**Interest expense and similar expense**

	<u>2004</u> CZK million	<u>2003</u> CZK million
Liabilities to the state	140	143
Liabilities to banks	11,394	12,320
Liabilities to clients	<u>63</u>	<u>135</u>
Total interest expense and similar expense	<u>11,597</u>	<u>12,598</u>

**22 LOSS FROM FINANCIAL OPERATIONS**

Loss from financial operations can be analysed as follows:

	<u>2004</u> CZK million	<u>2003</u> CZK million
Realised gain from securities	2,466	5,910
Realised loss from securities	(1,807)	(3,297)
Net foreign exchange losses	(60,135)	(29,481)
Net gains from currency forwards	1,499	5,923
Realised and unrealised gains less losses from interest futures	(21)	19
Unrealised gains less losses from securities	<u>2,94</u>	<u>(2,306)</u>
Total loss from financial operations	<u>(55,104)</u>	<u>(23,232)</u>

In 2004 net gains from currency forwards includes foreign exchange loss of CZK 865 million and interest differential of CZK 2,314 million (2003: foreign exchange gain of CZK 5,096 million and interest differential of CZK 827 million).

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**23 ADMINISTRATION EXPENSES**

The administration expenses can be analysed as follows:

	<u>2004</u> CZK million	<u>2003</u> CZK million
Wages and salaries	596	579
Social security and health insurance	<u>212</u>	<u>206</u>
Total personnel costs	<u>808</u>	<u>785</u>
Depreciation of tangible fixed assets (Note 9)	505	547
Amortisation of intangible fixed assets (Note 9)	87	152
Rent	13	14
Other	<u>506</u>	<u>544</u>
Total other administration expenses	<u>1,111</u>	<u>1,257</u>
Total administration expenses	<u>1,919</u>	<u>2,042</u>

**Staff statistics**

	<u>2004</u>	<u>2003</u>
Average number of employees	1,464	1,477
From which: Number of members of the Bank Council	7	7

**24 OTHER EXPENSES**

	<u>2004</u> CZK million	<u>2003</u> CZK million
Settlement of CF losses	134	172
Expenses for issuing bank notes and coins	261	285
Other expenses and damages	<u>146</u>	<u>198</u>
Total other expenses	<u>541</u>	<u>655</u>

## **25 FINANCIAL RISKS**

### **Liquidity risk**

The Bank monitors and manages the structure and duration of its foreign currency reserves in compliance with the mission of the Bank. The table in Note 26 analyses assets and liabilities of the Bank into relevant maturity bands based on the remaining period at the balance sheet date to the contractual maturity date.

### **Interest rate risk**

The Bank takes on exposure resulting from fluctuations in the prevailing levels of market interest rates on its financial position and cash flows. Changes in interest rates result in a change in market value of securities held in the portfolio of the Bank. Rules for investing foreign currency reserves are targeted to limit the significant risk of a change in interest rates. The table in Note 27 summarises the Bank's exposure to interest rate risks. Included in the table are the Bank's interest bearing assets and liabilities at carrying amounts, categorized by the earlier of contractual, re-pricing or maturity dates.

### **Currency risk**

The Bank takes on exposure resulting from fluctuations in prevailing foreign currency exchange rates on its financial position and cash flows. The structure of foreign currency reserves is targeted to limit the significant risk of a movement in mutual foreign exchange rates of single currencies. The CNB cannot reduce the risk of the strengthening of the Czech currency against foreign currencies, as it is responsible for the administration of the foreign exchange reserves. The table in Note 28 summarises the Bank's exposure to the currency risk. Included in the table are the Bank's foreign currency denominated assets and liabilities at carrying amounts, categorized by currency.

### **Credit risk**

The Bank manages the levels of credit risk it undertakes by placing limits on the amount of risk accepted in relation to one borrower or groups of borrowers and to geographical segments. Such risks are monitored on a revolving basis and are subject to an annual or more frequent review. Geographical concentrations of assets and liabilities are stated in Note 29.



