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## **Výroční zpráva České národní banky za rok 2006**

Česká národní banka  
2007

Dostupný z <http://www.nusl.cz/ntk/nusl-42866>

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

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

Datum stažení: 01.05.2024

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## ANNUAL REPORT

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# ANNUAL REPORT

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I cannot start my foreword to the report on the Czech National Bank's activities in 2006 without mentioning the significant change made to the organisation of financial market supervision in the Czech Republic. On 1 April 2006, financial market supervision was fully integrated and concentrated into the Czech National Bank. I can therefore now evaluate developments not only in the banking sector, but also in the insurance industry, collective investment and the capital market as a whole. The central bank is responsible for supervising all these areas and also issues implementing legal rules, methodological guidelines and opinions on legislation regulating the financial market. Responsibility for preparing most of the laws covering the financial market area lies with the Ministry of Finance.

The legal and – in particular – actual integration of financial market supervision into one institution has already generated many savings and synergies, and I am confident it will continue to do so in the future. All the experts involved in financial market supervision are now located together at the Czech National Bank's headquarters and make use of the same technical resources. What is more, all the supervisory units remained fully operational during this organisationally and logistically demanding exercise. The integration process was more than a straightforward relocation, as the information systems of the former independent institutions also had to be merged. In my opinion, it was all done in a very professional manner and I would like to thank all those involved.

I am fully aware that the simple integration of the previous "sectoral" supervisors is merely a necessary condition for achieving greater efficiency and transparency and cutting the regulatory costs of supervised entities. An intense debate is therefore now going on at the Czech National Bank as regards the way forward in this area. In the near future, the "supervisory" departments will probably be re-organised so we can realise the expected synergies better than under the existing "sectoral" system.

Turning to the primary objective of the Czech National Bank, i.e. maintaining price stability, and the overall macroeconomic situation, I can say that the relatively successful trends of 2005 continued into 2006. The Czech National Bank successfully achieved its objective of making a low-inflation environment a permanent feature of the Czech economy. In order to maintain price stability going forward, interest rates were raised slightly during the year in response to the business cycle in both the domestic and external economy. Compared to interest rate levels in neighbouring Central European countries and the euro area, however, domestic interest rates are still very low.

As in 2005, a positive economic result was last year's high GDP growth, which according to figures from the Czech Statistical Office reached just over 6%. That said, there was some change in the GDP growth structure compared to 2005. Foreign trade was replaced as the main factor of economic growth by stronger household demand and aggregate domestic demand. Obviously, this did not mean a halt in export growth. The growth in household consumption, coupled with solid investment growth, merely resulted in a similar rise in imports, leading in turn to a decrease in the contribution of net exports to GDP growth.

The macroeconomic developments were accompanied by stability and good results in the financial market. The banking sector – the largest segment of the Czech

financial market – saw continued growth. Its assets rose by CZK 197 billion (or 6.7%) and the banking sector as a whole attained a net profit of CZK 37.9 billion. At 11.4%, the sector's capital adequacy ratio was compliant with the required standards. The funds administered by insurance companies, collective investment funds and pension funds also recorded growth. At the end of 2006, insurance companies, investment funds (including mutual funds) and pension funds managed assets worth about CZK 332 billion, CZK 156 billion and CZK 157 billion respectively.

Last year also saw a de facto postponement of the Czech Republic's entry into the European Monetary Union. Although the joint document of the Czech National Bank and the Czech Government *The Czech Republic's Euro-area Accession Strategy* remains in effect, the planned entry date of 2009–2010 is no longer realistic. As a result, the Czech National Bank and the Czech Government this year face the task of preparing a new strategic document defining the conditions and possibly also the timing of the Czech Republic's entry into the European Monetary Union.

The Czech National Bank ended 2006 with a loss. As in the past few years, however, this loss was due solely to the need to re-value our foreign exchange reserves using the exchange rate effective at the end of the year. It cannot be ruled out that the gradual appreciation of the koruna's nominal exchange rate, which is part of the Czech economy's process of convergence towards the advanced economies, will lead to some exchange rate losses in the future as well. Our calculations nonetheless suggest that the Czech National Bank will gradually cover these losses from its future profits.

Two members of the Bank Board were replaced in December 2006. In my opinion, they made a positive contribution to the perception of the Czech National Bank as a credible and open institution. In its previous line-up the Bank Board achieved much in the area of integration of financial market supervision, and I would like to thank all its members for that. I firmly believe that the Bank Board in its new composition will build on its past successes, as public confidence in the Czech National Bank is vital to the performance of its duties in all the areas entrusted to it by law.



Zdeněk Tůma  
Governor



The CNB is the central bank of the Czech Republic and the supervisor of the Czech financial market. It is an entity governed by public law having its registered address in Prague. It is vested with the powers of an administrative authority to the extent stipulated by law. It manages the assets entrusted to it by the state independently and with due diligence. Interventions in its activities are only permissible on the basis of a law.



Under Article 98 of the Constitution of the Czech Republic and Act No. 6/1993 Coll., on the Czech National Bank<sup>1</sup>, the primary objective of the CNB is to maintain price stability. Achieving and maintaining price stability, i.e. creating a low-inflation environment in the economy, is the central bank's ongoing contribution to the creation of conditions for sustainable economic growth. Central bank independence is a key precondition for the successful implementation of monetary policy and hence for sustainable non-inflationary economic growth. Ever since it came into being in January 1993, the CNB has had a high degree of independence from political structures in performing its statutory functions.

Without prejudice to its primary objective, the CNB also supports the general economic policies of the Government. In accordance with its primary objective, the CNB sets monetary policy, issues banknotes and coins and manages the circulation of currency, the payment system and settlement between banks. It also performs supervision of the banking sector, the capital market, the insurance industry, pension funds, credit unions and electronic money institutions, as well as foreign exchange supervision. The CNB also performs other activities pursuant to the Act on the CNB and other legal rules.

<sup>1</sup> 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., Ruling of the Constitutional Court No. 278/2001 Coll., Act No. 482/2001 Coll., Act No. 127/2002 Coll., Act No. 257/2004 Coll., Act No. 377/2005 Coll., Act No. 57/2006 Coll. and Act No. 62/2006 Coll.



The CNB's high degree of independence goes hand in hand with a high degree of monetary policy transparency. The public is kept informed about the CNB's primary monetary policy objective and about the nature of the inflation targeting regime through which this objective is fulfilled. The CNB also keeps the public informed about its inflation target, about its inflation forecasts and the risks attaching to those forecasts, and about its monetary policy measures and the reasons for implementing them. To this end, the CNB issues quarterly Inflation Reports, which are submitted to the Chamber of Deputies (the lower house of the Czech parliament) and published on the CNB website. It also makes use of articles in the press and in professional journals, lectures, speeches by Bank Board members and so on.

The CNB issues a number of periodical publications (quarterly Inflation Reports and an annual Financial Stability Report, an Annual Report, and as from 2007, following the integration of supervisory authorities into the CNB, also an annual Financial Market Supervision Report). All CNB publications are available in electronic form on the CNB website, which is a key information channel of the central bank. The CNB also deals with written enquiries relating to its activities filed by individuals and legal entities.

As with commercial banks, the CNB's accounts are inspected by external auditors. 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, including an external auditor's report, for discussion in the Chamber of Deputies.

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





# MANAGEMENT AND ORGANISATION



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

### THE BANK BOARD

The Bank Board is the supreme governing body of the CNB and takes decisions as a collective body by a simple majority of the votes cast. It has seven members: the Governor, two Vice-Governors and four other board members. On 1 December 2006, following the expiration of the six-year terms of office of Michaela Erbenová and Jan Frait, the President of the Czech Republic appointed Mojmír Hampl and Vladimír Tomšík as new Bank Board members.



The Bank Board sets monetary policy and the instruments for implementing this policy, decides on the fundamental monetary policy measures and transactions of the CNB, approves key measures relating to financial market supervision and rules on appeals in administrative proceedings. It sets the CNB's overall development strategy and decides on the bank's organisational structure and the responsibilities of the organisational units at its headquarters and branches. In respect of staff, the Bank Board assigns tasks to the executive directors of departments and to the individual board members. It approves the CNB's budget and budgetary rules and defines the types, amounts and uses of the CNB's funds.

### SENIOR MANAGEMENT

The executive directors of the CNB's departments and branches are responsible – subject to the CNB's overall strategy, the Medium-term Plan approved for 2005–2010 and annual work programmes – for effective performance of the tasks falling within their areas of competence and powers as set out in the Organisational Statute. Their competencies and responsibilities include in particular methodological and management activities, including preparing proposals for solutions to issues of fundamental significance and presenting them at Bank Board meetings. They carry out the decisions adopted by the Bank Board and set targets for the staff under them. The executive directors also perform the employer's rights and duties under labour law in respect of employees. They are responsible for co-operation with other organisational units of the bank and with domestic and foreign partner institutions.



## HEADQUARTERS

The fundamental organisational units of the CNB's headquarters are departments. The bank's main activities, including branch management, and ancillary and service activities are concentrated at headquarters. Activities covering the areas of competence of more than one department are co-ordinated by standing advisory bodies, committees and project teams.

A number of changes were made to the CNB's organisational structure in 2006. Following the adoption of Act No. 57/2006 Coll., on Integration of Financial Market Supervision, the Banking Regulation and Supervision Department took over responsibility for the regulation and supervision of credit unions and electronic money institutions. Two new departments were created: the Capital Market Regulation and Supervision Department and the Insurance Companies Regulation and Supervision Department. The areas of competence of the Cash and Payment Systems Department and the Banking Regulation and Supervision Department in administrative proceedings against electronic money institutions were redefined in line with an amendment to Act No. 124/2002 Coll., the Payment Systems Act. A Financial Market Committee was established as an advisory body to the Bank Board for financial market supervision. At the same time, the role of the CNB's Appeals Committee was revised and its members were re-appointed.

In this context, the areas of competence of the Bank Board were extended to include issues and activities relating to:

- the approval of actions in the area of integrated financial market supervision,
- the appointment and dismissal of Financial Market Committee members who are Bank Board members,
- the appointment of the chairman and members of the Appeals Committee,
- the appointment of an examining board to verify the competence of insurance agents and insurance brokers,
- the approval of the Financial Market Supervision Report.

The Bank Board approved the principles of the CNB's security policy and the division of responsibilities for its specific areas. The responsibilities of some units were updated and revised. The Board defined the responsibilities of selected departments and branches for the implementation of Act No. 69/2006 Coll., on International Sanctions, which is directly related to the Anti-Money Laundering Act. Within the General Secretariat, EU Legislation was merged with Legal Services, and changes were made in the EU and International Organisations Division. Following the conversion of the database of specimen signatures of CNB employees into electronic form, the Risk Management and Transactions Support Department is now responsible for record-keeping and administration of the database and the Information System Department provides technical support for the database.

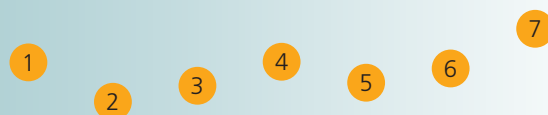
## BRANCHES

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 state budget and other CNB clients, making cash and non-cash payments, conducting the accounting of the branch and operating safe deposit boxes. To a specified extent 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.



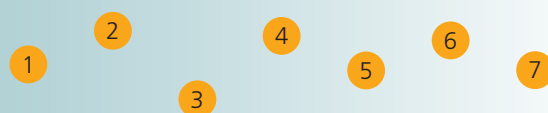
The Bank Board as of 30 November 2006



1. Luděk Niedermayer, 2. Jan Frait, 3. Pavel Řežábek,  
4. Zdeněk Tůma, 5. Michaela Erbenová,  
6. Robert Holman, 7. Miroslav Singer

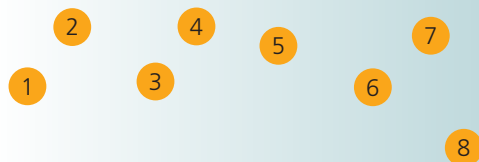


The Bank Board as of 31 December 2006



1. Miroslav Singer, 2. Vladimír Tomšík, 3. Mojmír Hampl,  
4. Robert Holman, 5. Zdeněk Tůma, 6. Pavel Řežábek,  
7. Luděk Niedermayer

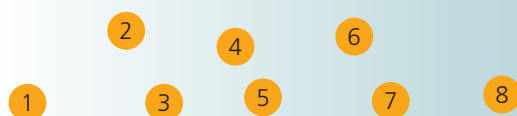
## Executive Directors of Departments



1. Jana Báčová, 2. Leoš Pýtr, 3. Zdeněk Virius, 4. Vladimír Kolman,  
5. Marian Mayer, 6. Ota Kaftan, 7. Karel Gabrhel, 8. Pavlína Bolfová



## Executive Directors of Departments



1. Miloš Hrdý, 2. Tomáš Hládek, 3. Jan Hampl, 4. Pavel Hollmann,  
5. Kateřina Šmídková, 6. Tomáš Kvapil, 7. Jan Schmidt, 8. Tomáš Holub



## Executive Directors of Branches

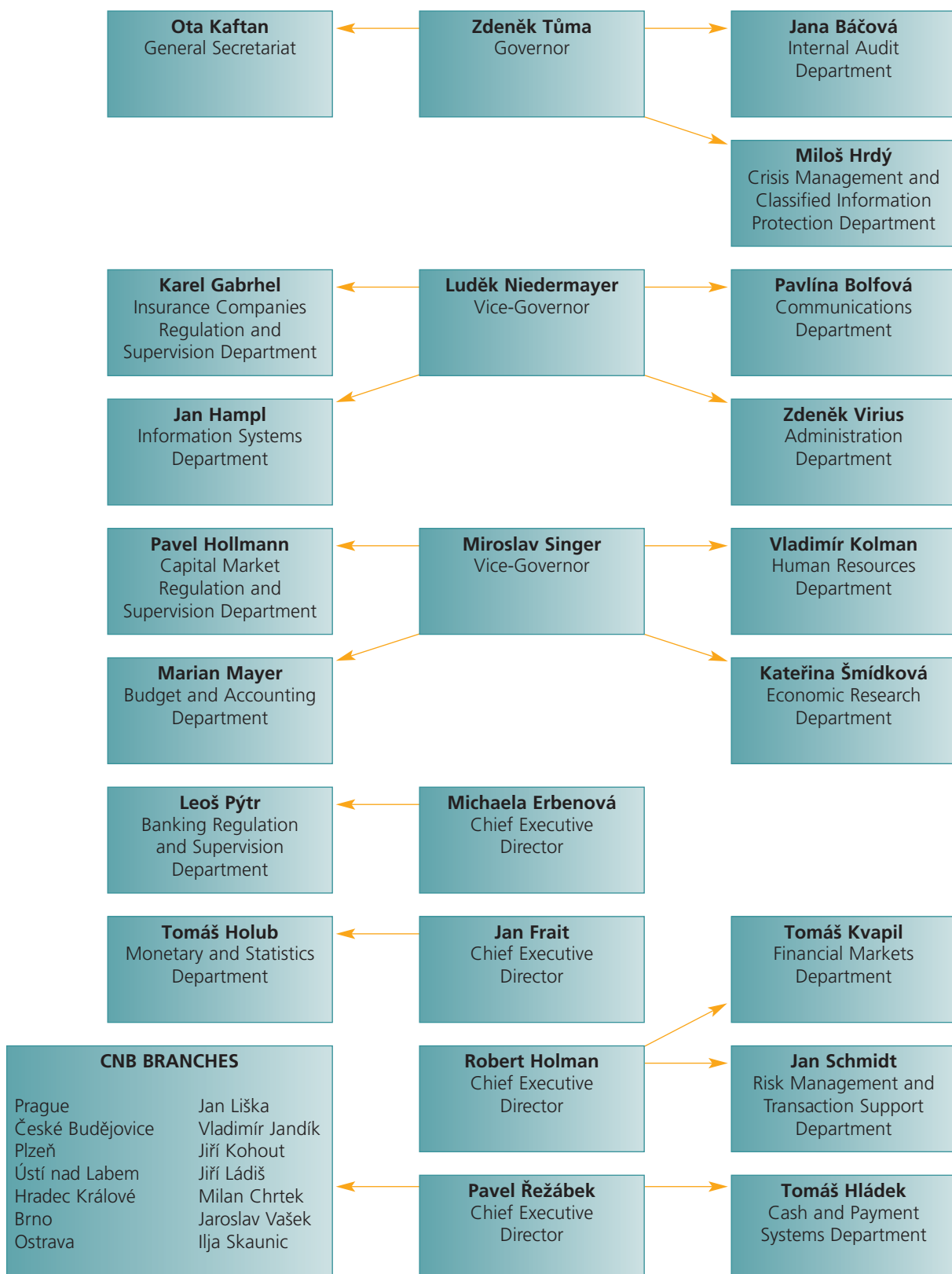


1. Milan Chrték (Hradec Králové branch),  
2. Jiří Ládiš (Ústí nad Labem branch), 3. Jan Liška (Prague branch),  
4. Vladimír Jandík (České Budějovice branch),  
5. Jaroslav Vašek (Brno branch), 6. Jiří Kohout (Plzeň branch),  
7. Ilja Skaunic (Ostrava branch)

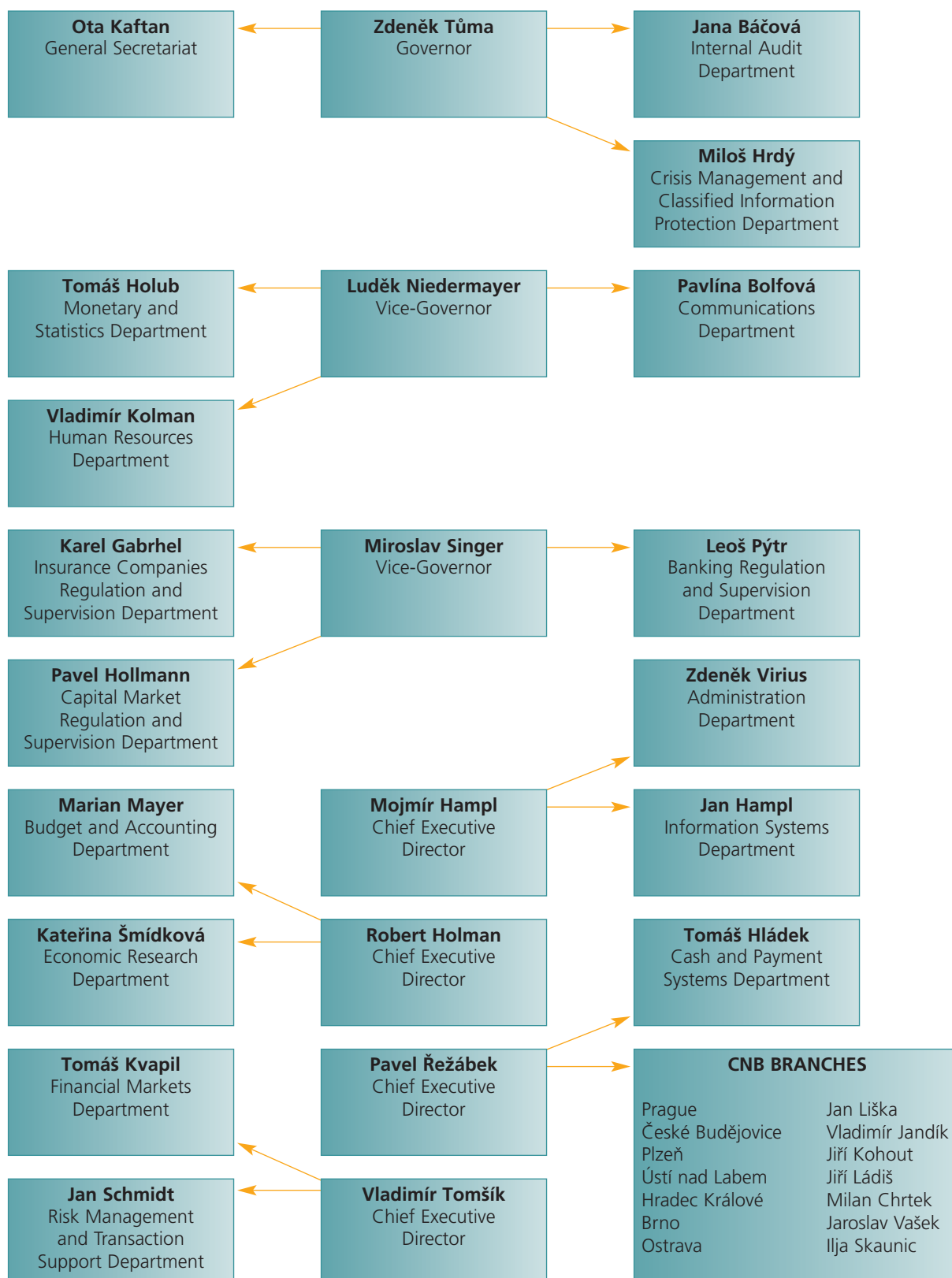




## ORGANISATIONAL CHART AS OF 30 NOVEMBER 2006



## ORGANISATIONAL CHART AS OF 31 DECEMBER 2006





## THE CNB'S OBJECTIVES AND TASKS AND THEIR FULFILMENT



In its strategic document *Challenges for the Czech National Bank in 2005–2010*, the CNB published the main subject areas that will be crucial for successful fulfilment of its mission in the years ahead. *The Czech National Bank's Medium-term Plan for 2005–2010*, approved by the Bank Board at the end of 2004, builds on this document by specifying the key areas, processes and methods in detail (see the CNB website: *About the CNB – Mission and functions*).

The CNB's mission is to continue promoting the smooth development of the economy and thereby of society as a whole. A prerequisite for fulfilling these objectives in the monetary and regulatory areas is central bank independence of the political cycle. Independence, however, must be balanced by accountability, which – together with professionalism, transparency and efficiency – reinforces the central bank's credibility.

On 1 May 2004, the Czech Republic became an EU Member State and the CNB became part of the European System of Central Banks (ESCB). In addition to its tasks in the fields of monetary policy, financial market supervision and regulation, its current challenges therefore involve tasks related to the functioning of the central bank as a representative of the state and a partner of European institutions and the national monetary policy authorities of other EU Member States. The CNB's status at European level is ensured by high-quality personal representation in European structures and active involvement in negotiations, especially in those areas where the CNB has a high level of expertise.