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**25 FINANCIAL RISKS (continued)**

**Spot transactions and derivative financial instruments**

The receivables and payables from spot, term and option transactions can be analysed as follows:

	<u>31 December 2004</u> CZK million	<u>31 December 2003</u> CZK million
<u>Off balance sheet receivables:</u>		
- from future transactions	14,232	3,964
- from unsettled spot transactions	12,432	-
- from forward transactions	77,035	103,348
- from option transactions	<u>25,9</u>	<u>14,98</u>
	<u>129,599</u>	<u>122,293</u>
<u>Off balance sheet payables:</u>		
- from future transactions	14,232	3,964
- from unsettled spot transactions	1,672	-
- from forward transactions	76,960	99,571
- from option transactions	<u>25,9</u>	<u>14,98</u>
	<u>118,764</u>	<u>118,516</u>

The Bank has outstanding currency forwards at the balance sheet date hedging the movement of foreign exchange rates:

	<u>31 December 2004</u> CZK million	<u>31 December 2003</u> CZK million
Off balance sheet receivables from forward transactions	77,035	103,348
Off balance sheet payables from forward transactions	76,960	99,571
Positive fair value (Note 10)	877	4,122
Negative fair value (Note 19)	1,121	586

The nominal or notional amounts provide a basis for volume comparison with instruments recognised on the balance sheet but do not indicate the Bank's exposure to credit risk.

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**25 FINANCIAL RISKS (continued)**

**Spot transactions and derivative financial instruments (continued)**

Despite the fact that these foreign currency forwards provide efficient financial hedging of the Bank's position from a foreign exchange reserves administration point of view, they do not fulfil the criteria for hedge accounting required by the Czech accounting rules, so that they are treated as trading derivatives. Gains and losses from the change of the fair value of these foreign currency forwards are recorded in the loss from financial operations (Note 22).

The Bank has outstanding futures at the balance sheet date:

	<u>31 December 2004</u> CZK million	<u>31 December 2003</u> CZK million
Off balance sheet receivables from futures transactions	14,232	3,964
Off balance sheet payables from futures transactions	14,232	3,964
Net loss from change in fair values of futures transactions	(1)	-

Gains or losses from change in fair values of futures transactions are settled daily against cash on margin account reported within other assets.

	<u>31 December 2004</u> CZK million	<u>31 December 2003</u> CZK million
Net loss from change in fair values of futures transactions	(1)	-
Cash on margin account	<u>19</u>	<u>19</u>
Margin account including settled change in fair value of futures transactions (Note 10)	<u>18</u>	<u>19</u>

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26 LIQUIDITY RISK

<b>As at 31 December 2004</b>	Up to 1 month	1-3 months	3-12 months	1-5 years	Over 5 years	Un- specified	Total
	CZK m	CZK m	CZK m	CZK m	CZK m	CZK m	CZK m
<b>Assets</b>							
Gold	542	-	-	283	-	-	825
Receivables from IMF	-	-	-	-	-	31,611	31,611
Treasury bills and other discounted securities	57,727	61,221	90,116	-	-	-	209,064
Bonds and other coupon securities	25,886	25,466	72,286	168,336	79,410	-	371,384
Deposits, loans and other receivables from foreign countries	62,789	2,593	-	-	-	-	65,382
Receivables from domestic banks	-	10	10	50	-	-	70
Receivables from clients	2	-	4,427	8,325	102	-	12,856
Receivables from the state	-	-	-	13,682	-	8,753	22,435
Fixed assets	-	-	-	-	-	6,319	6,319
Other assets	<u>4,21</u>	<u>-</u>	<u>20</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>4,23</u>
<b>Total assets</b>	<u>151,157</u>	<u>89,290</u>	<u>166,859</u>	<u>190,676</u>	<u>79,512</u>	<u>46,68</u>	<u>724,177</u>
<b>Liabilities and equity</b>							
Currency in circulation	-	-	-	-	-	261,430	261,430
Liabilities to IMF	-	-	-	-	-	22,159	22,159
Liabilities to foreign countries	23,481	10	10	50	-	-	23,551
Liabilities to domestic banks	428,337	-	-	-	-	-	428,337
Deposits from clients	55,662	-	371	260	1,280	-	57,573
Liabilities to the state	37,507	-	-	-	-	-	37,507
Reserves	-	-	-	-	-	4,781	4,781
Equity	-	-	-	-	-	(116,195)	(116,195)
Other liabilities	<u>5,03</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>5,03</u>
<b>Total liabilities and equity</b>	<u>550,021</u>	<u>10</u>	<u>381</u>	<u>310</u>	<u>1,28</u>	<u>172,175</u>	<u>724,177</u>
<b>Net liquidity gap</b>	<u>(398,864)</u>	<u>89,280</u>	<u>166,478</u>	<u>190,366</u>	<u>78,232</u>	<u>(125,492)</u>	<u>-</u>
<b>Balance as at 31 December 2003</b>							
<b>Total assets</b>	189,154	89,683	176,574	175,026	82,587	48,808	761,832
<b>Total liabilities</b>	<u>550,521</u>	<u>12</u>	<u>354</u>	<u>357</u>	<u>-</u>	<u>210,588</u>	<u>761,832</u>
<b>Net liquidity gap</b>	<u>(361,367)</u>	<u>89,671</u>	<u>176,220</u>	<u>174,669</u>	<u>82,587</u>	<u>(161,780)</u>	<u>-</u>