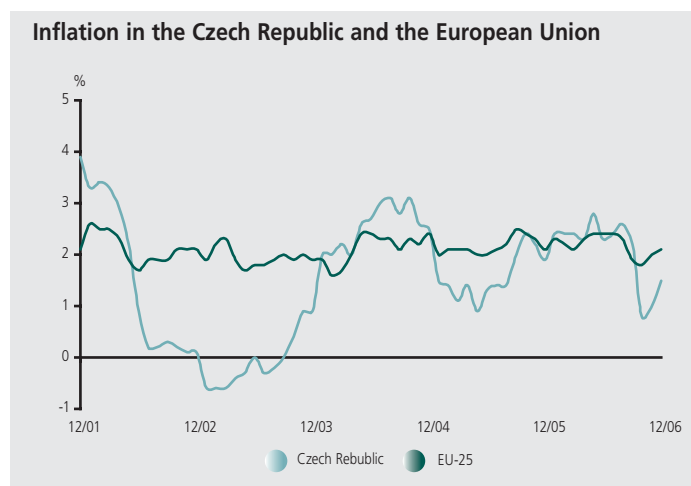
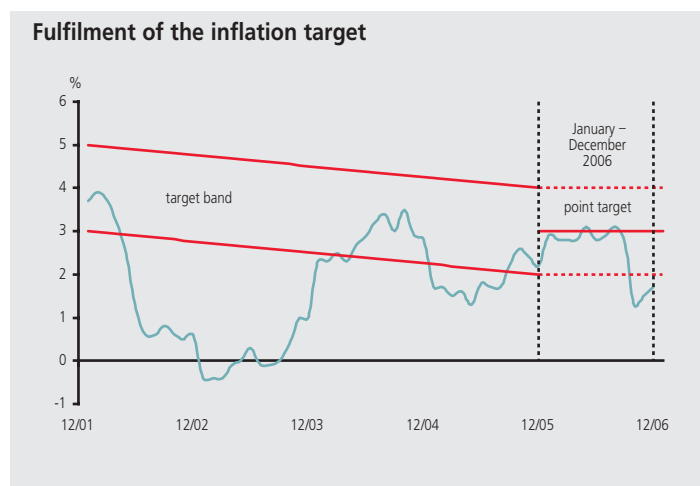
The CNB's main objectives for 2005–2010 can be defined as follows:

- to stabilise inflation at the low level defined by the inflation target;
- to work closely with the Government to lay the groundwork for smooth adoption of the euro and stable development of the Czech economy within the European Monetary Union;
- to introduce the new capital adequacy framework and successfully complete the unification of financial market regulation and supervision;
- to further develop its analytical and research capacity;
- to establish itself as a respected ESCB member representing the interests of the Czech Republic;
- to prepare comprehensively for the introduction of the single European currency, including putting euro cash into circulation and connecting the domestic payment and settlement system to EU systems;
- to develop human capital so as to make the CNB an open institution capable of adapting to new requirements, with a corporate culture based on professionalism, transparency and efficiency;
- to analyse the position of the euro-area National Central Banks well before adoption of the euro, identify future changes in the CNB's activities, determine their impacts and ensure timely institutional adjustment.

### MONETARY POLICY AND ECONOMIC DEVELOPMENTS

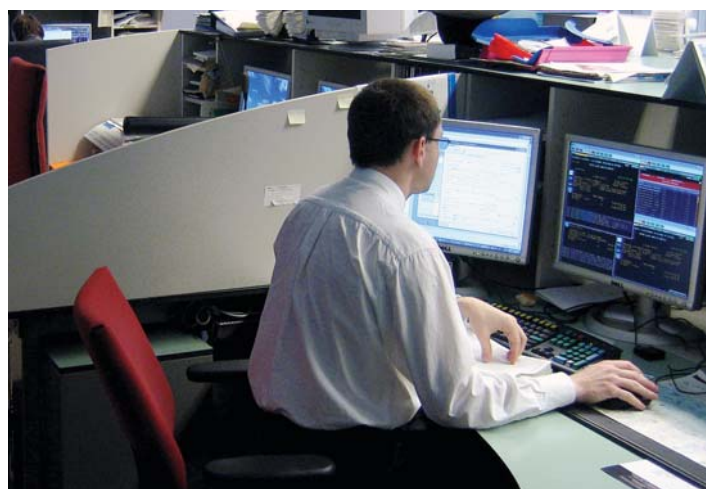
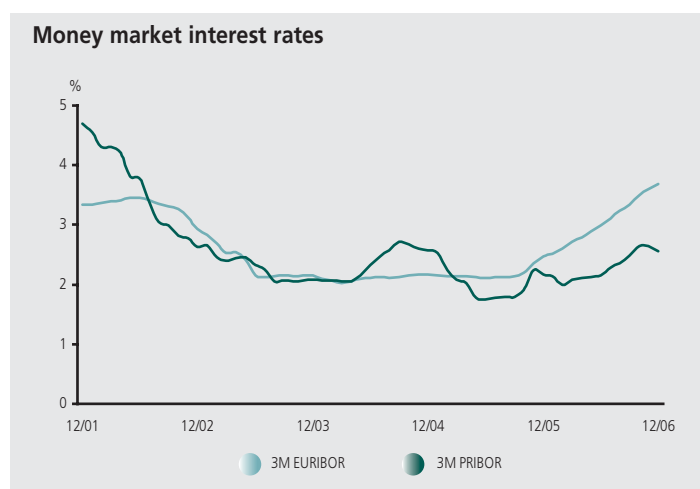
The CNB's primary monetary policy objective is expressed as an inflation target, i.e. the level at which the CNB tries to keep inflation. At the start of 2006, the annual inflation target in the form of a band descending evenly from 3%–5% in January 2002 to 2%–4% in December 2005 was replaced by a horizontal point inflation target of 3%. The CNB endeavours to ensure that actual inflation does not differ by more than one percentage point in either direction from this target. This new inflation target was announced in advance in March 2004 (for more details see the CNB website: *Monetary policy – MP strategic documents – The CNB's inflation target from January 2006*).

For most of 2006, inflation was higher than in the previous year, although it fluctuated very close to the inflation target. In the fourth quarter, inflation fell sharply and was below the lower boundary of the tolerance band of the inflation target.



Annual consumer price inflation was broadly stable in the first three quarters of 2006, fluctuating between 2.7% and 3.1%. In October, however, it declined to 1.3%, i.e. roughly half the September level, mainly because of a slowdown in annual regulated price inflation. In the remaining months of the year it showed only a very modest rise. In the first three quarters of 2006, HICP inflation was slightly above the average inflation level in the EU countries, but in the final quarter it was considerably lower.

Domestic interest rates (illustrated in the chart by 3-month interbank money market rates) remained lower than the corresponding EURIBOR rates. This difference gradually widened during 2006.

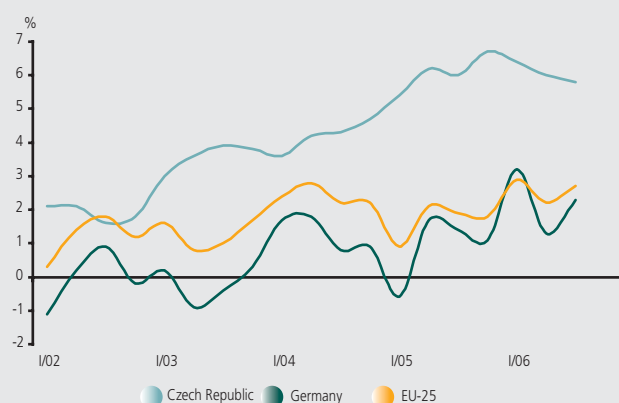


In 2006, consumer prices were most affected by regulated prices, which on average accounted for roughly three-quarters of headline inflation. The rise in inflation in the first nine months of 2006 compared to the previous year was due mainly to faster growth in prices of electricity, heat and natural gas for households as from

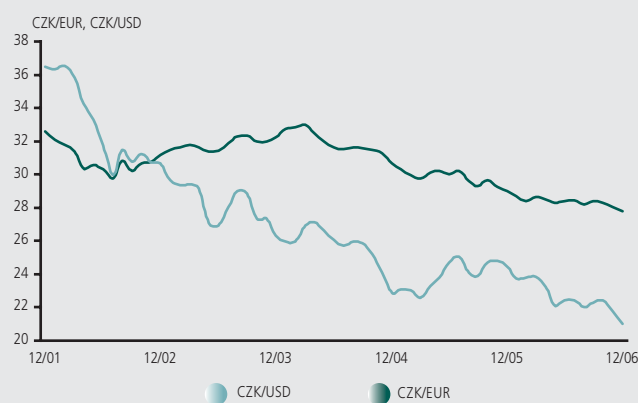
the end of 2005. The sharp slowdown in annual consumer price inflation in the fourth quarter primarily reflected a decline in regulated price inflation in the category of housing, water, energy and fuels, which, in turn, was largely due to an easing of world prices of energy-producing materials. The other major price categories had a less significant effect on headline inflation and, moreover, the individual effects offset each other to a large extent. The inflation pressures from the real economy remained subdued.

The rate of growth of the Czech economy in 2006 was roughly the same as in the previous year (around 6%). As in the previous four years, it was much stronger than in Germany and compared to the EU average. There was, however, a change in the structure of economic growth compared to the previous year. The contribution of foreign trade, which had been dominant in 2005, decreased considerably, although the rate of growth of exports remained high. By contrast, the contributions of changes in inventories, fixed investment and, to a lesser extent, household consumption all increased. Although GDP fluctuated above its potential, the resulting moderate inflation pressures were offset by anti-inflationary real wages, so overall there were no noticeable inflation pressures from the real economy.

Gross domestic product



Nominal exchange rate of the koruna against the euro and dollar



The nominal exchange rate of the koruna against the euro appreciated during 2006 (particularly in the last two months), despite the fact that domestic interest rates were more than one percentage point lower than euro area rates. The depreciation effect of the negative interest rate differential was outweighed by the opposite effects of other factors, most notably the increasing attractiveness of the Central European region for investors, linked, in turn, with expected rapid economic growth. The stronger koruna-euro rate reduced the prices of most imported commodities, thereby contributing to the low inflation level. Owing to the weakening exchange rate of the dollar against the euro, the koruna-dollar rate appreciated even more than the koruna-euro rate, alleviating the effect of the high prices of energy-producing materials on world markets. As in the previous year, the CNB made no interventions in the foreign exchange market.

The trade balance was favourable despite the continuing appreciation of the koruna, modest external demand growth and (for most of the year) rising prices of energy-producing materials. In 2006, the trade surplus (of CZK 47.3 billion) was slightly higher than in the previous year. However, the current account deficit widened significantly, mainly because of a worsening income balance. The financial account surplus remained roughly at the previous year's level. A decline in the direct investment surplus to approximately half the level recorded in 2005 was offset by a renewed inflow of other investment and a smaller outflow of portfolio investment.

The inflation forecasts on which monetary policy was based in 2006 suggested a

gradual rise in inflation in 2007 and 2008. The forecasts were based mainly on expected relatively fast growth in regulated prices and on the price impacts of a harmonisation-related increase in excise duty on tobacco products. They also took into account a subsiding of the anti-inflationary pressures from the real economy, an assumed future weakening of the anti-inflationary effect of the koruna's appreciation, a rise in inflation expectations, a pick-up in food price inflation and easy fiscal policy. To keep inflation adjusted for the first-round effects of changes to indirect taxes (i.e. inflation to which monetary policy reacts) close to the point inflation target, it was therefore necessary – according to the forecast – to gradually raise interest rates. The interest rate path consistent with these forecasts gradually shifted upwards in the first three forecasts, particularly in the longer term. In line with the forecasts and an assessment of the balance of their risks, monetary policy interest rates were raised in 2006 in two steps – at the end of July and at the end of September – by half a percentage point overall. There were no rate increases in the remainder of the year, however, as the balance of the risks of the forecast shifted towards lower inflation owing to new information. At the end of 2006, the CNB's main monetary policy interest rate – the two-week repo rate – thus stood at 2.50%, well below the corresponding rate in the euro area.

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

A document drawn up jointly by the CNB and the Ministry of Finance entitled *Assessment of the Fulfilment of the Maastricht Convergence Criteria and the Degree of Economic Alignment of the Czech Republic with the Euro Area*, (available on the CNB website: *Monetary policy – MP strategic documents – Assessment of the Fulfilment of the Maastricht Convergence Criteria and the Degree of Economic Alignment of the Czech Republic with the Euro Area – October 2006*), which analysed the current and expected situation in that area, was completed in the autumn of 2006 and approved by the Government on 25 October. Based on these analyses, the document recommended that the Czech Government should not attempt to enter the ERM II during 2007. This decision means postponing the Czech Republic's potential entry into the euro area beyond the originally planned horizon of 2009–2010. At the same time, the CNB flagged the possibility of a future reduction of the inflation target to a level allowing the criterion on price stability, as interpreted by the European Commission and the European Central Bank, to be fulfilled with a high degree of probability.

## THE BANKING SECTOR AND ITS REGULATION

The Czech banking sector saw no fundamental changes in 2006. In terms of the number of banks and their ownership, the sector has been stable in structure for several years now. Almost 97% of the sector's total assets are either directly or indirectly controlled by foreign owners.

At the end of 2006, a total of 24 banks and building societies and 13 foreign bank branches were offering banking services to clients in the Czech Republic. Since EU accession in 2004, the single banking licence system has applied in the Czech Republic. Banks from an EU home country are thus entitled to benefit from the freedom to provide services in all Member States without having to apply for approval from the host state. As a result, any bank having a licence from an EU country may expand its business across the entire EU area, either by establishing branches or by cross-border provision of services not having the character of permanent economic activity.

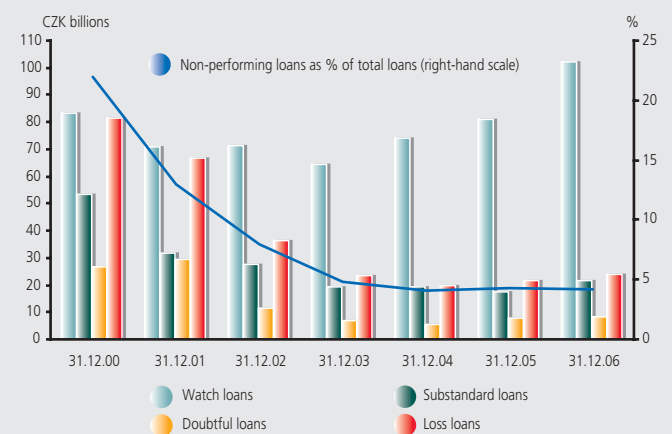
In 2006, one foreign bank branch opened for business in the Czech Republic under the single banking licence system. The number of institutions that had notified the CNB of provision of cross-border services in the Czech Republic increased by 37 to 145 in 2006. Two institutions with a banking licence granted by the CNB reported that they were providing services outside the Czech Republic under the freedom to provide services.



**Sectoral breakdown of claims**

in CZK billions	31 Dec. 2004	31 Dec. 2005	31 Dec. 2006
Residents and non-residents, total	1,010	1,186	1,413
Residents	969	1,119	1,339
Non-financial corporations	460	525	635
Financial corporations	81	97	99
General government	115	81	68
Households	312	413	531
Households - trades	29	33	36
Households - individuals	283	380	495
Non-profit institutions serving households	2	2	6
Non-residents	41	67	74

In 2006, the total assets of the banking sector rose by CZK 196.3 billion to CZK 3,150.7 billion.<sup>2</sup> The increase in total assets largely reflected continued growth in lending. New loans were channelled into both the household sector and the corporate sector (which recorded annual increases of 30.4% and 20.8% respectively).

**Loans to households (residents)****Credit portfolio quality (individually assessed loans)**

Alongside the growth in the loan portfolio, the volume of non-performing loans (i.e. loans classified by banks as substandard, doubtful or loss) rose by CZK 7.1 billion to CZK 54.2 billion in 2006. However, their share of the total loan volume remains low, at 4.1% as of 31 December 2006.

Client deposits rose by 9.5% to CZK 2,102.2 billion in 2006. Further growth was recorded particularly for demand deposits (an annual increase of CZK 119.8 billion, or 12.5%), whereas time deposits grew more slowly (by CZK 62.8 billion, or 6.5%).

The total volume of regulatory capital used to calculate capital adequacy increased by CZK 28.6 billion to CZK 195.7 billion in 2006. The growth in lending led to a rise in the volume of risk-weighted assets and an increase in capital charges. The resulting capital ratio fell from 11.9% to 11.4% year on year. All domestic banks constantly exceeded the minimum capital adequacy requirement of 8%.

<sup>2</sup> The figures for the banking sector are based on unaudited results of banks as of 31 December 2006.

The banking sector was again profitable in 2006, although the net profit of CZK 37.9 billion was CZK 1.2 billion lower than a year earlier. Compared to 2005, however, the 2006 profit was less affected by specific one-off revenues. In 2006, a positive trend was again recorded in particular for interest profit, which rose by CZK 8.3 billion year on year to CZK 72.4 billion. Profit from fees and commissions grew by CZK 1.1 billion to CZK 32.9 billion, i.e. less than would correspond to GDP growth. Administrative expenses rose by CZK 3.9 billion to CZK 55.7 billion. Write-offs and creation of provisions increased as well, rising by CZK 1.3 billion to CZK 14.4 billion in 2006.

Banking sector indicators					
	31 Dec. 2002	31 Dec. 2003	31 Dec. 2004	31 Dec. 2005	31 Dec. 2006
No. of banks and foreign bank branches	37	35	35	36	37
Total assets (CZK bn)	2,481.1	2,527.7	2,635.6	2,954.4	3,150.7
Liabilities to clients (CZK bn)	1,608.7	1,665.9	1,731.8	1,919.6	2,102.2
Net profit (CZK bn)	30.4	30.2	32.9	39.1	37.9
Administrative expenses (CZK bn)	47.0	47.5	48.8	51.8	55.7
Capital adequacy (%)	14.3	14.5	12.6	11.9	11.4
Non-performing loans to total loans (%)	8.1	4.9	4.1	4.3	4.1
No. of bank employees	39,493	39,004	38,158	37,540	38,232
No. of banking units	1,631	1,670	1,785	1,825	1,877
No. of ATMs	1,975	2,572	2,750	3,005	3,281

A total of 38,232 people were employed in the banking sector as of 31 December 2006, a rise of 692 compared to the end of 2005.

Basic banking sector indicators updated on a quarterly basis are available on the CNB website (*Financial market supervision – Banking supervision – Banking sector – Basic indicators of the banking sector*).

### Assumption of responsibility for credit union supervision

On 1 April 2006, in connection with the integration of supervisory activities, the CNB assumed responsibility for supervising the credit union sector. At present, 20 credit unions with valid licences are operating on the market, with total assets amounting to around CZK 7 billion as of 31 December 2006. In 2006, CNB supervisors focused on reviewing the current situation in the sector and in selected credit unions, tackling major problems and harmonising the procedures for the supervision of credit unions with those applied to banks. In this context, on-site examinations were commenced sequentially in 10 credit unions.

### What's new in regulation

Several laws were passed in 2006 changing and regulating the business activities of banks, credit unions and other entities subject to regulation and supervision. These amendments, which to varying extents concerned the Act on the Czech National Bank, the Act on Banks, the Act on Credit Unions and the Payment Systems Act, had a significant effect on the conduct of banking supervision.

The most substantial change was that on 1 April 2006 the Czech National Bank became the sole domestic supervisory authority in the Czech financial sector. In the banking sector it supervises banks, branches of foreign banks, credit unions, electronic money institutions, branches of foreign electronic money institutions and other entities that issue electronic money under special legal rules. As regards branches of banks from EU countries, however, primary responsibility for supervision of these entities still lies with the supervisory authority in their country of origin (the home regulator). The CNB's supervisory competences are limited primarily to monitoring liquidity and compliance with the obligations arising from the Act on Banks.

The issuing of licences to banks or branches of foreign banks (from countries outside the European Economic Area) and certain matters associated with mergers, transfers of assets to partners and dissolutions of banks are now fully within the authority and powers of the Czech National Bank. The terms "electronic money institution" and "foreign electronic money institution" – meaning a joint-stock company or European company which has its registered office in the Czech Republic and which issues electronic money under a licence granted by the Czech National Bank – have been introduced into Czech law.

A fundamental addition to the financial markets legislation was the issuing of Decree No. 347/2006 Coll., implementing some provisions of the Act on Financial Conglomerates. The decree regulates in detail the methods for calculating the supplementary capital adequacy requirements for financial conglomerates, specifies the documents required for the assessment of the trustworthiness of persons, and lays down conditions for regulatory reporting.

Another completely new legal rule is the Insolvency Act, which will replace the existing inadequate Act on Bankruptcy and Composition. The Insolvency Act introduces a new bankruptcy framework and new bankruptcy resolution methods. In relation to the banking sector it contains special provisions on the bankruptcy of banks, credit unions, electronic money institutions and entities authorised to issue electronic money, as well as foreign banks, foreign electronic money institutions and foreign entities authorised to issue electronic money.

Major changes will be made to the Act on Banks and the related subordinate regulations in connection with the adoption of the new capital framework (see below).

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

In November 2005, the Basel Committee on Banking Supervision published an updated version of the new capital framework, often referred to as Basel II. However, given the Czech Republic's membership of the EU, Basel II – in the form resulting from its transformation into the relevant directives 2006/48/EC<sup>3</sup> and 2006/49/EC<sup>4</sup> – is and will continue to be crucial for the Czech Republic. These directives were published in the EU Official Journal on 30 June 2006. The directives should have been incorporated into the member states' national legislation with effect from 1 January 2007. However, owing to delays in legislative processes caused by the political discussions following the June elections, the new rules are not expected to take effect in the Czech Republic until July 2007.

The CNB worked closely with the Ministry of Finance in preparing other legislative amendments implementing Basel II, namely amendments to the Act on Banks, the Credit Unions Act and the Capital Market Undertakings Act. The CNB also drafted a related CNB decree implementing the above acts and, following the integration of financial market supervision, held consultations on it – via the relevant associations – with the regulated entities concerned (banks, credit unions and investment firms). In 2006, the CNB worked more closely with the regulated entities that intend, in connection with Basel II, to switch in 2007 to one of the special (advanced) capital requirement calculation approaches, which require verification and subsequent approval from the competent supervisory authority. In this context, CNB Banking Supervision continued to communicate and co-operate with relevant foreign supervisory authorities. In the case of selected regulated consolidated groups (whose members include banks in the Czech Republic) which have applied at European level

<sup>3</sup> Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions.

<sup>4</sup> Directive 2006/49/EC of the European Parliament and of the Council of 14 June 2006 on the capital adequacy of investment firms and credit institutions.

to use a special approach, the co-operation focused on the issue of granting consent to such approaches and on the division of responsibilities between home and host regulators. The CNB's approach to implementing the new capital framework, including progress with legislative work, is published and regularly updated on the CNB website (*Financial market supervision – Banking Supervision – Basel II*).

### **International co-operation**

As mentioned above, bilateral co-operation with partner banking supervisors became increasingly important in 2006 owing to the need to jointly assess the special approaches of banks in the credit and operational risk areas in compliance with the new capital adequacy directive. CNB Banking Supervision is currently involved in the work of the committees and working groups of the European Commission, the European Central Bank and the Bank for International Settlements. About one-quarter of the CNB's supervisory staff were involved in various ways in the activities of five committees and twelve working groups in 2006. Following the integration of financial market supervision into the Czech National Bank on 1 April 2006, the supervisory departments together formulate and communicate to international institutions their collective opinions on common issues relating to two or all sectors of the financial market.

### **Use of the Central Register of Credits**

The Central Register of Credits has served banks as credit risk mitigation instrument since 2002. In 2006, the options for using it were further extended to include a clear timeline of clients' credit commitments and their quality, the option of entering groups of connected clients and acquiring aggregated data on the credit exposures of such groups, and access to aggregated banking sector data via an analytical module. In 2006, aggregated data from the register were also used for the first time by CNB analysts from the financial stability unit. Starting in 2007, data from the register will be included in the banking supervision information base. As of 31 December 2006, a total of 143,000 legal entities and 214,000 individual entrepreneurs with liabilities amounting to CZK 911 billion were recorded in the Register.

### **Banking supervisory activities in 2006 in figures**

- 17 on-site inspections were carried out in 2 banks, 4 building societies and 10 credit unions.
- In the area of licensing and authorisation, 12 prior consents to the acquisition of qualifying holdings in banks, one prior consent of the regulator to an agreement on the sale of a business to a bank and one change (extension) to a licence were issued. One application for consent to invest another membership contribution in a credit union was refused.
- In 2006, CNB Banking Supervision conducted no penalty proceedings directed at revoking licences or imposing fines for violations of the Act on Banks or the Act on Credit Unions.
- 13 remedial measures were imposed on banks and 3 on credit unions.
- 64 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.
- 18 opinions were issued on nominees for managerial positions in banks and 22 prior consents were issued regarding the assessment of compliance with the conditions for the performance of the position of member of a credit union body or senior officer.

Detailed information on developments in the banking and credit union sectors and on banking supervisory activities will be presented in a new CNB publication, the Financial Market Supervision Report, which will be issued in June 2007.

### THE INSURANCE INDUSTRY

The CNB's Insurance Companies Regulation and Supervision Department is the successor to the Ministry of Finance's Office of State Inspection in the Insurance and Pension Scheme Industry. It was integrated into the CNB as an organisational unit on 1 April 2006 (together with the Czech Securities Commission). At the CNB, the Insurance Companies Regulation and Supervision Department is no longer responsible for private pension schemes, as this area of competence has been transferred to the Capital Market Regulation and Supervision Department.

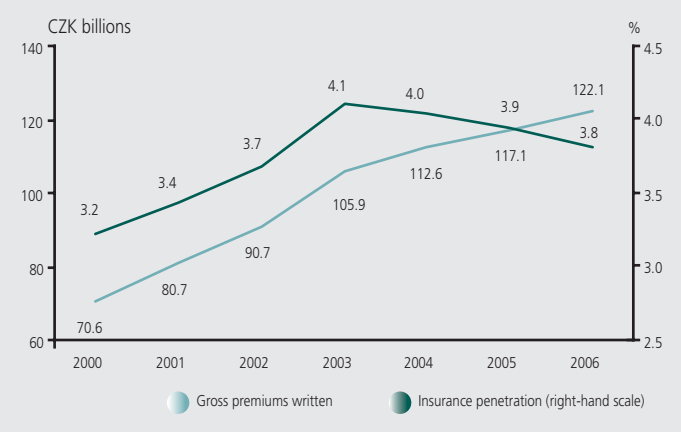
#### Insurance sector developments

The insurance sector recorded no major changes threatening its proper operation in 2006. As of 31 December 2006, there were 33 domestic insurance companies (life, non-life and universal) carrying on business in the Czech market (the same number as a year earlier), along with 16 branches of foreign insurance companies (compared to 12 branches as of 31 December 2005).<sup>5</sup> A significant number of insurance companies and branches of insurance companies from EU and EEA Member States declared their intention to provide services temporarily in the Czech Republic; as of the end of 2006 they totalled 401. According to the latest available data (for 23 countries) their market share as of 31 December 2005 was 1% of the total premiums written on the Czech market.

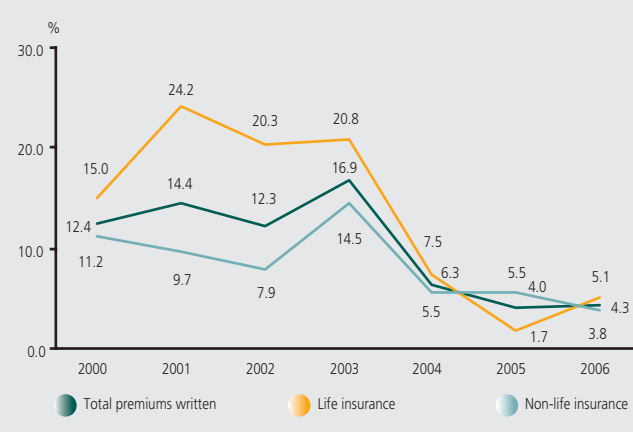
As for capital origin, there are 20 domestic insurance companies with a controlling share of foreign capital and 13 with a controlling share of domestic capital. Of the foreign shareholders, those from Austria accounted for the largest share (25.6%) of the total registered capital of Czech insurance companies. The share of the four largest insurance companies operating on the Czech market exceeds 65%. The level of market concentration is comparable with all the new EU and EEA Member States, although it exceeds the level in the old EU Member States. The Czech insurance market is highly competitive despite this higher concentration.

While gross domestic product increased by 6.1% year on year in real terms in 2006 (the same as a year earlier), premiums written in the Czech market rose by just 4.3%, confirming the 2005 tendency (an increase in premiums of 4.0%). Insurance penetration (premiums as a proportion of GDP) fell by 0.1 percentage point compared to 2005, to 3.8%.

Gross premiums written and insurance penetration



Rate of growth of gross premiums written



<sup>5</sup> These figures do not include the Czech Insurers' Bureau.

### **Insurance intermediaries**

In 2006, the CNB recorded a total of 12,762 legal/natural persons in the Register of Insurance Intermediaries and Independent Loss Adjusters<sup>6</sup>, 121 of which were insurance agents and 58 insurance brokers. At the end of 2006, a total of 50,121 insurance intermediaries were entered in the register, 2,390 of them foreign.

### **Regulation – new legislation**

There were no major changes in the legislative area in 2006. Decree No. 303/2004 Coll., implementing certain provisions of the Act on Insurance, was slightly amended twice by means of Decree No. 96/2006 Coll. and Decree No. 458/2006 Coll. The provisions on financial investment structure limits underwent some changes in formulation and the adjusted solvency calculation method was modified on the basis of Directive 2002/87/EC on financial conglomerates.

The amendment also affected Decree No. 582/2004 Coll., implementing certain provisions of the Act on Insurance Intermediaries and Independent Loss Adjusters (as amended by Decree No. 40/2006 Coll.). The list of training institutions in the annex to this decree was extended.

### **Co-operation with the Ministry of Finance**

Under an agreement of 2 May 2006 signed between the Czech National Bank and the Ministry of Finance on co-operation in the preparation of draft national legislation concerning the financial market, the Ministry of Finance initiated the preparation of a new Act on Insurance at the end of 2006. This act will, among other things, incorporate Directive 2005/68/EC on reinsurance. The CNB is working on the bill in co-operation with the Ministry and representatives of the Czech Insurance Association.

### **Solvency II project**

Solvency II is an entirely new risk-oriented approach to insurance regulation and supervision and is analogous to Basel II in banking. The Solvency II project is based on three pillars – the assessment of quantitative (particularly capital) requirements, the setting of supervisory powers and responsibilities (qualitative requirements) and the regulation of reporting and information disclosure by supervised entities. In the legislative area, a European directive is under preparation and is expected to be completed in July 2007, by which time a European Commission proposal should have been prepared for the legislative process.

The second round of the Quantitative Impact Study (QIS 2) – aimed primarily at testing capital requirement calculation methods – took place in mid-2006. Two Czech insurance companies contributed to the study.

### **International co-operation**

The Insurance Companies Regulation and Supervision Department co-operated internationally in several areas and at several levels in 2006. Roughly one-third of the staff of this department participated actively or passively in such co-operation.

Within the EU, the most significant involvement is in CEIOPS expert groups in work on the Solvency II Project, specifically the Pillar 1 and Pillar 3 expert groups.

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<sup>6</sup> The Register of Insurance Intermediaries is available on the CNB website at <http://ispoz.cnb.cz>.

Outside the EU, the Insurance Companies Regulation and Supervision Department also co-operates with the IAIS<sup>7</sup> and partner supervisory authorities. In the latter area, a memorandum of understanding was signed with the Swiss supervisory authority in 2006 on exchange of information and co-operation in supplementary supervision of insurance companies in a group.

### **Inspection work**

Inspection work is one of the CNB's core activities in the supervision of insurance companies. This work involves in particular monitoring insurance companies' ability to fulfil the obligations arising from their insurance or reinsurance activities. Supervision takes the form of on-site inspections and off-site surveillance. When selecting entities for on-site inspections, the results of off-site surveillance, i.e. analysis of insurance companies' financial and other statements, are taken into consideration.

Two on-site inspections launched in 2005 were completed in early 2006. A total of 11 new inspections were commenced, all of them comprehensive inspections. Of this number, inspection reports had been submitted to the responsible representatives of nine supervised entities by the end of 2006.

Of the total number of inspections completed in 2006, the CNB received objections to the wording of inspection reports from two supervised entities. In the other cases, the supervised entities did not exercise their right to file objections.

The CNB opened no administrative proceedings regarding the imposition of remedial measures in 2006.

It was decided in administrative proceedings to impose a duty on some insurance companies to present statements for inspection more frequently than stipulated by law. Five insurance companies fulfilled this duty in 2006, although two had the duty cancelled in the course of the year.

A significant change in 2006 associated with data reporting by insurance companies for the purposes of CNB supervision was the introduction of data collection via an automated SDNS<sup>8</sup> system, which replaced the previous e-mail reporting system.

Detailed information on insurance market developments and supervision of insurance companies is published in regular reports – most recently the *Insurance Market Supervision Report 2005*. This information can also be found on the CNB website (*Financial market supervision – Supervision of the insurance industry – Annual Reports – Annual reports: supervision of the insurance industry*).

### **THE CAPITAL MARKET**

The integration of financial market supervision into the Czech National Bank as of 1 April 2006 and the resulting transfer of the Czech Securities Commission's responsibilities to the Czech National Bank proceeded successfully. The integrated capital market supervisory authority continued seamlessly where the Czech Securities Commission had left off.

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<sup>7</sup> International Association of Insurance Supervisors

<sup>8</sup> Non-Banking Institution Data Collection.



Collective investment underwent significant changes in 2006. An amendment to the Act on Collective Investment allowed the establishment of real estate funds and funds for qualified investors. This led to increased interest in setting up investment companies that can manage such funds. At the end of 2006, there were approximately 40% more investment companies on the market than a year earlier and the first funds for qualified investors had been licensed. As part of the supervision integration process, the regulation and supervision of pension funds was transferred from the Ministry of Finance to the CNB, except for inspection of state contributions to pension schemes.

The supervisory work chiefly included inspection of the internal operations of investment companies. In the case of pension funds, the "risk-based" approach to inspection activities was introduced. From the regulatory point of view, the CNB focused primarily on unifying the secondary legislation in the reporting area, and work also started on a draft amendment to the Act on Private Pension Insurance.

Out of the active domestic collective investment undertakings and pension funds, a total of 13 investment companies, 11 pension funds, 9 depositories and 77 open-ended mutual funds, 26 of them standard funds, were subject to supervision as of 31 December 2006. The CNB also registered 1,271 foreign funds and 29 foreign investment companies from EU Member States as of the same date. Assets totalling around CZK 300 billion, invested by almost 5 million investors and pension planholders, were subject to supervision.

The investment services providers area saw no major changes in 2006, although intensive preparations were under way for implementing the Markets in Financial Instruments Directive (MiFID) and the directive relating to the capital adequacy of credit institutions (Basel II), particularly in the second half of the year. The two directives are expected to impact substantially on the business activities of investment firms. Basel II will open up the way to tailoring the regulatory requirements for the capital of specific investment services providers, while the MiFID will affect the nature of their business. The MiFID not only changes the regulatory obligations of the entities concerned, but also affects the established market structure and the way in which services are provided on the capital market. For many investment services providers this may generate new business opportunities.

The CNB registered 46 investment firms (13 of them banks) and 12 foreign entities from EU states providing investment services in the Czech Republic via their branches (10 of them banks) as of end-2006. Thirty rounds of broker examinations took place in 2006, with 270 participants. The CNB issued a total of 70 broker's licences and withdrew one such licence. As of 31 December 2006, the CNB thus registered a total of 1,859 licensed brokers. The CNB also issued 2,273 investment intermediary registration certificates and as at the end of the year registered 10,628 predominantly natural persons with such registration. In 2006, the CNB notified 83 foreign entities intending to provide investment services in the Czech Republic under the free movement of services of their disclosure duties and rules of conduct towards clients. As of the end of 2006, the CNB thus registered a total of 293 foreign non-banking institutions authorised to provide investment services in the Czech Republic.

In the public markets area, the CNB in July granted the Prague Stock Exchange a licence to operate a market in selected financial and commodity futures, warrants and investment certificates. For the settlement of transactions in such investment instruments, the CNB expanded the settlement system operator licence. Issues associated with extending trading on regulated markets to include new share issues were also addressed. Transactions executed on regulated markets were continuously monitored to detect undesirable situations in capital market trading, and work continued on refining the capital market monitoring information system.



Compliance with the duty of issuers' directors to report transactions in an issuer's securities was also checked.

In the field of securities issues, compliance with the information duties of 92 issuers of listed securities was supervised, the issue conditions of bonds and securities prospectuses were approved for the purposes of offers to the public, and notifications of managers' transactions by directors of issuers were verified. Company valuations in respect of public offers of contracts and takeover bids relating to listed shares were also reviewed. In 2006, a total of 83 company valuations for the purposes of squeeze-outs were reviewed in administrative proceedings, with consent granted in 66% of cases. In addition, the discharge of the obligation to report the exceeding of the legally defined thresholds of shares in all the voting rights of an issuer whose shares have been admitted to trading on official markets was inspected. The activity of national agency for assigning international codes to securities (ISIN) was performed.

### **Legislation in the capital market area in 2006**

Many changes were made to the primary capital market legislation during the year. Act No. 57/2006 Coll., on the Amendment of Acts in Connection with the Integration of Financial Market Supervision, took effect on 1 April 2006. Under this act, the responsibilities of the Czech Securities Commission were transferred to the Czech National Bank. The act also amended Act No. 15/1998 Coll., which, renamed the Act on Capital Market Supervision and on the Amendment of Other Acts, contains general rules for CNB supervision in the capital market area.

The Capital Market Undertakings Act was amended six times during the year. Most of the changes were of a technical nature and related to the integration of supervision. The more substantial changes which the CNB (and the Czech Securities Commission) worked on in co-operation with the Ministry of Finance involved the transposition of the directive on prospectuses. Act No. 562/2006 Coll. (known as the "technical amendment") incorporated the directive on prospectuses, completed the transposition of the directive concerning distance marketing of consumer financial services, and made some changes relating to the central depository of securities. This Act also transposed the issue of distance securities contracts into the Civil Code (amendment of Act No. 591/1992 Coll., on Securities). The changes arising from Act No. 57/2006 Coll. were mostly associated with the integration of supervision into the Czech National Bank. Further amendments arising from Act No. 62/2006 Coll., No. 70/2006 Coll. and No. 159/2006 Coll. were limited in nature and linked with amendments to the Payment System Act, the Act on the Implementation of International Sanctions and the Act on Conflicts of Interest.

The Collective Investment Act was amended three times in 2006. Act No. 224/2006 Coll., which introduced new regulations for special funds, was a major change. It defined funds intended for the public (among them substantially amended real estate funds) and funds intended for a limited group of entities (funds for qualified investors).

### **International co-operation**

Co-operation between capital market supervisory authorities in the EU took the form of participation in the Committee of European Securities Regulators (CESR) as well as bilateral contacts and inquiries according to individual regulators' needs. The CNB participated in the work of 14 CESR expert groups. CNB representatives were actively involved primarily in the expert group dealing with key legal regulations in the capital market area, i.e. the Markets in Financial Instruments Directive and its implementing regulations. A new framework for collective investment regulation in the EU was discussed in the Investment Management Expert Group. In addition, the CNB took part in the discussions of two operational groups focused on market integrity and financial reporting (CESR-Pol and CESR-Fin).

Besides co-operation within European structures, the CNB contributed to the activities of the International Organisation of Securities Commissions (IOSCO) and negotiated accession to the Multinational Memorandum of Understanding, which is to replace bilateral MoUs. The primary objective of this Memorandum is to facilitate information-sharing in the event of cross-border violations of capital market laws.

### **Supervisory activities in 2006 in figures**

- In the area of licensing and authorisation, 140 decisions were issued in the area of collective investment and pension funds concerning the approval of directors, the approval of changes to statutes, licences to establish investment companies and mutual funds, etc; a further 193 decisions were issued in the investment services area, mostly relating to the issuance, extension or withdrawal of investment firm licences, broker's licences, registration of investment intermediaries, prior consents to the discharge of office of director of an investment firm, etc.
- 97 decisions were issued in administrative or administrative offence proceedings
- 18 on-site inspections were carried out; a total of 12 examinations were undertaken in collective investment and pension funds, 4 of which concerned the internal operations of investment companies, 5 concerned risk assessment of pension funds and compliance with the rules for the management of assets entrusted to third parties and the rules for calculating the real value of assets, and 3 concerned risk assessment of depositories' activities. In the area of investment service provision, 5 state on-site inspections were commenced, 4 of them in investment firms and one in an investment intermediary. One on-site inspection was carried out in the public markets area.
- 281 standard foreign funds were given approval to offer securities to the public, and 35 foreign funds terminated their activities in the Czech Republic.
- The number of notifications from foreign banks providing investment services without establishing an organisational unit in the Czech Republic increased by 81, and two foreign banks gave notification of providing investment services via an organisational unit.
- A total of 198 administrative proceedings were conducted in the area of securities issues, 79 of which concerned the approval of documents connected with new securities issues, 21 concerned the granting of consent to the publication of takeover bids, 83 concerned the application of the squeeze-out principle, and 15 concerned the information duties of issuers of listed securities.

Detailed information on developments in the capital market sector and capital market supervision are published in the CNB publication *Financial Market Supervision Report 2006*, which, together with other information, analytical publications and lists of supervised entities, can be found on the CNB website.

### **THE CNB AS A FOREIGN EXCHANGE AUTHORITY**

Under powers contained in Act No. 219/1995 Coll., the Foreign Exchange Act, as amended, the CNB is responsible for regulation and supervision in the foreign exchange area. These activities include issuing foreign exchange licences (in particular for cash sales of foreign currency, non-cash foreign currency transactions and provision of financial services) and overseeing compliance with the foreign exchange regulations. In the foreign exchange area, the CNB thus regulates and supervises the activities of money changers and non-banking institutions offering non-cash conversion of foreign currency or intermediation of payments abroad and accepting payments from abroad. The number of applications for foreign exchange licences submitted last year and the way in which they were dealt with is shown in the following table:

**Number of foreign exchange licence applications in 2006**

	Total	Foreign exchange licences granted	Foreign exchange licences refused	Licences valid as of 31 December 2006
Prague	6	3	2	92
Č. Budějovice	1	1	0	28
Plzeň	2	2	0	32
Ústí nad Labem	2	2	0	33
H. Králové	1	1	0	11
Brno	5	3	1	39
Ostrava	3	2	1	36
Headquarters	7	6	1	47
<b>Total</b>	<b>27*</b>	<b>20</b>	<b>5</b>	<b>318</b>

\* Two proceedings had not been definitively closed as of 31 December 2006.

More detailed information on individual foreign exchange licence holders is available on the CNB website (*Financial market supervision – Foreign exchange supervision – Complete list of foreign exchange licences from the register of foreign exchange entities*).

In the case of foreign exchange licence holders, the CNB checks compliance with the foreign exchange regulations and fulfilment of the obligations arising from Act No. 61/1996 Coll., on Some Measures against Money Laundering and on the Amendment of Related Acts, and since 1 April 2006 also from Act No. 69/2006 Coll., on the Implementation of International Sanctions. The CNB also inspects compliance with the foreign exchange regulations by bureau-de-change licence holders. The number and orientation of the on-site inspections carried out by foreign exchange supervisors in 2006 are shown in the following table:

**On-site foreign exchange inspections in 2006**

CNB units	Completed		Purchase of foreign currency in cash	By orientation		
	With violations found	Without violations found		Sale of foreign currency in cash	Non-cash transactions, financial services, casinos	Other (unauthorised business, notification duty)
Prague	147	58	193	25	10	5
Č. Budějovice	35	7	40	11	0	1
Plzeň	40	9	38	14	1	1
Ústí nad L.	60	8	60	13	2	0
H. Králové	40	8	52	16	2	6
Brno	38	4	31	15	0	1
Ostrava	33	2	20	12	4	0
RMTSD	0	0	0	0	0	0
<b>Total</b>	<b>393</b>	<b>96</b>	<b>434</b>	<b>106</b>	<b>19</b>	<b>14</b>

Where it finds that the foreign exchange regulations have been contravened, the CNB imposes remedial measures or is authorised to impose penalties in administrative proceedings. A total of 33 administrative proceedings opened due to suspicion of violation of the foreign exchange regulations were definitively closed in 2006. The fines imposed in 2006 totalled CZK 1,540,000. These fines constitute revenues to the state budget. The CNB did not impose the restriction, suspension or withdrawal of foreign exchange licences in any of the proceedings conducted last year.