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27 INTEREST RATE RISK

<b>As at 31 December 2004</b>	Up to 1 month	1-3 months	3-12 months	1-5 years	Over 5 years	Un- specified	Total
	CZK m	CZK m	CZK m	CZK m	CZK m	CZK m	CZK m
<b>Assets</b>							
Gold	-	-	-	-	-	825	825
Receivables from IMF	-	-	-	-	-	31,611	31,611
Treasury bills and other discounted securities	57,727	61,221	90,116	-	-	-	209,064
Bonds and other coupon securities	37,912	44,632	49,092	160,338	79,410	-	371,384
Deposits, loans and other receivables from foreign countries	62,789	2,593	-	-	-	-	65,382
Receivables from domestic banks	-	10	10	50	-	-	70
Receivables from clients	2	-	4,427	8,325	102	-	12,856
Receivables from the state	-	-	-	13,682	-	8,753	22,435
Fixed assets	-	-	-	-	-	6,319	6,319
Other assets	4,23	-	-	-	-	-	4,23
<b>Total assets</b>	<u>162,661</u>	<u>108,456</u>	<u>143,645</u>	<u>182,395</u>	<u>79,512</u>	<u>47,51</u>	<u>724,177</u>
<b>Liabilities and equity</b>							
Currency in circulation	-	-	-	-	-	261,430	261,430
Liabilities to IMF	-	-	-	-	-	22,159	22,159
Liabilities to foreign countries	23,481	10	10	50	-	-	23,551
Liabilities to domestic banks	428,337	-	-	-	-	-	428,337
Deposits from clients	57,573	-	-	-	-	-	57,573
Liabilities to the state	37,507	-	-	-	-	-	37,507
Reserves	-	-	-	-	-	4,781	4,781
Equity	-	-	-	-	-	(116,195)	(116,195)
Other liabilities	5,03	-	-	-	-	-	5,03
<b>Total liabilities and equity</b>	<u>551,932</u>	<u>10</u>	<u>10</u>	<u>50</u>	<u>-</u>	<u>172,175</u>	<u>724,177</u>
<b>Net interest sensitivity gap</b>	<u>(389,271)</u>	<u>108,446</u>	<u>143,635</u>	<u>182,345</u>	<u>79,512</u>	<u>(124,667)</u>	<u>-</u>
<b>Balance as at 31 December 2003</b>							
<b>Total assets</b>	185,962	88,78	174,680	178,093	84,672	49,64	761,832
<b>Total liabilities</b>	<u>551,148</u>	<u>12</u>	<u>12</u>	<u>72</u>	<u>-</u>	<u>210,588</u>	<u>761,832</u>
<b>Net interest sensitivity gap</b>	<u>(365,186)</u>	<u>88,77</u>	<u>174,668</u>	<u>178,021</u>	<u>84,672</u>	<u>(160,947)</u>	<u>-</u>