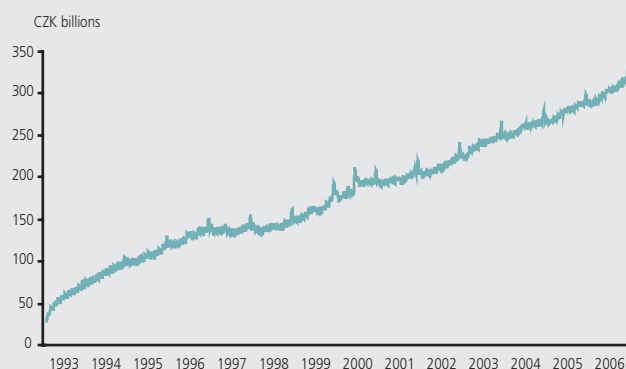
In 2006, as in previous years, most of the foreign exchange offences were due to breaches of the conditions for cash purchases/sales of foreign currency in return for Czech currency (in particular incorrectly made out and labelled deductions for foreign currency sales and purchases, insufficient identification of clients in transactions exceeding CZK 100,000, and failure to fulfil the reporting duty). The offence of unauthorised offering, performance or intermediation of foreign exchange trading (cash or non-cash) was identified in 7 cases.

## CURRENCY IN CIRCULATION AND THE PAYMENT SYSTEM

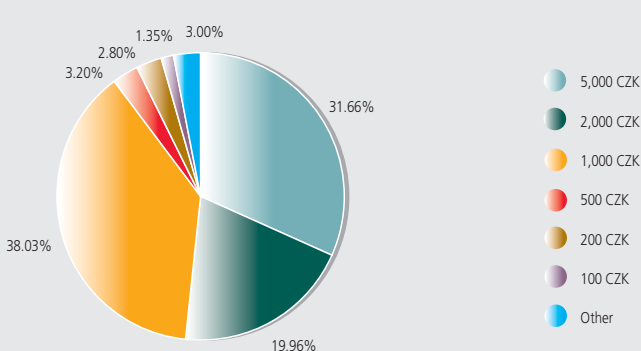
### Currency in circulation

The volume of currency in circulation increased by CZK 33.7 billion in 2006, reaching CZK 321.5 billion at the end of the year. This represents an increase of 11.7% compared to the end of 2005. The rate of growth in currency in circulation in 2006 was truly extraordinary in both koruna and percentage terms. The increase in currency in circulation was the largest in the history of the Czech currency in absolute terms, with the exception of 1999. The long-term annual average growth in currency in circulation rose to around CZK 18.8 billion.

**Currency in circulation in the Czech Republic – 8 Feb. 1993 to 31 Dec. 2006**



**Structure of currency in circulation (in CZK)**



The number of banknotes in circulation rose more slowly than currency in circulation in koruna terms. This was due to changes in the structure of banknotes in circulation, as the highest-denomination banknotes account for more than 95% of the growth in the value of currency in circulation in the long term. The number of banknotes in circulation rose by a mere 4.3% compared to 2005.

Both the value and number of coins in circulation increased significantly in 2006. The value of coins in circulation grew by 22.7% to CZK 7.6 billion. The number of circulating coins increased by 116.7 million. More than 34 million fifty-heller coins, 24 million one-koruna coins, 23 million fifty-koruna coins and more than 17 million two-koruna coins were put into circulation. By contrast, the withdrawal of ten- and twenty-heller coins continued at a very slow pace.

Cash turnover at the CNB's branches amounted to almost CZK 1,416 billion in 2006, up by 7.4% year on year. The growth in currency in circulation is being accompanied by an increase in the volumes of banknotes and coins accepted from circulation and processed at the CNB's branches. In terms of the number of banknotes and coins, the increase was just 3.1%. However, almost 2.6 billion banknotes and coins weighing more than 7,100 tonnes passed through the hands of cashiers, counting-house staff and money stock custodians during 2006.

In 2006, the CNB put into circulation commemorative silver coins with a total nominal value of CZK 19.1 million and gold coins with a total nominal value of CZK 28.96 million. Five commemorative silver 200 koruna coins were issued: to mark the 250th anniversary of the birth of physicist and engineer F. J. Gerstner and the 200th anniversary of the start of teaching at the Prague Polytechnic University; the 150th anniversary of the foundation of the School of Glassmaking in Kamenický Šenov; the 500th anniversary of the death of architect Matthias Rejsek; the 700th anniversary of the end of the male line of the Přemyslid dynasty; and the 100th



anniversary of the birth of composer Jaroslav Ježek. The first two 2,500 koruna gold coins were issued from the Industrial Heritage Sites cycle, featuring motifs of the Hand-Paper Mill at Velké Losiny in April and the Observatory at Prague Klementinum in September. Sales of legal tender, i.e. mainly precious metal coins, amounted to CZK 27.4 million. In November 2006, a sum of CZK 297.51 million was written to the CNB's income, representing the value of the federal silver commemorative coins that had not been returned from circulation by the time the exchange period expired.



As in 2005, training programmes were held in 2006 for sellers of foreign currency, who, under CNB Decree No. 434/2002 Coll., implementing Article 9(3) of Act No. 219/1995 Coll., the Foreign Exchange Act, are required to present a certificate demonstrating that they have completed a course on counterfeit recognition. In all, 495 people attended these courses in 2006, and a total of 2,047 people have attended the courses since the statutory duty came into existence.

The quantity of counterfeit Czech and foreign currency seized in the Czech Republic was lower than a year earlier. The denomination structure of the counterfeits seized and the ratio of counterfeits seized from circulation and by the police from counterfeiters and distributors prior to circulation recorded changes compared to 2005.

**Counterfeit and altered banknotes and coins seized in 2006**

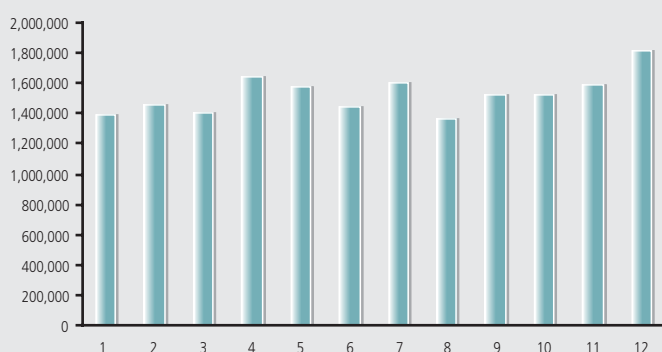
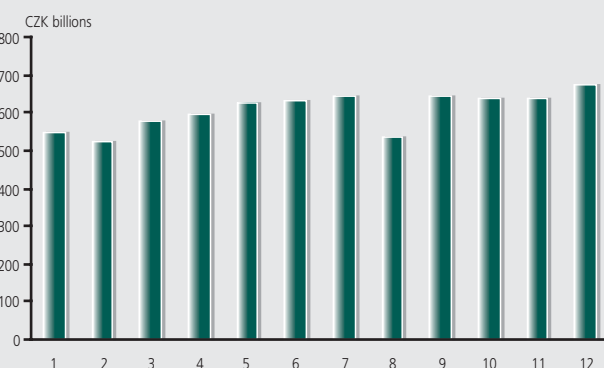
	Seized from circulation	Seized by the police	Total
Counterfeit CZK banknotes	1,643	4,629	<b>6,272</b>
Counterfeit USD banknotes	366	84	<b>450</b>
Counterfeit EUR banknotes	514	66	<b>580</b>
Other counterfeit banknotes	99	1	<b>100</b>
Counterfeit CZK coins	171	0	<b>171</b>
Counterfeit foreign currency coins	114	0	<b>114</b>
Altered CZK banknotes and coins	77	63	<b>140</b>
Altered foreign currency banknotes and coins	6	1	<b>7</b>
<b>Total</b>	<b>2,990</b>	<b>4,844</b>	<b>7,834</b>

### The non-cash payment system

By law, the Czech National Bank operates the non-cash payment system, i.e. it maintains the accounts of the central bank and the accounts of the state and it arranges interbank payments and settles short-term securities transactions. Non-cash payment transactions are executed through the CERTIS, SKD and ABO systems.

The CERTIS system processes interbank payments in the Czech Republic. The system participants are banks. As of 31 December 2006, the participants included 39 banks and 8 third parties – for example, card payment clearing houses and securities clearing and settlement institutions. The CERTIS2 project, consisting in the transfer of the core of the CERTIS system from a mainframe platform to a server environment, continued during 2006, the main aim being to cut the running costs of the system. The new system went live on 1 November 2006. The fees paid by system participants were reduced on 1 January 2007. CERTIS processed 382 million transactions in 2006 (up by 7% year on year), representing a total value of CZK 151,537 billion (up by 23%). The system processed a daily average of 1.52 million transactions. The average daily value of the transactions was CZK 607 billion. The peak amount in a single day was 4.95 million transactions.

The following charts show the number of transactions processed and the volume of funds transferred in 2006.

**Average daily number of transactions****Average daily turnovers**

### SKD – the short-term securities settlement system

The short-term securities settlement system (SKD) operated by the Czech National Bank is a separate register of securities and a settlement system for the securities recorded therein. In SKD, records are kept of the securities issued by the Czech

Republic (the Czech Ministry of Finance) with maturities of up to one year, the short-term securities issued by the CNB with maturities of up to six months, and other bonds with maturities of up to one year.

The development of the SKD system had been completed in past years. At present, the only modifications being made are those relating to legal and tax changes. The CNB monitors settlement system trends in the EU, in particular with regard to the connection of such systems to Target2, a new system under development, and to the proposed Target2Securities single settlement system, which will become relevant as the Czech Republic prepares to adopt the euro.

**On 31 December 2006, the following numbers of accounts and participants were registered in SKD**

Number of owner accounts	152
Number of clients (securities owners)	109
Number of custodians	4
Number of agents	22

Note: Agents are banks that provide securities settlement services to their securities owner clients. They have direct interactive access to the SKD system. Custodians administer securities accounts owned by persons other than custodians, i.e. customers of custodians.

The securities recorded in SKD are used as collateral for intraday credit, which the CNB extends to banks for accounting purposes within CERTIS.

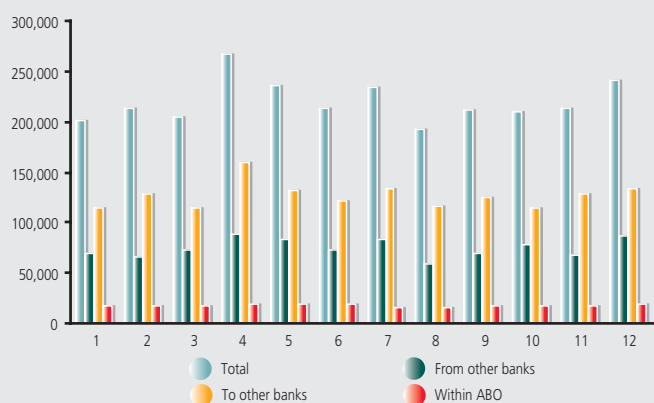
### ABO – the CNB's accounting and payment system

As of 31 December 2006, the ABO system maintained 43,278 live accounts, 8,987 of which were internal accounts, 4,178 employees' accounts and 30,113 accounts of legal entities. As regards the accounts of legal entities, 25,506 fall into the Treasury accounts category. The other accounts are mostly owned by state institutions, as well as banks, foreign financial institutions, etc.

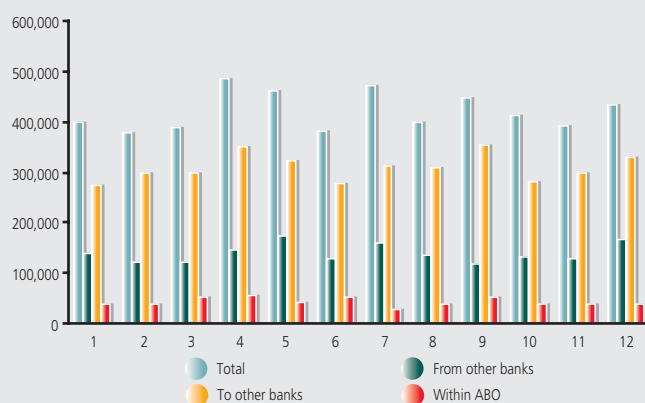
The development of the ABO system continued in 2006 with the launch of the first version of an internet banking application and the creation of new tools for budget chapter managers which make it possible to interactively set budget limits on Treasury expenditure accounts and provide both general and detailed information over the Internet.

The following charts show the number of transactions processed in 2006. A slight increase was recorded compared to 2005.

**ABO – Daily average number of items**



**ABO – Maximum daily number of items**



In addition, the Cash and Payment Systems Department was closely involved in the preparation of the relevant parts of the Czech Republic's Euro Changeover Plan.

### PREPARATIONS FOR INTRODUCING THE EURO IN THE CZECH REPUBLIC

A National Co-ordination Group (NCG) responsible for the technical, institutional and legislative arrangements for the introduction of the euro was established in the Czech Republic in February 2006 under a government resolution. At the same time, six working groups were set up for the individual changeover areas (the financial sector, the non-financial sector and consumer protection, public finances and public administration, legislation, information technology and statistics, and communication). The management of the whole process was delegated to the Ministry of Finance. The CNB's role in the NCG is significant, as many of the tasks associated with the changeover will fall within the direct competence of the central bank. The CNB is represented in the leadership of the NCG (a CNB board member is a vice-chairman of the Group) and has also been entrusted with the leadership of the Financial Sector Working Group (again at board member level). The CNB – jointly with the Ministry of Finance – also chairs the Communication Working Group, and it has representatives as members of all the other working groups at the expert level.

In the first phase of its work, the NCG formulated a recommendation for the choice of optimum changeover scenario for the Czech Republic. In October 2006, in line with the NCG's opinion, the Czech Government approved the simultaneous adoption of the euro in both cash and non-cash form (the "Big Bang" scenario). Under the direction of the CNB, the Financial Sector Working Group played a major role in preparing input documents for meetings of the NCG and the Government. The NCG was initially supposed to draw up and submit the first version of the National Changeover Plan to the Government by the end of 2006. However, this was postponed until March 2007, primarily because no decision had been made to join ERM II in 2007 in the regular assessment of the country's alignment with the euro area at the end of 2006. As one of the conditions for joining the euro area is a stay of at least two years in ERM II, the chosen procedure virtually ruled out 1 January 2010 as the euro adoption date. At the same time, a need arose to review the Czech Republic's existing euro area accession strategy of 2003. The Government is expected to discuss the relevant document by the end of August 2007.

Although the changeover date was postponed, work continued on the completion of the first version the National Changeover Plan. The Plan contains an overview of the technical, legislative and institutional steps that need to be taken in connection with the adoption of the single currency. The CNB will be responsible mainly for the introduction of euro banknotes and coins and the non-cash euro, the adjustment of payment systems, and co-operation with the financial sector in this process. It will also play a significant role in communication with the public. The CNB was involved in the preparation of the general part of the Plan and authored the relevant sections in the Financial Sector Working Group and the Communication Working Group. The main tasks of the central bank are covered in more detail in the CNB's January 2005 document *Overview of Tasks in the Field of Competence of the CNB and Outline of Other Tasks Relating to the Introduction of the Euro in the Czech Republic*, which can be found on the CNB website. CNB representatives also attend meetings of the European Commission's working group for technical and organisational issues relating to adoption of the euro (PAN II). Valuable information and experience can be gained here from the existing euro area members and other EU Member States at more advanced stages of preparation for the introduction of the single currency.

For the first time in November 2006, the CNB organised a workshop on the institutional and technical preparations for the changeover. Opening presentations given by lecturers from the CNB, the Czech Ministry of Finance, the European Commission, the ECB and the central banks of Slovenia, Germany and Slovakia were followed by a discussion among experts from the new EU Member States. The professional standard of the presentations, the opportunity to discuss, and the interactive nature of the event were highly praised by the participants, including the ECB and the European Commission.



### FINANCIAL MARKET OPERATIONS

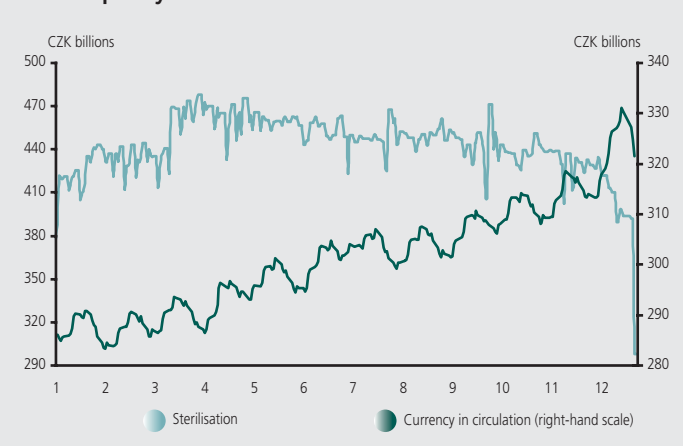
The CNB implements monetary policy by means of a system of monetary policy instruments consisting of financial market operations, automatic facilities and reserve requirements. Financial market operations play a pivotal role in steering interest rates, managing the liquidity of the banking system and signalling the monetary policy stance. 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.

The Bank Board decided to change the two-week repo rate two times last year, raising it in two steps of 0.25 percentage point from 2.00% to 2.50% with effect from 28 July and 29 September.

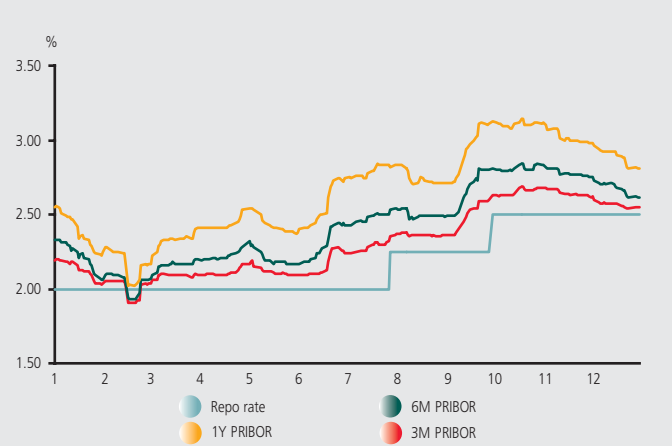
The CNB manages the liquidity of the banking sector through money market operations so as to maintain an optimum liquidity level for compliance with the reserve requirement. This ensures that short-term interest rates are stable at the desired level. The decision-making on the central bank's money market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

In 2006, the main instrument for managing short-term interest rates was again the two-week repo. Given the 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 most. The frequency at which the main monetary operations are conducted was changed with effect from 4 May, when the CNB Bank Board decided to reduce their frequency from daily announcements to three operations a week. By doing so, the CNB moved into line with the standard currently applied in advanced EU financial markets. The volume of excess liquidity absorbed in monetary operations in 2006 varied between CZK 298 billion and CZK 478 billion, the average being CZK 442 billion. The average amount of liquidity absorbed fell by approximately CZK 1.7 billion relative to the 2005 average.

Excess liquidity in 2006



Interest rates in 2006



This decrease was due to steady growth in currency in circulation (see the chart). Another factor reducing the volume of sterilisation was the continuing sell-off of a portion of the returns on the international reserves. The volume of returns sold totalled EUR 208 million in 2006.

The large decline in the sterilisation volume at the end of the year (of around CZK 153 billion compared to the end of October) was due mainly to seasonal effects. There was an increase in state fixed-purpose funds with the CNB, since they are not allowed to be short-term invested in the market over the end of the year (around CZK 99 billion), and the growth rate of currency in circulation rose in connection with Christmas. These factors are short-term and closely linked with the end of the calendar year, and their effect gradually abates during January. Interest paid to banks as a result of monetary operations totalled CZK 9.6 billion in 2006.

The CNB's instruments also included two "automatic" facilities – the marginal lending facility and the deposit facility. Under the lending facility, the CNB lends overnight funds to banks 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 CNB-issued bills, bonds issued and unconditionally guaranteed by the Czech Republic and koruna securities issued or unconditionally guaranteed by EU governments and selected multilateral issuers as collateral. The deposit facility gives banks the option of making overnight deposits with the CNB at the discount rate. The discount rate provides a floor for short-term interest rates. The minimum volume for these operations is CZK 10 million. Fine-tuning operations (ad hoc repos and reverse repos under market conditions) are used only rarely.

In 2006, the CNB continued issuing its own bills, which it used as collateral for open market operations. In addition, CNB bills are used by banks as collateral against intraday credit from the CNB. Such credit is provided to ensure the smooth running of the payment system at CNB Clearing. The CNB charges no interest on such credit. There is automatic spillover into the marginal lending facility in the event of non-repayment of intra-day credit at the end of the day.

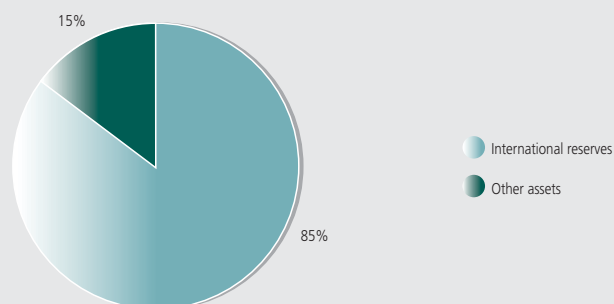
### **Management of the CNB's international reserves in 2006**

International reserves are the Czech National Bank's foreign assets in convertible currencies. They comprise deposits in foreign banks, securities, gold, the reserve position with the IMF and other reserve assets. The CNB holds international reserves to support its independent monetary and exchange rate policy-making.

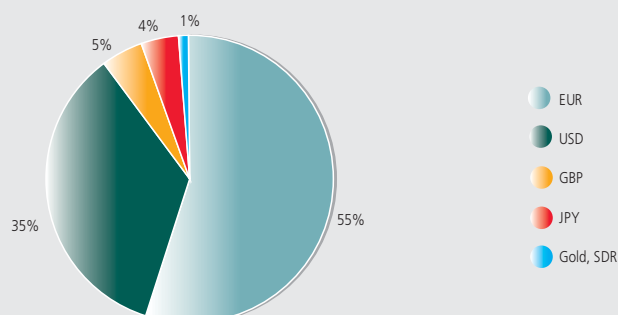
In managing the international reserves, the CNB aims to attain maximum and stable returns subject to compliance with the stipulated liquidity restrictions and market and credit risk limits. The international reserves are invested so that the state's foreign exchange obligations and, if necessary, interventions in the foreign exchange market are secured. The volume of the reserves is regularly published in the *Financial Markets* section of the CNB website.

The international reserves represent approximately 85% of the CNB's balance sheet, and the return on these reserves is one of the CNB's most significant revenues. The volume of international reserves in the central bank's balance sheet is shown in the chart below.