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28 CURRENCY RISK

As at 31 December 2004	<u>CZK</u>	<u>EUR</u>	<u>USD</u>	<u>JPY</u>	<u>Other</u>	<u>Total</u>
	CZK m	CZK m	CZK m	CZK m	CZK m	CZK m
<b>Assets</b>						
Gold	-	-	-	-	825	825
Receivables from IMF	22,159	-	-	-	9,452	31,611
Treasury bills and other discounted securities	-	64,140	76,692	68,232	-	209,064
Bonds and other coupon securities	-	247,900	121,132	-	2,352	371,384
Deposits, loans and other receivables from foreign countries	-	18,618	37,996	8,730	38	65,382
Receivables from domestic banks	-	70	-	-	-	70
Receivables from clients	12,856	-	-	-	-	12,856
Receivables from the state	22,435	-	-	-	-	22,435
Fixed assets	6,309	-	-	-	10	6,319
Other assets	<u>3,72</u>	<u>279</u>	<u>4</u>	<u>-</u>	<u>231</u>	<u>4,23</u>
<b>Total assets</b>	<u>67,48</u>	<u>331,007</u>	<u>235,824</u>	<u>76,962</u>	<u>12,908</u>	<u>724,177</u>
<b>Liabilities</b>						
Currency in circulation	261,430	-	-	-	-	261,430
Liabilities to IMF	22,159	-	-	-	-	22,159
Liabilities to foreign countries	406	70	23,075	-	-	23,551
Liabilities to domestic banks	428,337	-	-	-	-	428,337
Deposits from clients	56,243	1,288	42	-	-	57,573
Liabilities to the state	28,675	8,832	-	-	-	37,507
Reserves	4,781	-	-	-	-	4,781
Other liabilities	<u>4,4</u>	<u>633</u>	<u>-</u>	<u>-</u>	<u>1</u>	<u>5,03</u>
<b>Total liabilities</b>	<u>806,431</u>	<u>10,82</u>	<u>23,12</u>	<u>-</u>	<u>1</u>	<u>840,372</u>
<b>Net assets / (liabilities)</b>	(738,955)	320,184	212,707	76,962	12,907	(116,195)
<b>Net off-balance sheet assets / (liabilities)</b>	<u>-</u>	<u>43,09</u>	<u>33,94</u>	<u>(76,959)</u>	<u>-</u>	<u>76</u>
<b>Net foreign exchange position</b>	<u>(738,955)</u>	<u>363,278</u>	<u>246,648</u>	<u>3</u>	<u>12,907</u>	<u>(116,119)</u>
<b>Balance as at 31 December 2003</b>						
<b>Total assets</b>	<u>70,95</u>	<u>362,262</u>	<u>213,753</u>	<u>99,572</u>	<u>15,293</u>	<u>761,832</u>
<b>Total liabilities</b>	<u>816,692</u>	<u>4,96</u>	<u>2,62</u>	<u>-</u>	<u>-</u>	<u>824,276</u>
<b>Net assets / (liabilities)</b>	(745,740)	357,299	211,132	99,572	15,293	(62,444)
<b>Net off-balance sheet assets / (liabilities)</b>	<u>-</u>	<u>79,9</u>	<u>23,44</u>	<u>(99,571)</u>	<u>-</u>	<u>3,78</u>
<b>Net foreign exchange position</b>	<u>(745,740)</u>	<u>437,203</u>	<u>234,576</u>	<u>1</u>	<u>15,293</u>	<u>(58,667)</u>

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**29 CREDIT RISK AND CONCENTRATION OF LIABILITIES**

**Geographical concentrations of assets**

	<u>31 December 2004</u> CZK million	<u>31 December 2003</u> CZK million
Czech Republic	46,052	52,573
Germany	136,305	146,522
France	49,345	48,981
Italy	64,523	66,577
Other Euro zone countries	77,183	53,071
Switzerland	19,665	30,134
Great Britain	31,993	55,146
Other European countries	17	1
Canada and USA	212,293	198,151
Japan	76,963	99,572
Other countries	<u>9,84</u>	<u>11,1</u>
	<u>724,177</u>	<u>761,832</u>

**Geographical concentrations of liabilities**

	<u>31 December 2004</u> CZK million	<u>31 December 2003</u> CZK million
Czech Republic	678,723	738,953
Euro zone countries	931	2,684
Other European countries	5	4
Canada and USA	<u>44,52</u>	<u>20,19</u>
	<u>724,177</u>	<u>761,832</u>

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**30 CONSOLIDATION OF THE BANKING SECTOR**

**Consolidation of the banking sector**

Pursuant to its role in supporting and maintaining the stability of the banking sector and monitoring the security of the clients' deposits in CR, the CNB took over certain assets and liabilities or guaranteed certain liabilities of various commercial banks. The Czech Government issued a guarantee of CZK 22,500 million in favour of the Bank (hereinafter the "Guarantee") to cover the exposure of the Bank arising as a consequence of these activities. The Guarantee was issued on 19 March 1997 and is valid for ten years from that date. The CNB has fully provided for the estimated losses resulting from the consolidation of the banking sector not covered by the Guarantee. The CNB obtained a payment of CZK 500 million from the Guarantee in 2004.