Share of international reserves in CNB balance sheet assets



Monetary allocation as of 29 Dec. 2006



The CNB's international reserves amounted to CZK 656.6 billion at the end of 2006, down by CZK 70.1 billion from a year earlier. The decline in the reserves in koruna terms was mainly due to the appreciation of the koruna against the dollar (15%, or CZK 45 billion) and the euro (5.2%, or CZK 20 billion). The volume of the reserves was also affected by income on investment activities, the sell-off of returns realised in the previous period and external flows. No foreign exchange interventions were made in 2006.

In euro terms the international reserves amounted to EUR 23.9 billion (an annual decrease of EUR 1.2 billion) and in dollar terms they rose by USD 1.9 billion to USD 31.5 billion. Besides the aforementioned factors, the change in the international reserves (expressed in these terms) was also affected by the euro-dollar exchange rate.

At the end of 2006, the international reserves were allocated as follows: 54.6% EUR, 35.2% USD, 4.7% GBP, 4.3% JPY and 1.2% SDR and gold. As in the previous year, the allocation of the reserves saw changes up until the end of May due to changes in the monetary base, movements in the koruna-dollar exchange rate and the size of the dollar portfolio.

In 2006, there were two major changes in the way the currency allocation is set. First, the Bank Board approved a currency diversification of part of the dollar reserves into JPY and GBP on 12 January 2006. After being incorporated into the regulations, this decision was progressively implemented in Q2 and Q3. The diversification was executed by means of currency forwards. The position was gradually built up and the required currency structure of the dollar portfolio – 80% USD : 10% GBP : 10% JPY – was achieved at the end August. The return on the GBP and JPY positions forms part of the return on the dollar portfolio. The underlying reason for this decision was an effort to use the diversification effects of the exposure to other currencies to stabilise the returns on the dollar reserve portfolio.

Overall, the international reserves still consist of two main portfolios. Foreign exchange risk may not be accepted when managing these portfolios. The parameters defining the interest rate risk assumed – portfolio duration in particular – are also set separately for each portfolio. The duration set in 2006 continued to be based on the requirement that the euro portfolio should not record a loss in any moving twelve-month period. At the start of 2006, the duration of the euro portfolio was 1.8 years. In addition to historical data, the methodology for determining the duration takes into account the situation on the financial markets. Consequently (given the increase in interest rates), the duration of the euro portfolio was gradually extended to 2.1 years in 2006. In the case of the dollar portfolio, the investment horizon was extended at the decision of the Bank Board and the duration was gradually extended to 3.6 years.

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 the situation 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 with maturities of more than one year. At the same time, a large part of both portfolios is invested in credit instruments with the highest rating – AAA.

The rate of return on the reserve portfolios is measured both in absolute terms and relative to benchmark portfolios. Measuring the relative rate of return indicates how successful the strategies implemented by the portfolio managers were relative to the benchmark portfolios.

The rate of return on the dollar portfolio was 4.43% and that on the euro portfolio 1.80% in 2006. The relative rate of return (i.e. the difference between the rate of return on the actual portfolio and that on the benchmark) was 0.14% for the dollar portfolio, which is around USD 17.3 million in absolute terms, and 0.08% for the euro portfolio, or around EUR 10 million in absolute terms. The rate of return on the gold portfolio, including valuation changes, amounted to 24.7% due to a large increase in the gold price. The price of gold rose from around USD 517 per ounce to USD 636 per ounce last year. The overall rate of return on the international reserves<sup>9</sup> in 2006 was 3.02% (up by 0.38 percentage point compared to 2005). The weighted average of the return on the koruna portfolios, i.e. including exchange rate gains and losses, was -6.86% due to the koruna appreciation.

## ECONOMIC RESEARCH

The objective of the research work at the CNB is to expand the knowledge base for monetary policy-making and for maintaining financial stability. The research outputs must be relevant and, equally importantly, of a high standard. The research results are disseminated to the economics community through the publication of research papers (in international and regional journals) and an information bulletin, and by organising seminars. All the information is made available on the CNB website. The economic research contributes to the development of the central bank's human capital and helps to develop the CNB's position within the ESCB. All relevant information relating to economic research activities and documents is made available to the public in the *Economic Research* section of the CNB website.

A document entitled *CNB Economic Research 2007–2010*, defining the focus of the economic research at the CNB and its priority topics for the next six years, was published in early 2006. The document was followed by a first call for projects focusing on the newly defined priority areas. The project proposals submitted were considered by the Research Advisory Committee, and the Bank Board subsequently decided which projects would be implemented.

The Research Advisory Committee, which is an advisory body to the CNB Bank Board, had a new line-up: Stephen Cecchetti (Brandeis University, USA), one of the world's leading experts on central banking, and Andrew Blake, an adviser at the Bank of England's Centre for Central Banking Studies, attended the meeting of the Committee for the first time, replacing Eduard Hochreiter (Oesterreichische Nationalbank) and David Mayes (Bank of Finland), who had served two consecutive terms of office in the Committee. As in the previous year, the external members of

<sup>9</sup> The weighted average of the rates of return on the individual portfolios (the rates of return on the dollar, euro and gold portfolios are weighted by their share in the overall volume of the international reserves).

the Committee also included Nicolleta Batini (International Monetary Fund), Aleš Bulíř (International Monetary Fund), Carsten Detken (European Central Bank) and László Halpern (Hungarian Academy of Sciences). The President of the Committee is the Governor of the CNB Zdeněk Tůma. The Committee is chaired by Vice-Governor Miroslav Singer. The internal members of the Committee are the Executive Directors of the CNB's Economic Research Department, Monetary and Statistics Department, Banking Regulation and Supervision Department and Risk Management and Transactions Support Department, together with the research project co-ordinators.

An integral part of the research work at the CNB is the preparation of opinions on the situation reports on economic developments, which are a fundamental internal input for the CNB Bank Board's decisions on policy interest rates. This activity ensures that the usual analytical activities are subject to internal review, thereby fostering better decision-making. The preparation of such opinions also includes the subsequent writing of the minutes of the Bank Board meetings on monetary policy issues, which are usually published on the CNB website eight days after each meeting. The involvement of research workers in the monetary policy decision-making process enables economic research findings to be taken into account during the monetary policy discussion and the results of this discussion to be used to steer research projects in the future.

The main outputs of the CNB's economic research are two research paper series: CNB Working Papers and CNB Research and Policy Notes. A total of 14 research papers were published in 2006, a number comparable with those published by other inflation-targeting central banks in small open economies. In addition to research papers, two issues of the Economic Research Bulletin were published. The first one described the discussion about the priorities for 2007–2012 at the meeting of the Research Advisory Committee, and the latter presented research outputs in the exchange rate area with reference to EMU entry.

The CNB held its second Research Open Day in May 2006. This took the form of a half-day economic research conference featuring four lectures by leading world economists, organised jointly with the Czech Economic Society and CERGE-EI (The Centre for Economic Research and Graduate Education of Charles University – The Economics Institute of the Academy of Sciences of the Czech Republic).



### FINANCIAL STABILITY

In recent years, maintaining the stability of the financial sector has become one of the primary objectives of the CNB. This objective was incorporated into the Act on the CNB after the integration of supervision of the individual segments of the financial market. The Act states that the CNB shall, in accordance with its primary objective, supervise the activities of entities operating on the financial market, analyse the evolution of the financial system, see to the sound operation and development of the financial market in the Czech Republic, and contribute to the stability of its financial system as a whole.

The importance of financial stability analyses is amplified for the CNB by the fact that the Czech financial sector operates in an open-economy environment shaped significantly by external macroeconomic developments and changes in international financial markets. The financial sector's resilience to potential shocks stemming from both the external environment and the domestic economy can significantly reduce the adverse impacts of such shocks on economic activity. Financial institutions' ability to cope with potential financial imbalances depends on their ability to manage risk, their capital strength and, of course, their efficiency and profitability.

The regulatory framework and supervision of financial institutions are of great significance as regards preventing financial instability. Smooth operation of the financial infrastructure, including payment systems and securities settlement systems, is also important. Financial stability analysis focused on both banking and non-banking financial institutions in past years, too, but the integration of the supervisory authorities into the CNB should further enhance the preventive function. The target of interest will continue to be the stability of the financial sector as a whole. This makes financial stability analysis distinct from financial market supervision, which deals primarily with the stability of individual financial institutions. Financial stability analysis is also significantly different from macroeconomic and monetary analysis, as it is not aimed at modelling the most probable development of the economy, but instead focuses on testing the impact of improbable, but plausible, adverse scenarios which could threaten the stability of the entire financial system.

The CNB has been assessing the stability of the Czech economy since 2004 in its Financial Stability Reports. The aim of this publication is to assess developments in the past year and to identify potential risks that might affect financial stability in the Czech economy in the period ahead. The CNB has a legal obligation to submit this report to the Chamber of Deputies (the lower house of the Czech Parliament). The 2005 report assessed the overall developments as very positive, although it highlighted some risks associated with the strong credit growth during the cyclical recovery and with some aspects of the growing internationalisation of the financial markets. The third Financial Stability Report, containing an analysis for the whole of 2006, will be published in June 2007. It will be made available in electronic form in both Czech and English in the *Financial Stability* section of the CNB website.

In 2006, the CNB made considerable progress in building up its analytical resources and expertise in the financial stability area. A twinning project between the CNB and Deutsche Bundesbank, which ran from spring 2005 to autumn 2006, was of significant help in this respect. Under this project a number of seminars were held, attended by experts from the two central banks. The project also included expert consultations, study programmes for CNB experts at Deutsche Bundesbank and research placements for CNB experts at the German central bank's Research Centre. Research work forms an integral part of financial stability analysis, which is one of the CNB's five research areas. The results can be found in research publications (for details see the *Economic Research* section of the CNB website), thematic articles in the Financial Stability Report, and in published articles and papers.



Rising interest in the stability of the financial system can also be observed in foreign central banks and international economic and financial institutions. Financial stability experts represent the CNB in the official committees and working groups of the European System of Central Banks (Banking Supervision Committee, Working Group on Macro-Prudential Analysis, Working Group on Banking Developments). In 2006, the major issues in the international context included the activities of hedge funds, the growth in debt in Central and Eastern Europe, the considerable rise in the significance of private equity, property market fluctuations and widening global macroeconomic imbalances.

### **STATISTICS**

In 2006, statistical activities were again affected significantly by the development of statistics in EU institutions. The CNB has now basically reached the level of the old EU Member States and in most areas meets the requirements placed on euro area countries. It is therefore able to participate in the preparation of new statistics as an equal partner. Within the European System of Central Banks, the emphasis is currently being put on the efficiency of statistical work, with the costs and benefits of new requirements being assessed in particular. A new formal procedure for this assessment was first applied last year during the introduction of investment fund statistics. For the CNB, this was a new experience, and one which will also be applied at national level. The organisation of data collection and the specification of compilation methods, including the determination of the reporting coverage of primary data and the method for grossing up unreported data, is usually at the discretion of the Member States. From the point of view of data collection, last year was unusual owing to the integration of financial market supervision. The main goal was to establish co-ordinated data collection for regulatory and statistical purposes.

### **Money and banking statistics**

The development and production of harmonised financial sector statistics continued in 2006. Statistics relating to monetary financial institutions, which cover monetary and credit aggregates as well as a whole range of client interest rates, are the most important for users. The increasingly complex range of services offered by other financial institutions also requires the development of statistics in the non-banking segments of the financial sector. Following the publication of collective investment fund statistics, statistics of corporations engaged in lending (leasing, hire purchase and consumer credit companies) were also introduced, allowing, among other things, household debt with the financial sector to be covered more comprehensively. This information was included in the monthly Monetary Statistics publication on the CNB website. Another important product introduced last year was the publication of classified loans within the banking statistics.

### **Balance of payments statistics**

The public was informed about the evolution of the balance of payments every month, with more detailed information provided on a quarterly basis. Special attention was paid to more efficient methods of primary data collection. The general trend in the EU is to address key respondents directly, and the division of labour between national statistics offices and national central banks is undergoing fine-tuning. In 2006, the CNB introduced a new comprehensive system of direct reporting on external assets and liabilities by non-banking institutions. The reporting population is being gradually expanded to achieve representative coverage. A pilot project of direct collection of data on services exports and imports from companies was assessed in co-operation with the CZSO and extended further for 2007.

### **Financial accounts statistics**

Following test compilations in 2005, the quarterly compilation of stocks from the quarterly financial accounts was launched in 2006. Further preparatory steps towards the publication of these statistics were taken with the sending of draft reports to the ECB. Regular collection of data for the insurance companies and pension funds sub-sectors was launched under the relevant decree. Co-operation with the CZSO continued as regards co-ordinating the collection of primary data and harmonising individual related statistics, specifically the financial accounts falling within the responsibility of the CNB and the non-financial accounts produced by the CZSO.

### **Integration of financial market supervision in the reporting area**

Preparations for the introduction of co-ordinated reporting for regulatory and statistical purposes went on throughout 2006. With few exceptions, the reports used by the former supervisory institutions were successfully integrated into the system operated at the CNB. Each respondent is thus addressed by the CNB in only one way. Duplication in data collection was eliminated, as all users within the CNB – regulators and statisticians alike – can share common primary data stored in a single database. This is an important step towards reaping the benefits expected in the reporting area as a result of the integration.

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

The CNB provides banking services for the state and the public sector under Act No. 6/1993 Coll., on the Czech National Bank, as amended, and Act No. 218/2000 Coll., on Budgetary Rules and on the Amendment of Some Related Acts (The Budgetary Rules), as amended. It maintains the revenue and expenditure accounts of state organisational units connected to the state budget, revenue and customs offices, the Czech Social Security Administration, labour offices, subsidised organisations, state funds and businesses that receive subsidies from the state budget, and accounts connected to the budget of the European Communities. At the end of 2006, the CNB maintained more than 25,000 such accounts. The CNB is also responsible for the non-cash payment of state social benefits. For example, 11.4 million transactions relating to state social benefits, 9.0 million health insurance and employment policy contributions and 2.0 million transactions connected with VAT administration were recorded on these accounts in 2006.

### **Support for Treasury liquidity management**

The CNB has long been working in close partnership with the Ministry of Finance on a Treasury development project in the Czech Republic, under which it is currently responsible for the "Payment System" sub-project.

Under agreements on the performance of Treasury activities, the CNB created financial tools for the Ministry of Finance enabling automated provision of information on the intra-day Treasury balance. The CNB also launched a new system for setting budget limits for Treasury expenditure accounts, which gives budget chapter administrators direct access to information. Following a change to the relevant article of the Act on Budgetary Rules, budget chapter administrators will be able to set budget limits directly via the Internet.

The CNB is also responsible for the daily consolidation of state sector funds<sup>10</sup> on an aggregate Treasury account and works closely with the Ministry of Finance on

<sup>10</sup> Accounts subject to consolidation are defined in Act No. 218/2000 Coll., on Budgetary Rules. Above all, they include revenue and expenditure accounts of the state budget, state financial assets accounts, revenue offices' accounts, Treasury liquidity management accounts and, since October 2005, the reserve fund accounts of organisational units of the state.



continuously managing intra-day liquidity on this account. Current-day expenditures and their coverage by funds on these state accounts are continuously compared in the CNB's payment and settlement system (ABO) so that maximum use can be made of any temporary free liquidity. In the event of any temporary mismatch between revenues and expenditures, either additional funds are obtained to finance expenditures through sales of T-bills on the financial market, or surplus Treasury funds are invested in T-bills. In this way, Treasury funds are used in the most effective way possible and so debt service costs are minimised. The target balance on the aggregate Treasury account continued to decline moderately during 2006, reaching levels around CZK 11 million at the close of the year (the daily average balance on the aggregate Treasury account was roughly CZK 14 million last year).

The CNB provides partner departments of the Ministry of Finance with information on the intra-day liquidity on the aggregate Treasury account, including recommendations for daily borrowing or investment operations. At the end of the day the CNB provides detailed information on state budget revenues and expenditures broken down by type, state budget chapter, etc.

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

The CNB acts as a fiscal agent for state debt management on behalf of the Ministry of Finance. In practice, this chiefly involves organising primary sales of government bonds and providing expert consultations. In line with the Ministry of Finance's strategy of extending the average maturity of the national debt, debt issued in the area of medium-term and long-term koruna bonds saw further growth, rising by CZK 101.4 billion to CZK 588.9 billion. Conversely, the volume of T-bill issues fell further to CZK 89.6 billion (a decrease of CZK 4.7 billion compared to 2005).

In 2006, the CNB organised 31 auctions of T-bills on behalf of the Ministry of Finance. These bills had maturities ranging from 3 months to 1 year and totalled CZK 270.3 billion. Of this amount, bills with a face value of around CZK 150 billion were purchased by direct participants in the auctions. The remainder were purchased by the issuer and placed in its portfolio to be used later on as collateral in financial market operations to bridge short-term liquidity shortages. The bills were sold by Dutch auction. The investors at T-bill auctions were particularly interested in bills with short maturities. At the end of 2006, the outstanding volume of T-bills (including bills held in the issuer's portfolio) was around CZK 119.6 billion.

In 2006, as in previous years, the technique of reopening existing issues continued to be applied to government bonds with agreed maturities of over 1 year. This helped to increase the liquidity of the secondary market. The Ministry of Finance also issued two new government bonds last year: a bond with a maturity of 3 years and the first-ever koruna bond with a maturity of 30 years. The long maturity of this bond compared to other bonds (which have maximum maturities of 15 years) attracted unusually high interest. More than 30% of the total volume was demanded on the primary market by institutional investors, especially investment companies, investment and pension funds and insurance companies. Foreign investors showed considerable interest, purchasing more than 50% of the total volume sold. The CNB organised 25 auctions of medium-term and long-term government bonds, totalling CZK 159.4 billion. Two issues, with maturities of 3 and 5 years and a total face value of CZK 58 billion, were duly redeemed.

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

Since 1 May 2004, the CNB has been a full member of the European System of Central Banks (ESCB). Following the accession of Bulgaria and Romania on 1 January 2007, the ESCB comprises the European Central Bank (ECB) and the 27 National Central Banks (NCBs) of the EU.

The CNB Governor regularly attends meetings of the ECB General Council – one of the ECB's decision-making bodies (along with the Governing Council and the Executive Council), which meets four times a year and where the governors of all the NCBs of the EU countries are represented. In 2006, two extraordinary meetings of the General Council were held in the form of a teleconference to discuss and adopt the Convergence Reports. In May, the meeting was devoted to an assessment of the fulfilment of the euro area accession criteria at the request of Slovenia and Lithuania. In November, the regular report on the other nine EU Member States that have not yet adopted the euro (besides Denmark and the United Kingdom, which have an opt-out clause) was assessed. Other important issues discussed at the regular meetings of the General Council included macroeconomic, monetary and financial developments around the world and in the EU, the functioning of ERM II, an analysis of public finance developments and fiscal predictions for 2006–2008, an analysis of the most important banking groups in the EU, macroeconomic modelling in the new Member States and the EU's external representation in international economic organisations.

As in previous years, CNB representatives actively participated in the work of the ESCB's 13 committees and numerous working groups. The major issues discussed in 2006 included financial stability, global imbalances, the fiscal outlook, the TARGET2 project – a new centralised settlement system (Trans-European Automated Real-time Gross Settlement Express Transfer System), counterfeits of euro banknotes and coins, preparations for the second series of euro banknotes and the enhancement of euro coin security features.

In written consultations and written procedures (the Member States have a duty to consult the ECB about draft legislation falling within its fields of competence), 101 documents were prepared at the CNB in 2006. In 15 cases the CNB made comments in the form of a Governor's letter to the President of the ECB.

The Czech side twice initiated consultations to evaluate the harmonisation of national law with European law. The CNB consulted the ECB on a draft decree on the terms under which it is possible to reproduce banknotes, coins, cheques, securities and payment cards and to produce objects imitating them. The Ministry of Industry and Trade consulted the ECB on a draft amendment of the Act on the CNB in the area of consumer protection.

The CNB's representation in bodies linked either to the Council of the European Union or to the European Commission also plays an important role. The CNB Governor attends the informal meetings of ECOFIN held twice a year in the country that holds the Presidency of the Council of the European Union. In 2006, the main topics at the Helsinki meeting were globalisation, the current economic situation and financial stability. A CNB vice-governor also attends the meetings of the Economic and Financial Committee (EFC), which acts in an advisory capacity to the Council of the European Union. Among other things, the Committee discussed the Convergence Reports of the Commission and the ECB, the interpretation of the Maastricht criteria and financial services issues. The CNB is also actively involved in the work of the EFC Sub-Committee on International Monetary Fund Matters (SCIMF), which in 2006 dealt with the IMF's medium-term strategy. In particular, this included member quotas, making supervision more efficient, strengthening the IMF's role in developing countries and sustainable financing of this organisation.

The most important domestic platform for co-ordination of policies towards the EU is the government-level EU Committee established in December 2006 in response to the need to institutionalise the debate on key political issues related to the Czech Republic's membership of the EU and in connection with the proposal for a national co-ordination mechanism for the Czech Republic's presidency of the EU Council in the second half of 2009. The CNB is involved in this committee at governor level. Inputs for the meetings of the government-level committee are always discussed in

advance in the working-level committee, where the CNB is represented by a vice-governor. Both committees assist primarily in forming and approving positions, instructions and mandates for the Czech Republic's representatives in the Council of the European Union and its working groups. The CNB submits a report on its relations with the ESCB/ECB to the Committee twice a year.

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.

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

A meeting of the representatives of the Belgian constituency of the IMF and the World Bank took place in Prague in June. The primary aim of this meeting was to provide information on recent developments in the two institutions and to discuss policy in the area of official development aid and international reserves management under a floating exchange rate.

An Article IV consultation with the IMF took place on 13–21 September 2006. The IMF's assessment of the current situation was relatively positive. In its opinion, the sharp acceleration in growth in 2005–2006 with continued low inflation had placed the economy on a firmer footing. Euro adoption remained an important opportunity for reaping the gains from enhanced trade and investment. The delayed timetable for euro adoption had been widely anticipated and by itself was not a significant setback. However, it would be useful to clarify the strategy for entry into the euro area as soon as possible.

Several important events were held in the CNB's Congress Hall in 2006 in the framework of co-operation with the World Bank Group. Following the Czech Republic's "graduation" from the group of IBRD/IDA client countries to the advanced countries, a graduation ceremony took place on 28 February 2006, attended by the President of the World Bank Paul Wolfowitz. This event was preceded by a two-day international conference on *Institutional Foundations for Sound Finance*. The main topics of the discussion were the stability of the financial system and the experience with implementing the International Financial Architecture.



### **Bank for International Settlements**

As in the previous period, the CNB Governor attended the regular meetings of central bank governors of BIS countries held every two months, where strategic issues relating to the international financial system and financial market stability are discussed. In addition, CNB Bank Board members attended the BIS Annual General Meeting in June 2006.

As in previous years, CNB banking supervisors participated in the Core Principles Liaison Group (CPLG) and the Working Group on Capital (WGC). The Core Principles for Effective Banking Supervision, which should be in line with best international practices, were finalised in 2006. The amended rules were endorsed and officially published at the International Conference of Banking Supervisors held in Mexico in October 2006. The amended Core Principles take into account the development of services in the banking sector, eliminate duplications and converge towards other international standards.

The WGC focused on some key aspects of the new Basel II capital adequacy framework, among them national discretion and the principles of co-operation between host and home supervisors.

### **The Organisation for Economic Co-operation and Development**

CNB representatives regularly attended the meetings of the Economic Policy Committee and the Committee on Financial Markets. These working bodies of the OECD discussed topical economic issues such as population ageing, financial sector reform in OECD countries and other major economies, developments in mortgage banking, etc.

In April 2006, the OECD Economic and Development Review Committee discussed and later published its regular report on economic developments in the Czech Republic, with the active involvement of the CNB. In addition to assessing overall economic developments, the report focused on fiscal policy, pension reform and the labour market. The assessment of the CNB's monetary policy was favourable. In the same committee, CNB representatives also acted as examiners in the discussion of the economic review for Finland.

At the close of 2006, the OECD published an assessment of the Czech Republic prepared by the Working Group on Bribery in International Business Transactions. The publication of this report was preceded by a comprehensive examination of the effectiveness of the Czech Republic's measures and control mechanisms in this area. The central bank was represented by staff from the financial market supervision departments.

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

In 2006, the EBRD signed six projects in the Czech Republic worth EUR 43 million in total. Two projects were regional in nature and the other four were related to credit lines for leasing companies and the funding of small towns' projects under the EU/EBRD Facility. The EBRD's total investment in the Czech Republic since its launch up to the end of 2006 amounted to EUR 1.4 billion and involved 65 projects. The EBRD had also financed 32 technical assistance projects for the Czech Republic, worth EUR 5.4 million.

In May 2006, the Government approved a document on the Czech Republic's "graduation" from EBRD operations. Graduation symbolises the maturity of the Czech economy and its financial sector and expresses the success of the transformation process. The Czech Republic thus became ranked as an advanced economy that no longer needs the services of the EBRD. At the annual meeting of the EBRD Board of Governors in London in May 2006, the Czech Republic presented the Government's position on graduation in a speech given by the CNB Governor. This made it the first EBRD credit recipient member country to publicly announce its intention to graduate. The graduation process also included a decision of the Czech Republic to get involved in the donor activities carried out through the EBRD. This was confirmed by the Government's decision to support the Western Balkans Fund with a donation of EUR 500,000. The Czech Republic thus became one of the founder countries of the Fund, which aims to support projects and foster the development of institutions and legislation in this region.



### Foreign technical assistance

The foundations for the CNB's technical assistance were laid in 2002, when an FTA programme designed mainly for countries of South-East Europe and the former Soviet Union was prepared for the first time. The assistance continued to be developed in 2006, when a total of 26 events, including 9 seminars, were held at the CNB, attended by 171 people from 34 central banks. In addition to seminars, the CNB organised 11 consultations for experts from the central banks of Armenia, China, Georgia, Mozambique, Romania, Serbia and Ukraine. CNB staff also provided technical assistance in the form of consultations and lectures at central banks and international organisations (the Joint Vienna Institute and the central banks of Belarus, Armenia, Morocco, Poland and Kazakhstan). Six consultations took place in recipient banks (Belarus, Macedonia, Romania and Slovakia). In addition, the CNB made two financial contributions to international organisations. The total amount spent by the CNB on such assistance was CZK 682,000.

CNB experts also took part in missions of the IMF and other international organisations. Opportunities to become involved in joint EU-funded projects with other ESCB central banks are opening up. This activity of the CNB 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 and the Transition Facility

A technical assistance project for Czech commercial banks and the CNB relating to the implementation of the New Basel Capital Accord (total budget: EUR 1.5 million) and a twinning project for the CNB to develop a system for monitoring and analysing financial stability in the Czech Republic (total budget: EUR 0.5 million) were implemented as part of the technical assistance received under the Phare and Transition Facility programmes in 2006. This twinning project in partnership with Deutsche Bundesbank was seen as very successful in terms of both content and form by the parties involved, fostering an increase in the analytical standard of the Financial Stability Report. The Czech National Bank and commercial banks received technical assistance amounting to about EUR 0.5 million and EUR 0.7 million respectively under the above projects in 2006.

## TECHNOLOGY AND SECURITY

### Computing and communication systems

The activities of the central bank are supported effectively by information systems and an internal system environment. The emphasis is on performance, reliability and accessibility, subject to maximum cost-effectiveness and security of the systems operated.

The priorities include reliable and sufficiently effective external communication with state institutions, commercial banks, non-banks, the European Central Bank and the internet environment, and internal communication between the CNB's premises.

The downward trend in investment and operating expenses, which started in 2001, continued into 2006, accompanied by an increasing technological level, reliability and performance, safer operation of information systems and technologies, and improved internal expertise. Further progress was made in unifying system platforms and using the Linux operating system as the basis for running critical applications.

One of the crucial tasks that were successfully accomplished was the integration of the information systems for supervision of insurance companies, the capital market and credit unions into the CNB's system environment as part of the establishment of the single financial regulator. The integration was completed without any information service downtime and gave users full continuity in their work.

In November 2006, after all the necessary IT had been installed and tested, the CNB put its back-up centre into full operation. The centre acts as a second computer centre and, at the same time, as an immediate back-up facility for the central bank's critical activities in the event of a malfunction at CNB headquarters.

Another key activity was the creation and launch of a new version of the CERTIS system, which provides settlement of all domestic interbank financial transfers. This update substantially improved the system's performance, reduced operating costs and cut the transaction processing time.

As regards internet banking, the CNB introduced new functions in the ABO system enabling safe and faster client transaction processing while creating the potential for greater efficiency at the CNB and its partner organisations. The system employs electronic signatures, which use qualified certificates issued by accredited certification authorities.

More transparent and efficient use of IS/IT services within the institution was fostered by the introduction of an information system for managing, monitoring and addressing service requirements. This system should in the future be a great aid in assessing the efficiency of use of human resources and an important resource for planning the upgrading and development of the CNB's system environment and information systems.

### The CNB's crisis management system

The CNB's central position in the Czech financial market makes it an important and, at the same time, highly sensitive location on which the smooth running of the economy crucially depends. A disruption to the CNB's core functions would necessarily imply immense economic damage. The CNB's crisis management system is therefore an essential part of its operations.



The primary purpose of crisis management is to ensure the continuity of selected activities, to eliminate potential security risks and to increase the organisation's resilience. At the CNB, these issues are addressed by the Crisis Management and Classified Information Protection Department. Its main responsibilities include developing the crisis plan and co-ordinating the response to emergencies that threaten the CNB's core functions.

In May 2006, the Bank Board adopted an updated CNB Crisis Plan. The update was based on the tried-and-tested structure of the crisis plan adopted in 2004 and responded to some changes connected with the integration of financial market supervision. The CNB is now responsible for co-ordinating banking, capital market and insurance undertakings.

The CNB's crisis documentation underwent extensive testing in 2006. The whole process was driven by an effort to test whether the documentation was implementable and to gain feedback for updating the plans. The tests proved the effectiveness of the testing procedure and in particular demonstrated that the CNB's ability to respond to emergencies was of a very high standard.

The backbone module of the CNB's back-up system – the Zličín back-up centre – was put into operation at the end of last year as scheduled. The back-up centre is one of the key factors safeguarding the continuity of the CNB's critical activities. Its launch means a significant improvement in the CNB's ability to maintain the continuity of its core functions in the event of a major emergency.

The CNB's crisis management system is fully compliant with the most stringent international standards in this field and contributes significantly to maintaining the high-quality security culture that is the source of the CNB's resilience.







# THE CNB AND THE PUBLIC



### EXTERNAL COMMUNICATIONS

2006 confirmed that the standard of communications is a key determinant of the central bank's success in performing the activities entrusted to it by law. And this applies not just to the fulfilment of its primary objective, which remains price stability. Given that the Czech Republic is converging towards the advanced Western European economies and its key macroeconomic indicators are broadly in line with the expected levels, public attention is now focusing on other equally important activities of the central bank.

This trend was amplified last year by the significant extension of the central bank's responsibilities for financial market supervision. On 1 April 2006, the Czech National Bank incorporated supervision of the capital market, insurance corporations, pension funds and credit unions into its portfolio of activities. The public was kept informed about all the steps of the integration process. New communication channels were employed, too. Supervision of the entire financial market put increased demands on communication with both the general public and finance professionals. One example is the capital market, where close contact with market participants and investors was essential.

For this reason, the Czech National Bank set up a 24-hour toll-free Green Line on 800 160 170 and also continues to operate the information e-mail address [info@cnb.cz](mailto:info@cnb.cz). The former supervisory authority for the capital market, the Czech Securities Commission, had successfully developed its own website. The CNB is temporarily operating this website in unchanged form at [www.sec.cz](http://www.sec.cz) and is currently preparing to incorporate it into its own site. The project is expected to be completed at the end of 2007.

The number of submissions (enquiries, requests, suggestions) made by the public recorded a significant rise in 2006, due primarily to the integration of supervision authorities into the CNB. Most of the submissions related to insurance companies and the capital market.

#### Number of submissions made by the public in 2006

Green Line	<a href="mailto:info@cnb.cz">info@cnb.cz</a>	Written submissions
2,785	1,930	397

The CNB's communications are often made by its most senior representatives – board members, who comment on numerous economic topics. One example is the adoption of the euro, which was frequently discussed last year. The Czech National Bank is endeavouring to act as an impartial expert in the ongoing debate and to provide the public with realistic expectations regarding the benefits of the euro and the necessary changes in national economic policy which will allow the Czech Republic to adopt the euro and, more importantly, to benefit from it. Besides the euro and monetary policy, household indebtedness was another topic which CNB experts commented on relatively frequently.

2006 also marked the 80th anniversary of the opening of the National Bank of Czechoslovakia. To commemorate this, the CNB organised several events for the public. Probably the largest was the CNB Open Day, which proved very popular. More than 3,500 people visited the Czech National Bank on a Saturday in June.



The three prepared routes allowed visitors to explore fascinating parts of the CNB's headquarters which are otherwise closed to the public, and of course to learn about the activities of the central bank. People had the opportunity to obtain information on monetary policy and financial market supervision, learn about clearing, and test their knowledge of the security features of Czech banknotes and their ability to detect counterfeits. In the CNB exhibition rooms, visitors could view an exhibition commemorating the 80th anniversary of the opening of the National Bank of Czechoslovakia, along with the permanent exhibition *People and Money*. An architectural model of the CNB headquarters was put on public display for the first time, and a film about the reconstruction of the CNB headquarters was screened.



## EXHIBITION

In March, an exhibition opened in the vestibule of the CNB Exhibition to commemorate the aforementioned 80th anniversary of the opening of the first central bank in the independent Czechoslovakia. The exhibition featured historical documents, period photographs, data on prices in individual years and exchange rates of the koruna against the dollar. Visitors could, among other things, see photographs of all the officials who have headed the central bank in the past 80 years.

The latest commemorative silver and gold coins were added to the exhibition as the year progressed. There was great interest in a newly installed showcase containing



examples of counterfeit current banknotes. Visitors particularly enjoyed the opportunity to test their ability to distinguish between genuine and counterfeit notes.

An average of 15,200 people visit the exhibition each year. The visitors consist mostly of school groups, in particular secondary school pupils. According to some teachers from secondary schools specialising in economics, a visit to the exhibition has become part of the tuition they provide and has even been incorporated into curricula. At the end of 2006, almost 5 years after it first opened its doors, the CNB exhibition welcomed its 75,000th visitor. The exhibition was also one of the most sought after and visited locations during the CNB's Open Day in June.



The CNB exhibition provides a unique set of information about the development of money and monetary policy in the Czech Republic, concentrated in one location, so it is also often visited by students seeking information for their dissertations and theses. Thanks to its completeness, clarity and attractive setting, the exhibition is used by television crews for filming special-interest programmes.



During the summer holidays the exhibition is visited mainly by foreign tourists, visitors from outside Prague or those for whom no suitable or free date can be found during the school year. The exhibition is still in high demand, as evidenced

by long booking periods for school groups (9 months or more). Further information is available on the CNB website at [http://www.cnb.cz/cz/expozice\\_cnb/](http://www.cnb.cz/cz/expozice_cnb/).

### **SPECIAL LIBRARY**

The CNB's special library has been operating without interruption since 1926. It provides services to the CNB's employees and to finance and banking professionals. The mission and work of the library are governed by Act No. 257/2001 Coll., on Libraries and Operating Conditions of Public Library and Information Services (Library Act). Users can obtain information from a highly specialised collection primarily comprising literature on banking and economics, law, politics, computer technology, mathematics and statistics, and languages. Overall, the library maintains and provides access to more than 48,000 books and research reports and 1,300 periodicals, daily newspapers and items of grey literature, representing about 200,000 copies in total. In 2006, the library acquired 3,228 books and research reports and about 8,000 periodicals and grey literature items. A collection of current books and periodicals is deposited in the reading room and is freely accessible to all users. In 2006, the library continued to provide access to domestic and foreign electronic information sources. As regards electronic journal databases, the focus was mainly on providing full-text sources.

The library provides its users with lending, advisory, reference, bibliographic and research services. In 2006, the library's catalogue was integrated into the Single Information Gateway, a nationwide information system that enables users to search a large number of various information sources simultaneously in a uniform user environment. 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 consistently high standard of the services provided met with a favourable response from the public, as reflected in further growth in the number of visitors and borrowings. In 2006, the library registered 4,386 active readers, who made 18,186 visits and borrowed 28,198 publications.

Further information is available on the CNB website at [www.cnb.cz/cz/knihovna\\_cnb](http://www.cnb.cz/cz/knihovna_cnb) or directly from the on-line catalogue at <http://sd.ruk.cuni.cz/tinweb/cnbanka/k6>. Information can be also obtained, necessary publications reserved, borrowing periods extended etc. by e-mailing [lib@cnb.cz](mailto:lib@cnb.cz).

### **CONGRESS CENTRE**

The CNB's Congress Centre, which is located in the former Commodity Exchange on Senovážné Square and connects with the main building of the CNB, is used primarily for the needs of the bank, but is also rented out to institutions such as economic universities, the Liberal Institute, the Czech Economic Society and the Czech Banking Association. Domestic and international conferences and seminars, training events, presentations, social events and regular press conferences are held in the Large and Small Halls.

The major events held last year included a meeting of the representatives of the Belgian constituency of the IMF (the 7th IMF/IBRD Constituency Meeting) and an international conference *Financial Market Stability and Regulation* organised jointly with the National Bank of Slovakia to mark the 80th anniversary of the opening of the National Bank of Czechoslovakia. The annual Liberal Institute lecture, with speeches given by Czech President Václav Klaus and Congressman Ron Paul of Texas, was well-attended. The Congress Centre hosted working meetings of the ECB's Information Technology Committee (ITC) and Information System Security (ISS) Working Group and a conference of the European Association of Labour Economists (EALE), held in co-operation with CERGE-EI.





The European Banking and Financial Forum, which took place at the Congress Centre, has become something of a tradition. A social event organised by the Embassy of the Republic of South Africa to mark the country's national holiday left a very good impression on guests. A presentation of the commemorative silver coin issued to mark the 700th anniversary of the end of the male line of the Přemyslid dynasty attracted media interest. This event was prepared in co-operation with the National Heritage Institute and was attended by the descendants of notable aristocratic families from all over Europe.



The Congress Centre, however, is not solely a venue for conferences and seminars, but also hosts important social events. Its excellent acoustics have made it popular with music lovers. Concerts of the Prague Spring and Young Prague international music festivals are performed here regularly. Performances by the Moyzes Quartet, the Stamic Quartet and the Pavel Haas Quartet met with a warm response from audiences. A concert given by the Czech Chamber Philharmonic Orchestra, with a programme devoted to Mozart and his "Cari Boemi", also attracted attention. A memorial evening to mark 11 September 2001, with works performed by the Prague Chamber Philharmonic Orchestra interspersed with short excerpts from major anti-war literature read by prominent personalities, was an extraordinary experience. The programme was broadcast live on Czech Radio 3. An interesting project was a performance by the Prague Cello Duo and the National Theatre ballet with a recitation by Otakar Brousek in a programme entitled *J. S. Bach: A Reflection*.

in *Music, Poetry and Dance*, which was accompanied by an exhibition of drawings by Alena Hořejší in a classical ballet setting.



Traditionally, the CNB's cultural activities are not limited to classical music concerts, but also include exhibitions of photographs in the foyer of the Congress Centre. An exhibition entitled *Gold Collection – Part II*, consisting of photographs from the National Museum of Photography in Jindřichův Hradec, opened in 2006 to present work by major Czech photographers to CNB staff and guests of the Congress Centre. *Part II* introduced photographers specialising in the nude. The collection covered all the main schools of nude photography from the 1970s up to the present. Other fascinating events included an exhibition of work by students of the Photography Department, Faculty of Fine Arts, Brno University of Technology, and an art history seminar entitled *Come and Listen to the Shadows* organised by the Faculty of Arts, Masaryk University, Brno, in co-operation with the Moravian Gallery in Brno under the project *Messages of Colours, Forms and Ideas*. The photographs were inspired by Baroque art forms which the students studied in ecclesiastical buildings. The exhibition year ended with the opening of an exhibition of photographs entitled *LIGHT* by students of the Photography Studio at the Academy of Arts, Architecture and Design in Prague, headed by Ivan Pinkava.



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



## THE CNB AND ITS PEOPLE





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

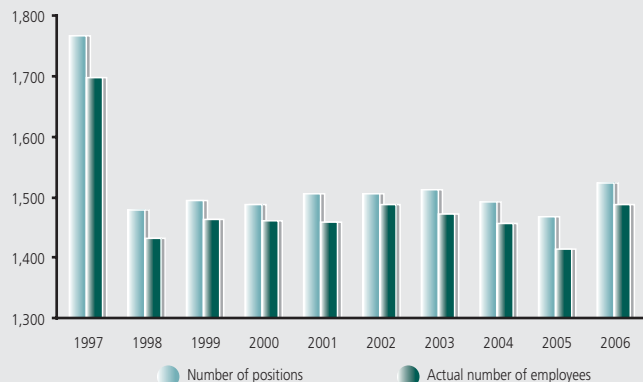
*"Future tasks and technological development will continue to change the requirements for the number, structure and skills of employees. The system of education, promotion and internal mobility of the CNB's employees must make the necessary adaptation as easy as possible. Continuing cultivation of the CNB's internal culture is a key challenge. These objectives can be achieved by enhancing teamwork, the information-sharing culture within the CNB and the basic ethical principles in working relations. The remuneration system must continue to be closely related to performance."*

(Challenges for the Czech National Bank in 2005–2010)

### Number of employees

At the end of 2006, the CNB had 1,488 employees, down by 252 compared to ten years ago. A personnel audit conducted in 2005 and in early 2006 resulted in the abolition of 103 posts, from which employees were released gradually. On 1 April 2006, the financial market supervision authorities were integrated into the CNB. This led to an increase of 161 in the number of positions. The resulting year-on-year rise in the number of posts at the CNB was 58.

Number of positions and actual number of employees



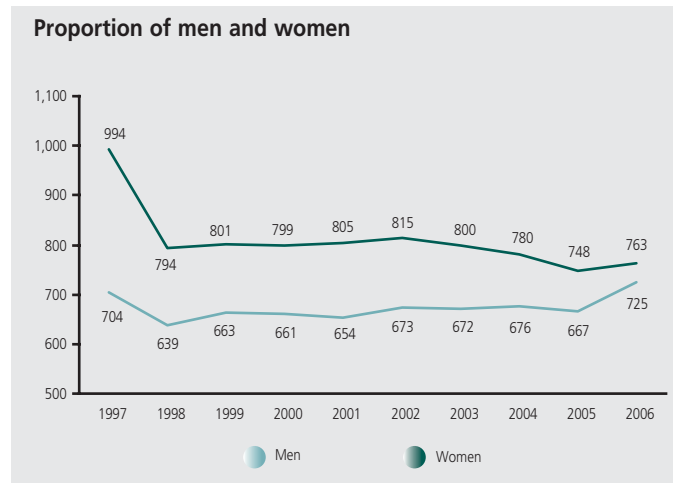
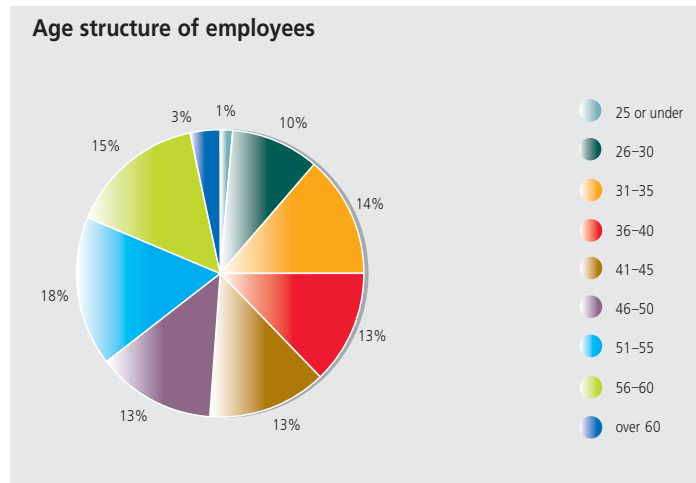
In 2006, a total of 83 new employees were taken on and 152 people became employees of the CNB under the process of integration of financial market supervision into the CNB. A total of 142 persons terminated their employment, of whom 18 retired. The number of employees who left the bank in 2006 as a result of the personnel audit and other organisational changes was 60. 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, or of taking on job applicants proposed by labour offices, 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 CNB employees

As of 31 December 2006, university graduates made up 46% of the total CNB workforce, while employees with secondary school education (ending with a school leaving exam) and higher vocational training recorded a 40% share. The remaining 14% had basic education or vocational training (without a school leaving certificate).