The assets taken over and specific provisions and reserves created as at 31 December 2004 and 2003 can be summarised as follows:

	<u>31 December 2004</u> CZK million	<u>31 December 2003</u> CZK million
Receivables from banks	11,716	26,971
Purchased receivables of banks	223	223
Guarantees and commitments	—	<u>467</u>
	11,939	27,661
Specific provisions (Note 18)	(3,622)	(4,694)
Reserves (Note 18)	—	<u>(467)</u>
Total net book value covered by the Guarantee (Note 20)	<u>8,32</u>	<u>22,500</u>

**Česká finanční, s.r.o.**

CF was 100% acquired by the Bank in 1997 as a special purpose vehicle to administer the banking industry Stabilisation and Consolidation programmes which focused on small and middle sized banks. Further to the resolution of the Czech Government number 1162 dated 8 November 1999, by which the Czech Government approved the restructuring of certain transformation institutions, the CNB sold its 100% ownership interest in CF for an agreed price of CZK 1 to Konsolidační Banka Praha, s.p.ú., now Česká Konsolidační Agentura (hereinafter the "CKA") in June 2000. The CNB has undertaken to cover all CF losses resulting from the Consolidation programme and concluded an agreement with CF on the settlement of operating costs and losses from assumed assets incurred in relation to the implementation of the Consolidation programme, which would exceed the share capital of CF and therefore could not be offset against the CF share capital of CZK 13,833 million. The CNB increased the share capital in CF in 1997 and 1998.

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**30 CONSOLIDATION OF THE BANKING SECTOR (continued)**

**Česká finanční, s.r.o. (continued)**

The Consolidation Programme involved transfers of certain doubtful assets of certain banks taking part in this programme to CF. CF purchased these assets from the CNB and other banks without any further claims. The aim of this programme was to regain financial stability and the programme was started in 1997. CF ceded the portfolio of three receivables against Agrobanka Praha, a.s., v likvidaci, included in the Consolidation programme back to the CNB in 2002. The unaudited net book value of the Consolidation Programme assets administered by CF (net of provisions created by CF but reflecting the guarantee received from the CNB) was CZK 4,411 million as at 31 December 2004 (31 December 2003: CZK 5,090 million).

In compliance with this agreement concluded by CF and the CNB, the relevant part of the operating costs of CF will be settled on a quarterly basis by the CNB. The agreement also specifies CF's reporting duties to the CNB on a regular basis and the mechanism whereby the CNB retains a certain level of control over CF activities relating to the Consolidation programme.

The calculation of the reserve can be summarised as follows:

	<u>31 December 2004</u> CZK million	<u>31 December 2003</u> CZK million
Provided loans	4,427	5,060
Less expected recoverability of		
- receivables in Consolidation programme	(110)	(170)
- securities in Consolidation programme	<u>(141)</u>	<u>(120)</u>
Created reserves (Note 18)	<u>4,176</u>	<u>4,770</u>

**Investiční a poštovní banka, a.s.**

In June 2000 the CNB declared forced administration in Investiční a poštovní banka, a.s. (hereinafter "IPB"). On 16 June 2000 the CNB issued a guarantee for deposits (hereinafter the "Guarantee for Deposits") covering all commitments resulting from deposits received by IPB and from bonds issued by IPB, including accrued interest, as at 16 June 2000. Liabilities with a fixed maturity date were guaranteed until the maturity date and liabilities without a fixed maturity date were guaranteed until June 2003.