### Age structure and proportion of men and women

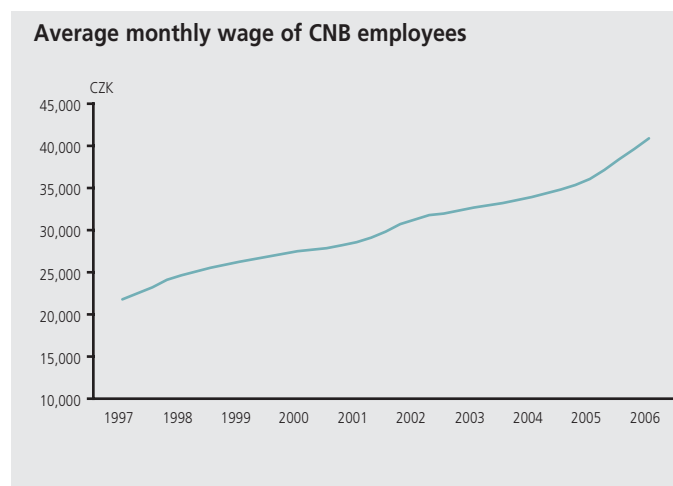
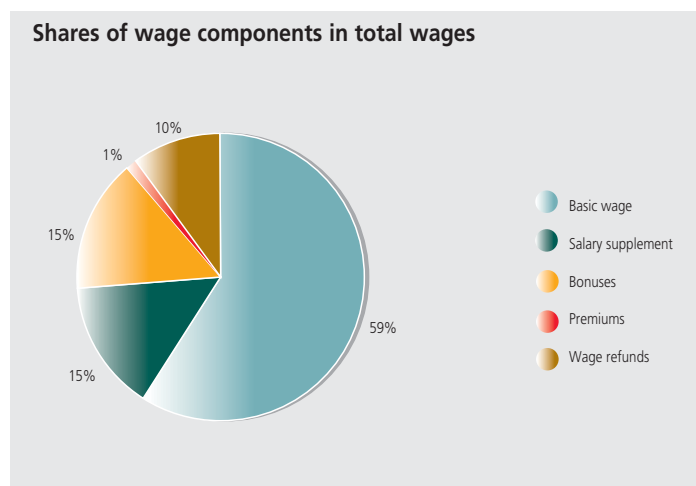
Disregarding the extreme age ranges (i.e. 25 years or under, and over 60 years), the age structure of CNB's employees is balanced, with all age groups evenly represented. The average age of the CNB's employees as of 31 December 2006 was 44.1 years.



The ratio between men and women employed at the CNB has gradually been equalising and has stabilised at approximately 49:51 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 beyond the framework of their general basic duties. Employees can be given performance-related bonuses.



A total of CZK 722 million was paid in salaries, i.e. 15.1% more than in 2005. This rise in the volume of wages paid was largely due to the integration of financial market supervision into the CNB (the total number of CNB staff increased and so did the proportion of specialists with above-average wages). The integration and the consequences of the personnel audit (employment was terminated mainly among employees with below-average wages) were also reflected in an increase in the average monthly wage, which amounted to CZK 40,842. The average annual wage increased by 13.4%. Statutory insurance payments amounted to CZK 253 million. Other social costs totalled CZK 20 million. The largest part of these costs comprised life insurance and pension scheme contributions provided to employees.

**The salaries of Bank Board members were as follows:**

	Gross salary in CZK <sup>1)</sup>	Net salary in CZK <sup>2)</sup>
Zdeněk Tůma	4,081,563	2,492,502
Luděk Niedermayer	3,281,633	2,010,544
Miroslav Singer	3,284,926	2,006,503
Robert Holman	2,733,139	1,690,190
Pavel Řežábek	2,733,765	1,678,562
Mojmír Hampl	187,500 <sup>3)</sup>	116,394 <sup>3)</sup>
Vladimír Tomšík	169,643 <sup>3)</sup>	104,669 <sup>3)</sup>
Jan Frait	3,542,710 <sup>4)</sup>	2,171,884 <sup>4)</sup>
Michaela Erbenová	3,609,086 <sup>4)</sup>	2,211,378 <sup>4)</sup>

1) 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

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

3) Salary for the period starting with appointment to the post of Bank Board member on 1 December 2006.

4) The figure comprises the salary for the period of performance of the duties of Bank Board member until 30 November 2006, a bonus for the entire period of performance of these duties, and compensation for the 1-month bar on working until the end of the "waiting time" (i.e. the period during which Bank Board members are obliged to remain CNB employees and not enter any other employment, owing to protection of the CNB's interests).

### Staff training

Staff training is one of the priorities of personnel work and encompasses a wide range of activities, 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. In 2006, spending on employee training amounted almost to CZK 33 million.

Language training was focused on preparing employees for prescribed standardised language exams. This involved employees who failed to meet the duty to prove a language qualification within the regular deadline, and a group of around 100 employees who joined the CNB under the process of integration of financial market supervision.

As for foreign training, the CNB worked mainly with partner central banks. Top-level training still consisted of courses and seminars organised by international banking and financial institutions. 2006 saw another increase in the proportion of training events held within the European System of Central Banks.

As in previous years, the bulk of the internal training events consisted of specialised banking courses offered in the CNB's annual catalogue of training events.

A major recent trend is the requirement of specialised organisational units to prepare selected employees for international certification such as ACCA, CIA and CFA.

Most of the CNB's managers took part in an extensive Development Centre project to assess the CNB's managerial potential and determine the focus of management training in the future in line with individual needs. This project will be completed and assessed in the first quarter of 2007.



# FINANCIAL REPORT





## REPORT OF INDEPENDENT AUDITORS

### TO THE BANK BOARD OF THE CZECH NATIONAL BANK

We have examined whether the financial information presented in the section 5 (hereinafter “the Section”) of the Annual Report entitled Financial report of the Czech National Bank (hereinafter “the CNB”) for the year 2006, which does not form part of the audited financial statements, is consistent with the audited financial statements of the CNB as at 31 December 2006 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 2006 dated 27 March 2007 and for the year then ended which do not form part of the accompanying Annual report of CNB for the year 2006 was as follows:

“We have audited the accompanying financial statements of the Czech National Bank (“the CNB”), which comprise the balance sheet as at 31 December 2006, the income statement for the year then ended and notes, including a summary of significant accounting policies (the “financial statements”). Details of the CNB are disclosed in Note 1 to these financial statements.

### The Management’s Responsibility for the Financial Statements

The management of the CNB is responsible for the preparation and fair presentation of the financial statements in accordance with Czech accounting legislation. This responsibility includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

### Auditors’ Responsibility

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

Czech National Bank

Report of Independent Auditors

## Auditors' Responsibility (continued)

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

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

## Opinion

In our opinion, the financial statements give a true and fair view of the financial position of the CNB as of 31 December 2006 and its financial performance for the year then ended in accordance with Czech accounting legislation."

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.

23 April 2007



PricewaterhouseCoopers Audit, s.r.o.  
represented by



Petr Kríž  
Auditor, Licence No. 1140

## FINANCIAL STATEMENTS

## BALANCE SHEET

in CZK millions	31. 12. 2006	31. 12. 2005
<b>1. Gold</b>	<b>816</b>	<b>821</b>
<b>2. Receivables from International Monetary Fund</b>	<b>26,614</b>	<b>29,146</b>
<b>3. Receivables from foreign countries including securities</b>	<b>729,455</b>	<b>803,065</b>
3.1. Deposits at foreign banks	120,413	140,921
3.2. Loans provided to foreign banks	522	34,031
3.3. Securities	608,436	627,991
3.4. Other receivables from foreign countries	84	122
<b>4. Receivables from domestic banks</b>	<b>27</b>	<b>29,050</b>
<b>5. Receivables from clients</b>	<b>92</b>	<b>12,470</b>
<b>6. Receivables from the state</b>	<b>0</b>	<b>8,683</b>
<b>7. Fixed assets</b>	<b>5,885</b>	<b>6,135</b>
7.1. Tangible fixed assets	5,803	6,064
7.2. Intangible fixed assets	82	71
<b>8. Other assets</b>	<b>6,676</b>	<b>5,970</b>
8.1. Prepayments and accrued income	27	23
8.2. Other	6,649	5,947
<b>TOTAL ASSETS</b>	<b>769,565</b>	<b>895,340</b>
<b>1. Currency in circulation</b>	<b>321,495</b>	<b>287,762</b>
<b>2. Liabilities to International Monetary Fund</b>	<b>23,765</b>	<b>24,210</b>
<b>3. Liabilities to foreign countries</b>	<b>81,626</b>	<b>87,077</b>
3.1. Loans from foreign banks	81,134	86,669
3.2. Other liabilities to foreign countries	492	408
<b>4. Liabilities to domestic banks</b>	<b>331,789</b>	<b>399,305</b>
4.1. Bank monetary reserves	30,611	17,249
4.2. Repo operations	297,811	377,757
4.3. Other liabilities	3,367	4,299
<b>5. Deposits from clients</b>	<b>40,133</b>	<b>68,094</b>
<b>6. Liabilities to the state</b>	<b>118,979</b>	<b>112,663</b>
<b>7. Provisions</b>	<b>240</b>	<b>4,097</b>
<b>8. Share capital</b>	<b>1,400</b>	<b>1,400</b>
<b>9. Funds</b>	<b>8,123</b>	<b>8,044</b>
10. Revaluation reserve	-1,440	-433
<b>11. Accumulated losses from previous periods</b>	<b>-105,748</b>	<b>-125,670</b>
<b>12. Net loss / profit for the period</b>	<b>-56,385</b>	<b>19,957</b>
<b>13. Other liabilities</b>	<b>5,588</b>	<b>8,834</b>
<b>TOTAL LIABILITIES</b>	<b>769,565</b>	<b>895,340</b>

## OFF BALANCE SHEET

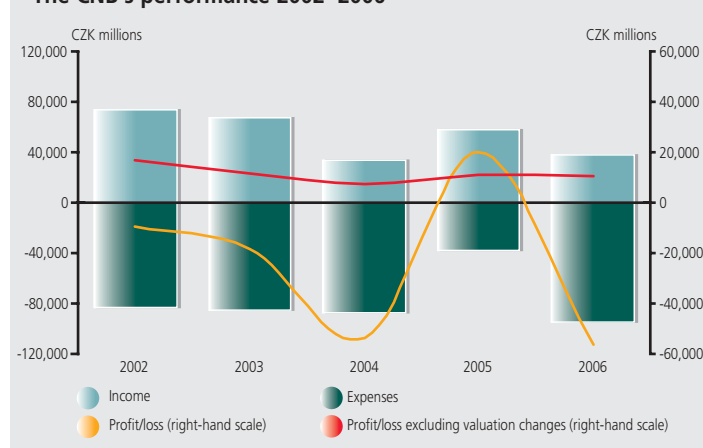
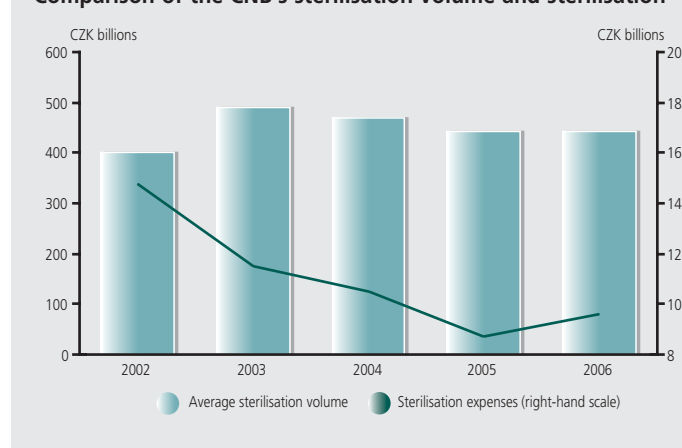
in CZK millions	31. 12. 2006	31. 12. 2005
<b>1. Guarantees issued</b>	<b>161,583</b>	<b>166,018</b>
<b>2. Receivables from spot, term and option transactions</b>	<b>110,479</b>	<b>109,672</b>
<b>3. Liabilities from spot, term and option transactions</b>	<b>100,598</b>	<b>135,200</b>
<b>4. Guarantees received</b>	<b>157,007</b>	<b>165,846</b>

**INCOME STATEMENT**

in CZK millions	31. 12. 2006	31. 12. 2005
<b>1. Interest income and similar income</b>	<b>27,906</b>	<b>20,587</b>
1.1. Interest from fixed income securities	22,207	17,173
1.2. Other	5,699	3,414
<b>2. Interest expense and similar expense</b>	<b>-14,269</b>	<b>-11,819</b>
<b>3. Income from shares and other interests</b>	<b>46</b>	<b>45</b>
<b>4. Fee and commission income</b>	<b>436</b>	<b>430</b>
<b>5. Fee and commission expense</b>	<b>-37</b>	<b>-37</b>
<b>6. Gains less losses from financial operations</b>	<b>-69,874</b>	<b>11,957</b>
6.1. Net foreign exchange losses / gains and foreign exchange spread	-65,999	10,267
6.2. Other	-3,875	1,690
<b>7. Other operating income</b>	<b>411</b>	<b>625</b>
7.1. Income from money issue	327	28
7.2. Other	84	597
<b>8. Other operating expense</b>	<b>-281</b>	<b>-467</b>
8.1. Expenses for production of notes and coins	-193	-170
8.2. Other	-88	-297
<b>9. Administration expense</b>	<b>-1,533</b>	<b>-1,332</b>
9.1. Personnel expenses	-1,027	-891
9.1.1. Wages and salaries	-722	-627
9.1.2. Social and health security	-253	-219
9.1.3. Training and other expenses	-52	-45
9.2. Other administration expenses	-506	-441
<b>10. Depreciation and amortisation of fixed assets</b>	<b>-535</b>	<b>-546</b>
<b>11. Release of specific and general provisions for receivables and guarantees, income from receivables already written off</b>	<b>1,383</b>	<b>1,087</b>
<b>12. Write offs, additions and utilisation of specific and general provisions for receivables and guarantees</b>	<b>-38</b>	<b>-573</b>
<b>13. Net loss / profit for the period</b>	<b>-56,385</b>	<b>19,957</b>

The notes to the financial statements are available on the CNB website ([www.cnb.cz](http://www.cnb.cz)), on the attached CD-ROM and from the CNB's Budget and Accounting Department, Na Příkopě 28, Praha 1

The profit/loss of the CNB depends on the volume and structure of its balance sheet. The CNB's total assets amounted to CZK 770 billion at the end of 2006, down by CZK 125 billion from the prior year. As regards assets, the largest declines were recorded for receivables from foreign countries and receivables from domestic banks. On the liabilities side, accumulated losses increased, liabilities to domestic banks fell and currency in circulation expanded. As for the balance sheet structure, receivables from abroad, i.e. the CNB's international reserves, accounted for 95% of assets. The majority of liabilities consisted of liabilities to domestic banks and currency in circulation, which together accounted for 85% of total liabilities.

**The CNB's performance 2002–2006****Comparison of the CNB's sterilisation volume and sterilisation**

The CNB recorded a loss of CZK 56,385 million as at the end of 2006. This figure was fundamentally affected by the appreciation of the domestic currency against the currencies in which the foreign exchange reserves were allocated. As the CNB has a significant excess of foreign exchange assets over foreign exchange liabilities due to its reserve holdings, the appreciation of the koruna generated an exchange rate loss. In year-on-year terms the domestic currency appreciated by CZK 1.51 against the euro and CZK 3.71 against the dollar. Due to these significant exchange rate movements and the volume of the CNB's foreign exchange assets and liabilities, the CNB recorded a total exchange rate loss of CZK 66,994 million as at the end of 2006.

The exchange rate losses are primarily a macroeconomic phenomenon related to the convergence of the Czech economy towards more advanced countries. As the convergence process is not over yet, it is possible that the CNB will continue to face exchange rate losses in the near future. For this reason, a model has recently been produced in the CNB enabling it to simulate its balance sheet in relation to expected macroeconomic developments. The properties and projections of the model were consulted with the external auditor and the model will soon be published as a CNB research paper. The model's simulations indicate that the CNB will cover its existing and potential exchange rate losses from its future profits (e.g. from income on international reserves).

The net return on foreign exchange reserves management was CZK 20,468 million (adjusted for valuation changes). This result chiefly reflects the evolution of interest rates abroad. In 2006, the weighted average return on the portfolios managed was 3.02% p.a., up by 0.38 percentage point on a year earlier. The CNB's foreign exchange reserves amounted to CZK 657 billion at the end of 2006, down by CZK 70 billion from a year earlier. Market income on securities, client operations and the realisation of gains achieved in the previous period were the most important real transactions as regards the volume of reserves.

#### The CNB's income and expenses in 2006

in CZK millions			
	Expenses	Income	Net
Monetary area	92,235	37,742	- 54,493
monetary policy-making	10,360	14	- 10,346
international reserves management	8,998	29,466	20,468
valuation changes	68,686	1,692	- 66,994
banking sector consolidation and other operations	3,921	5,267	1,346
client operations	270	1,303	1,033
Currency issuance and management	194	329	135
Operations	2,107	80	- 2,027
<b>Total</b>	<b>94,536</b>	<b>38,151</b>	<b>- 56,385</b>

The CNB's main monetary instrument was repo operations, which were used to sterilise the excess liquidity of commercial banks. An average of CZK 442 billion was sterilised in 2006, with total costs amounting to CZK 9,581 million. The CNB paid commercial banks interest on minimum reserves holdings totalling CZK 773 million, up by CZK 148 million on a year earlier. The increase was associated mainly with a rise in the repo rate, at which the central bank pays interest on minimum reserves.

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. The Czech Ministry of Finance made partial payments under this state guarantee of CZK 0.5 billion in 2004 and CZK 5 billion in 2005. The outstanding amount of CZK 17 billion was paid in 2006. The CNB used these payments under the state guarantee to cover bad debts stemming from the consolidation of the banking sector.

Nevertheless, the state guarantee issued by the Ministry of Finance did not cover the total expenses relating to the consolidation programme. The CNB has in the past therefore set aside provisions and reserves up to the difference between the total estimated expenses and the state guarantee. The volume of the provisions is continuously updated on the basis of changes in the estimated return on these assets as a result of repayments of the debts of banks in liquidation and partial satisfaction of the CNB's claims in bankruptcy proceedings.

At the end of 2006, the CNB received CZK 1.2 billion from the Ministry of Finance as partial compensation for the losses it had recorded in 2000 as a result of the transfer of a receivable from the National Bank of Slovakia to the Czech Republic.

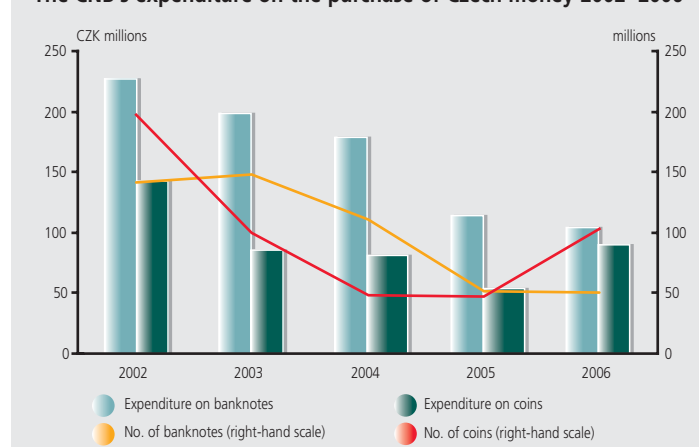
Following the winding-up of Česká finanční, s.r.o., on 31 August 2006 and under the relevant contracts, the CNB paid Česká finanční's losses of CZK 3,896 million stemming from the consolidation programme. At the same time, the CNB released reserves amounting to CZK 3,815 million which had been created to cover these losses.

In relation to its clients, the CNB recorded a profit of CZK 1,033 million. On the income side, this result was affected primarily by fees from the conversion of a foreign currency deposit of the Ministry of Finance (resulting from the remainder of the privatisation revenues of around EUR 1 billion from the sale of Český Telecom), income from foreign exchange operations, fees from interbank settlement and services related to the registration and settlement of short-term bond transactions as well as fees for maintaining Treasury accounts. Expenses primarily included interest paid to the Ministry of Finance (state funds deposited on accounts at the central bank).

In 2006, the CNB purchased a total of 50 million banknotes at a cost of CZK 104 million. The CNB paid CZK 90 million for base metal coins and silver and gold commemorative coins, of which CZK 64 million was paid for the supply of 103 million base metal coins. The aforementioned costs included funds for the preparation and protection of banknotes and coins (the development of new security features).

Income in the area of currency circulation and management was CZK 329 million, linked with the sale of numismatic material and above all the recording of income relating to the termination of exchange of Czechoslovak silver commemorative coins. The CNB recorded income of CZK 297 million due to the non-return of some silver coins from circulation.

**The CNB's expenditure on the purchase of Czech money 2002–2006**





Total operating expenses amounted to CZK 2,107 million, up by CZK 95 million year on year (net of the one-off addition to provisions connected with an operating claim on Pozemní stavby Zlín-Group, a.s., v konkurzu, in 2005). This increase was also affected by expenses incurred in relation to the integration of financial market supervision into the CNB. The integration process resulted primarily in a rise in personnel expenses.

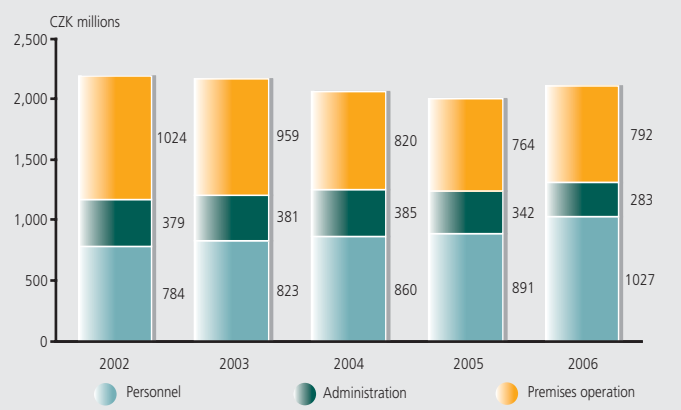
Personnel expenses totalled CZK 1,027 million, up by 15.3% on a year earlier. The bank paid out CZK 722 million (i.e. 15.1% more than in 2005) to its employees in wages, salaries and severance pay and in connection with employment contracts and service contracts with external employees.

Administration expenses totalled CZK 288 million (or CZK 283 million net of one-off creation of provisions for operating claims). Net of such provisions, they fell by CZK 59 million compared to 2005. The decrease was due mainly to VAT, which in 2006 was recorded not as a total under administration activities, but under individual operating expenses and asset acquisition items. In 2006, administration activities were also affected by a decline in telecommunication expenses (fees for communication links to the ECB, charges for Reuters and Bloomberg), primarily as a result of exchange rate movements. By contrast, spending on purchased services (especially consulting services) rose moderately.