**30 CONSOLIDATION OF THE BANKING SECTOR (continued)**

**Investiční a poštovní banka, a.s. (continued)**

The Guarantee for Deposits is regularly updated in the CNB off balance sheet based on an assessment of the liabilities covered by the Guarantee for Deposits performed by CSOB. The balance of the Guarantee for Deposits in the off balance sheet of the CNB as at 31 December 2004 was CZK 421 million (31 December 2003: CZK 3,651 million).

The forced administrator of IPB concluded with CSOB a contract about the sale of the business on 19 June 2000, and based on this agreement CSOB took over assets and liabilities of IPB. On 19 June 2000 the CNB and CSOB concluded the Indemnity Letter in which the CNB irrevocably and unconditionally undertook to pay to CSOB certain losses and it indemnifies CSOB for certain costs related to the transaction.

On 23 June 2000 the Czech Government issued a Government guarantee in which it undertook that it will refund certain losses incurred by the CNB in connection with CSOB indemnification based on the Indemnity Letter (hereinafter the "State Guarantee"). The State guarantee covers losses incurred by the CNB resulting from indemnification of CSOB's losses (damages) arising from unrecorded liabilities relating to IPB that were transferred to CSOB.

On 6 November 2002, the CNB obtained a unilateral obligatory declaration from CSOB according to which all claims for compensations under the Indemnity letter from the CNB will be made by CSOB and will be settled by the CNB by 31 December 2016 and the maximum amount of the compensation is CZK 160 billion. Based on this declaration, the CNB expects that the maximum compensation from the State Guarantee would be in the same amount. The CNB received a Binding representation from CSOB on 28 June 2004. A final List of claims is enclosed to this Binding representation. The CNB accepted this Binding representation on 28 June 2004. This does not mean that the CNB accepted or approved individual claims in the enclosure, however further claims not included in the Binding representation may not be brought by CSOB.

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**30 CONSOLIDATION OF THE BANKING SECTOR (continued)**

**Investiční a poštovní banka, a.s. (continued)**

The amounts covered under the Indemnity letter, advances and final payments to CSOB, the available state guarantee, advances received and final payments from the State Guarantee can be analysed as follows:

	<u>31 December 2004</u> CZK million	<u>31 December 2003</u> CZK million
Potential future claims under the Indemnity Letter	157,218	157,215
Advances paid to CSOB (Note 10)	2,744	2,785
Final payments to CSOB	<u>38</u>	<u>-</u>
	160,000	160 000
Advances received from the State Guarantee (Note 19)	(2,744)	-2
Final payments from the State guarantee	<u>(38)</u>	<u>-</u>
Available State Guarantee (Note 20)	<u>157,218</u>	<u>158,000</u>

The CNB has not created a provision for these claims as no claims not covered by the State Guarantee have been raised so far and the CNB is currently not able to assess reliably the expected outcome of legal proceedings or the amount of damages, if any, which may be incurred by CSOB and then claimed from the CNB.

In the case that CSOB will ask the CNB to settle any claim under the Indemnity Letter, based on the agreement the CNB should make the related payment within five working days after the receipt of the CSOB request. The payment calendar related to the State Guarantee is as follows:

<u>Amount claimed by the CNB</u>	<u>Maturity</u>
Below or equal to CZK 2 billion	in the same calendar year
Greater than CZK 2 billion and less than or equal to CZK 5 billion	CZK 2 billion in the same calendar year, the rest in the following calendar year
Over CZK 5 billion	CZK 2 billion in the same calendar year, CZK 3 billion in the following calendar year, the rest in the third calendar year after the request of the CNB

### **31 RELATED PARTY TRANSACTIONS**

Related parties are defined as follows:

- Members of the Banking Council, senior management and their relatives;
- Corporates in which members of the Banking Council or senior management hold at least a 10% shareholding;
- Subsidiaries;
- CF.

Related party transactions, including transactions with the management and employees of the CNB, arose under the same conditions and interest rates as for unrelated parties under the same terms. In the opinion of the Bank's management, a common interest rate was used in all cases and the deposits do not have different liquidity risk or other unfavourable features.

The objectives and basic activities of the CF are described in Note 30. Transactions were entered into with the CF when performing the Bank's role in stabilisation of the banking sector. Loans were provided on arm's length interest rate terms.

### **32 SUBSEQUENT EVENTS**

The CNB's management is not aware of any subsequent events that would have a material impact on the financial statements.