Expenditure on the operation of premises and facilities was CZK 792 million, of which CZK 535 million was asset depreciation. Total expenditure on the operation of premises and facilities increased by CZK 28 million compared to 2005. The increase was due mainly to the inclusion of VAT in purchase prices. Depreciation recorded a moderate decrease of CZK 9 million, due to a higher rate of depreciation of assets, especially computers, software and cash handling machines. Lower expenses were also recorded for repair and maintenance of information technology and security equipment. Other expenses were roughly the same as in 2005.

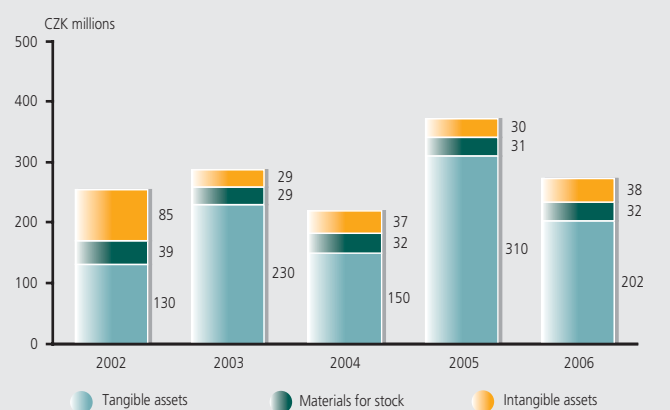
Operating income totalled CZK 80 million, with income relating to financial market supervision (administrative fees, fees for broker examinations) and rent received accounting for the largest part.

**Operating expenses 2002–2006**



Note: Administration expenses realised between 2002 and 2006 are adjusted for provisions created by the CNB for operating claims (arising mainly from contractual penalties applied against the bankrupt PS – Zlín Group, a.s.).

**Asset acquisition cost 2002–2006**



The CNB spent CZK 272 million on asset acquisition, i.e. 27% less than in 2005. The decline was due to the completion of the back-up centre (as regards construction and technological investment and computers) and the end of another phase of the upgrading of cash handling equipment at CNB branches. Total cost on asset acquisition is expected to decrease further in 2007 to the lowest level in 10 years, owing to the completion of recent key investments and to expected investments of only a smaller nature.



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



The Czech National Bank's procedure for complying with the duties ensuing from Act No. 106/1999 Coll., on Freedom of Information (hereinafter 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, on the communication of the Czech National Bank, as amended by Amendment No. 2 of 19 October 2006.

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

**A) Information provided in 2006 on the basis of applications:**

1. Number of applications for information under the Act:  
Three
2. Number of decisions refusing an application:  
None
3. Number of appeals against decisions:  
None
4. Transcript of the relevant parts of each court judgement concerning the examination of the legality of an obliged entity's decision refusing an application for information and an overview of all expenses incurred by the obliged entity in connection with court proceedings on rights and obligations under this Act, including its own staff expenses and legal representation costs:  
None
5. Number of exclusive licences granted, including justification of the necessity to grant exclusive licences:  
None
6. Number of complaints submitted under Article 16a:  
One
7. Other information relating to the application of the Act:  
Most written, e-mail and telephone applications for information received in 2006 concerned information whose provision went beyond the scope of the existing interpretation of the Act. In 2006, the CNB answered 425 written and 1,480 e-mail enquiries from the public.

**B) Information provided by way of public disclosure:**

The Czech National Bank publishes and continuously updates information in a manner allowing remote access. The information disclosed pursuant to Articles 5(1) and 5(2) of the Act is provided on notice boards at CNB headquarters and branches, in locations accessible to the public, and also on the CNB website ([www.cnb.cz/en](http://www.cnb.cz/en)). A wide range of other information on the activities and responsibilities of the CNB is also published on the state administration web portal.





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**Produced by:** Studio Press  
**Design:** Jerome s.r.o.





CZECH NATIONAL BANK  
NOTES TO FINANCIAL STATEMENTS FOR  
THE YEAR ENDED 31 DECEMBER 2006

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## **CZECH NATIONAL BANK**

### **NOTES TO FINANCIAL STATEMENTS**

**FOR THE YEAR ENDED 31 DECEMBER 2006**

## **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 „CNB 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 and the general economic policies of the European Community. The Bank acts in accordance with the principle of an open market economy.

In accordance with its primary objective, the Bank sets the monetary policy, issues bank notes and coins, manages the circulation of currency and inter-bank clearing and the settlement system, including the maintenance of this system to ensure its fluency and efficiency, supervises the institutions operating on the financial market (banks, credit unions, electronic money institutions, investment firms and issuers of securities, insurance companies and pension funds) and ensures to the safe functioning and development of the financial system in the CR. The Bank also performs management of foreign currency reserves and 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 organisations and international organisations involved in the supervision of banks and financial markets.

Based on the European Community foundation agreement and based on the Protocol about the Statute of the European Central Banks System and the European Central bank (hereinafter “the Statute”), the Bank is a part of the European Central Banks System and is obligated to follow the regulations set by the Statute in the extension of requirements for those European Union’s member states, which have not accepted the Euro as their national currency yet.

**CZECH NATIONAL BANK**

**NOTES TO FINANCIAL STATEMENTS**

**FOR THE YEAR ENDED 31 DECEMBER 2006**

**1 GENERAL INFORMATION (continued)**

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, administrative authorities, European Community authorities, Governments of the other European Union member states 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 supreme management body of the Bank is the Bank Board of the CNB. The Bank Board has seven members. The members include the governor of the Bank, two vice-governors of the Bank, and four other Bank Board members. The members of the Bank Board are appointed and recalled by the President of the CR. The members of the Bank Board are appointed for a period of six years. The Bank Board sets the monetary rules and instruments for their implementation and decides about the primary monetary-political measures of the Bank.

On 30 November 2006, the term of two Bank Board members expired so the President of the Czech Republic appointed new Bank Board members on 28 November 2006, Mr. Mojmír Hampl and Mr. Vladimír Tomšík, who replaced Mrs. Michaela Erbenová and Mr. Jan Frait. As at 31 December 2006, the members of the Bank Board were as follows (including information regarding the end of their term):

Mr. Zdeněk Tůma	Governor	until 12 February 2011
Mr. Luděk Niedermayer	Vice-Governor	until 26 February 2008
Mr. Miroslav Singer	Vice-Governor	until 12 February 2011
Mr. Mojmír Hampl	Head Manager	until 30 November 2012
Mr. Robert Holman	Head Manager	until 12 February 2011
Mr. Pavel Řežábek	Head Manager	until 12 February 2011
Mr. Vladimír Tomšík	Head Manager	until 30 November 2012

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

The Bank uses its income to cover the necessary 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 Board 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 financial statements, comprising a balance sheet, income statement and accompanying notes including statement of changes in equity, are prepared in accordance with the Act on Accounting, decree and Czech Accounting Standards for financial institutions issued by the Ministry of Finance of the CR. The financial statements are prepared under the historical cost convention as modified by the revaluation of financial instruments at fair value through profit or loss and available-for-sale financial instruments to fair values. The financial statements are prepared according to the principles of presentation and disclosure determined by the management of the CNB to be appropriate, bearing in mind the needs and requirements for reporting of central banks. The financial statements of CNB are prepared to give a true and fair view of its financial position and the results of its operations. The financial statements are rounded to millions of Czech Crowns (hereinafter "million CZK") unless otherwise stated.

### **(b) Foreign currencies and Special Drawing Rights**

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 are translated to CZK at the exchange rate effective as at the balance sheet date. All resulting realised and unrealised foreign exchange gains and losses are recognised in the income statement in the gains less losses from financial operations except for foreign exchange gains and losses from capital instruments in available-for-sale portfolio which are recognised in equity (Note 2(d)).

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

Gold and other precious metals are valued at historical cost. Deposits and securities denominated and payable in gold, which 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 into the income statement.

### **(d) Securities**

The Bank classifies all its debt securities as available-for-sale. 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 the foreign currency reserves administration, in accordance with predefined rules set by the Bank Board. They consist of money market and capital market securities.

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

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

Treasury bills, other discounted securities and bonds are stated at fair value. Available-for-sale securities are initially recognized at cost which includes expenses incurred in connection with their acquisition. Interest income is accrued based on the difference between the purchase price and the nominal value using effective yield method considering also coupon payments if relevant (amortised cost). Gains and losses arising from changes in the fair value of available-for-sale securities are recognized directly in equity until the financial asset is derecognized or impaired. In such case the cumulative gain or loss previously recognized in equity is recognized in the income statement.

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

- the share on the issuer's equity or the historical cost less impairment in the absence of any other measure;
- the risk adjusted net present value of cash flows for debt securities and notes.

Interest, dividends and foreign exchange differences on debt securities are recognized in the income statement. Foreign exchange differences on capital instruments are recognized in equity.

### **(e) Securities financing arrangements**

Securities borrowed or purchased under the purchase and resell agreements are not recognised on the balance sheet. Securities lent or sold under those agreements are retained in their original portfolio. The underlying cash-flows 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. The expenses for the production of notes and coins are expensed as incurred.

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

### **(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 only as collateral in repo operations with domestic banks.

### **(i) Derivative financial instruments**

Derivative financial instruments are initially recognised on the balance sheet at cost and subsequently are re-measured at their fair value. Fair values of futures are obtained from quoted market prices, in other cases the market value is derived from discounted cash flow models. 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 gains less losses from financial operations.

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

Interest income and expense are accrued using a linear yield method for loans and deposits. Interest income for available-for-sale securities is calculated using an effective yield method derived from purchase price. Accrued interest is recorded together with underlying assets and liabilities.

The effective interest rate is the rate that exactly discounts estimated future cash flows through the expected life of the instrument to its net carrying amount.

Interest income on non-performing loans is also accrued and included in the related loan balance. 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.

**CZECH NATIONAL BANK**

**NOTES TO FINANCIAL STATEMENTS**

**FOR THE YEAR ENDED 31 DECEMBER 2006**

**2 ACCOUNTING POLICIES (continued)**

**(k) Fee and commission income**

Fee and commission income from the maintenance of current accounts and other services are generally recognised on an accrual basis when the service has been provided, usually monthly. One-off fees are recognised immediately in the income statement when the service is provided.

**(l) Receivables**

Receivables originated by the Bank are stated at nominal value. Irrecoverable receivables are written off upon completion of bankruptcy proceedings against the debtor or on debtor's liquidation.

**(m) Provisions**

Provisions 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.

Additions to provisions are recognised in the income statement, their utilisation is recognised together with expenses or losses, for which purpose they were created in the income statement. Release of provisions in case they are no longer necessary is recognised as income.

**(n) Specific provisions for impairment**

Specific provisions are deducted from the nominal value of each receivable originated by the Bank. The amount of specific provisions for classified receivables and assets at risk is based on appraisals of these assets at the balance sheet date after taking into consideration the present forced sale value of collateral.

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 are taken into consideration (Note 29).

Specific provisions and provisions 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 current period income statement if previously written off.

**CZECH NATIONAL BANK**  
**NOTES TO FINANCIAL STATEMENTS**  
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**2 ACCOUNTING POLICIES (continued)**

**(o) Tangible and intangible fixed assets**

Tangible and intangible fixed assets are recorded at cost, which includes value added tax (hereinafter "VAT") unless the VAT is fully recoverable, and are depreciated / amortised by applying the straight-line basis of depreciation over the estimated useful lives following annual rates stated below.

If usage of intangible fixed assets is limited by contract, 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 not exceeding CZK 40,000, as well as low value intangible fixed assets with a unit cost not exceeding 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	5 – 6 years
Motor vehicles	4 years
Office equipment and computers	3 – 4 years
Software	3 – 4 years
Other intangible assets	6 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 is not adjusted.

Since 2006, depreciation and amortisation charges are reported separately, whereas they were included in the other administration expenses until 2005.

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.

**(p) 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 only for taxable supplies liable to VAT, where the input VAT is fully recoverable.

**CZECH NATIONAL BANK**

**NOTES TO FINANCIAL STATEMENTS**

**FOR THE YEAR ENDED 31 DECEMBER 2006**

**2 ACCOUNTING POLICIES (continued)**

**(q) 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 usage (e.g. budgeted compensation of accumulated losses from previous periods) is transferred to the state budget.

**(r) Staff costs, pensions and social fund**

Staff costs are included in Administration expense and they also include the Bank Board emoluments.

The Bank does not administer its own pension fund but operates defined contribution schemes for its employees, administrated by commercial pension funds. Contributions paid by the Bank are accounted for directly as an expense.

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. 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 recognised as a decrease of the fund.

**(s) 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.

**(t) Subsequent events**

The effects of events which occurred between the balance sheet date and the date of approval of the financial statements by the Bank Board 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 the approval of 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.



**CZECH NATIONAL BANK**  
**NOTES TO FINANCIAL STATEMENTS**  
**FOR THE YEAR ENDED 31 DECEMBER 2006**

**3 GOLD**

	<u>31 December 2006</u>	<u>31 December 2005</u>
	CZK million	CZK million
Gold at cost	<u>816</u>	<u>821</u>

Gold as at 31 December 2006 and 2005 includes a gold bond issued by the International Bank for Reconstruction and Development with maturity on 15 December 2007, at the book value of 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 2006 was CZK 1,974 million (31 December 2005: CZK 1,905 million).

The total market value of gold as at 31 December 2006 was CZK 5,691 million (31 December 2005: CZK 5,527 million).

**4 RECEIVABLES FROM AND PAYABLES TO IMF**

	<u>31 December 2006</u>	<u>31 December 2005</u>
	CZK million	CZK million
Membership quota at IMF	24,111	24,499
Deposits in IMF	<u>2,503</u>	<u>4,647</u>
Total receivables from IMF	<u>26,614</u>	<u>29,146</u>
Liability to IMF	15,381	17,347
Current account with IMF	<u>8,384</u>	<u>6,863</u>
Total payables to IMF	<u>23,765</u>	<u>24,210</u>

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

CZECH NATIONAL BANK

NOTES TO FINANCIAL STATEMENTS

FOR THE YEAR ENDED 31 DECEMBER 2006

**5 RECEIVABLES FROM FOREIGN COUNTRIES INCLUDING SECURITIES**

	<u>31 December 2006</u>	<u>31 December 2005</u>
	CZK million	CZK million
Current accounts with banks	45	1,480
Deposits	<u>120,368</u>	<u>139,441</u>
<b>Total deposits at foreign banks</b>	<b>120,413</b>	<b>140,921</b>
<b>Total loans provided to foreign banks</b>	<b>522</b>	<b>34,031</b>
Treasury bills and other discounted securities	129,300	179,239
Bonds and other coupon securities	<u>479,136</u>	<u>448,752</u>
<b>Total securities</b>	<b>608,436</b>	<b>627,991</b>
Cash in foreign currencies	<u>84</u>	<u>122</u>
<b>Total other receivables from foreign countries</b>	<b>84</b>	<b>122</b>
<b>Total receivables from foreign countries including securities</b>	<b><u>729,455</u></b>	<b><u>803,065</u></b>

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

**Treasury bills and other discounted securities**

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

	<u>Fair value</u>	<u>Fair value</u>
	<u>31 December 2006</u>	<u>31 December 2005</u>
	CZK million	CZK million
Treasury bills	41,834	84,591
Other discounted securities	<u>87,466</u>	<u>94,648</u>
<b>Total treasury bills and other discounted securities</b>	<b><u>129,300</u></b>	<b><u>179,239</u></b>

**CZECH NATIONAL BANK**  
**NOTES TO FINANCIAL STATEMENTS**  
**FOR THE YEAR ENDED 31 DECEMBER 2006**

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

**Bonds and other coupon securities**

Bonds and other coupon securities can be analysed as follows:

	Fair value <u>31 December 2006</u> CZK million	Fair value <u>31 December 2005</u> CZK million
State bonds	281,918	281,865
Other foreign bonds (bonds issued by foreign financial institutions)	<u>197,218</u>	<u>166,887</u>
Total bonds and other coupon securities	<u>479,136</u>	<u>448,752</u>

**6 RECEIVABLES FROM DOMESTIC BANKS**

	<u>31 December 2006</u> CZK million	<u>31 December 2005</u> CZK million
Receivables from reverse repo transactions	-	29,002
Non-performing loans	14	14
Loans provided by European Investment Bank (hereinafter the "EIB") funds (Note 12)	<u>27</u>	<u>48</u>
	41	29,064
Specific provisions against receivables from domestic banks (Note 17)	<u>(14)</u>	<u>(14)</u>
Total net receivables from domestic banks	<u>27</u>	<u>29,050</u>

**7 RECEIVABLES FROM CLIENTS**

	<u>31 December 2006</u> CZK million	<u>31 December 2005</u> CZK million
Standard loans	92	4,153
Loss loans net value	-	<u>8,317</u>
Total receivables from clients	<u>92</u>	<u>12,470</u>

**CZECH NATIONAL BANK**  
**NOTES TO FINANCIAL STATEMENTS**  
**FOR THE YEAR ENDED 31 DECEMBER 2006**

**7 RECEIVABLES FROM CLIENTS (continued)**

Loss loans can be analysed as follows:

	<u>31 December 2006</u>	<u>31 December 2005</u>
	CZK million	CZK million
Loss loans	8,588	17,057
Specific provisions (Note 17)	<u>(8,588)</u>	<u>(8,740)</u>
Net book value	<u>—</u>	<u>8,317</u>

The net book value and fair value of classified loans reflects the guarantee received from the Czech Government (hereinafter “the Guarantee”) (Notes 17 and 29). In 2006, the CNB received the final repayment of this Guarantee.

**8 RECEIVABLES FROM THE STATE**

	<u>31 December 2006</u>	<u>31 December 2005</u>
	CZK million	CZK million
Receivables from the state arising from an exercised Guarantee	—	<u>8,683</u>
Total receivables from the state	—	<u>8,683</u>

Receivables from the state arising from an exercised Guarantee as at 31 December 2005 represented a receivable from a former bank covered by the Guarantee (Notes 7 and 29). Since the liquidation of this former bank was finished and the bank was deleted from the Commercial register, this receivable did not exist any more and the CNB claimed it under the Guarantee. This claim was disclosed within receivables from the state. In 2006, the CNB received the final repayment of this Guarantee settling this receivables and partly also other receivables from former banks covered by the Guarantee.

**CZECH NATIONAL BANK**  
**NOTES TO FINANCIAL STATEMENTS**  
**FOR THE YEAR ENDED 31 DECEMBER 2006**

**9 FIXED ASSETS**

**Tangible fixed assets**

<u>Cost</u>	31 December <u>2005</u> CZK million	<u>Additions</u> CZK million	<u>Disposals</u> CZK million	31 December <u>2006</u> CZK million
Land	196	3	(11)	188
Buildings	6,814	156	(3)	6,967
Technical equipment	2,774	205	(479)	2,500
Furniture and fittings	332	10	(14)	328
Other	434	19	(8)	445
Tangible assets in the course of construction	14	387	(393)	8
Advance payments for tangible assets	<u>161</u>	<u>44</u>	<u>(205)</u>	<u>-</u>
Total cost	<u>10,725</u>	<u>824</u>	<u>(1,113)</u>	<u>10,436</u>
<u>Accumulated depreciation</u>				
Buildings	(1,689)	(234)	2	(1,921)
Technical equipment	(2,265)	(204)	474	(1,995)
Furniture and fittings	(307)	(13)	14	(306)
Other	<u>(400)</u>	<u>(16)</u>	<u>5</u>	<u>(411)</u>
Total accumulated depreciation	<u>(4,661)</u>	<u>(467)</u>	<u>495</u>	<u>(4,633)</u>
Net book amount	<u>6,064</u>			<u>5,803</u>

**CZECH NATIONAL BANK**  
**NOTES TO FINANCIAL STATEMENTS**  
**FOR THE YEAR ENDED 31 DECEMBER 2006**

**9 FIXED ASSETS (continued)**

**Intangible fixed assets**

<u>Cost</u>	31 December <u>2005</u> CZK million	<u>Additions</u> CZK million	<u>Disposals</u> CZK million	31 December <u>2006</u> CZK million
Software	1,196	83	(3)	1,276
Other intangible assets	7	5	-	12
Intangible assets not yet put into use	9	79	(88)	-
Advance payments for intangible assets	<u>-</u>	<u>2</u>	<u>(2)</u>	<u>-</u>
Total cost	<u>1,212</u>	<u>169</u>	<u>(93)</u>	<u>1,288</u>
<u>Accumulated amortisation</u>				
Software	(1,138)	(66)	3	(1,201)
Other intangible assets	<u>(3)</u>	<u>(2)</u>	<u>-</u>	<u>(5)</u>
Total accumulated amortisation	<u>(1,141)</u>	<u>(68)</u>	<u>3</u>	<u>(1,206)</u>
Net book amount	<u>71</u>			<u>82</u>

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

**CZECH NATIONAL BANK**

**NOTES TO FINANCIAL STATEMENTS**

**FOR THE YEAR ENDED 31 DECEMBER 2006**

**10 OTHER ASSETS**

	<u>31 December 2006</u>	<u>31 December 2005</u>
	CZK million	CZK million
Prepaid expenses	27	23
Advances in relation to the Indemnity letter (Note 29)	2,946	2,430
Other advances in relation to the consolidation of the banking sector	-	56
Other foreign financial assets	2,816	2,985
Other precious metals	7	18
Positive fair value of foreign currency forwards (Note 24)	766	364
Margin account including fair value of futures (Note 24)	22	53
Other	<u>1,180</u>	<u>1,125</u>
	7,764	7,054
Specific provisions to advances and other assets (Note 17)	<u>(1,088)</u>	<u>(1,084)</u>
Total other assets	<u>6,676</u>	<u>5,970</u>

Other foreign financial assets include the CNB's share in European Central Bank (hereinafter only "ECB"), Bank for International Settlement (hereinafter "BIS") and SWIFT.

In line with the article 29 of the Statute of European central banks and European central bank, the membership share on ECB of 1.4584% was calculated based on the population and gross domestic product in the total amount of EUR 5.7 million. The residual part will be paid after the accession of the Czech Republic into the European monetary union.

The shares of BIS and SWIFT are non-tradable and their holding results from the participation of the CNB in these institutions.

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

The shares in BIS are measured at CNB's share on the paid-up portion of BIS net assets (or equity) reduced by 30%, which reflects the valuation of shares used by BIS.



**CZECH NATIONAL BANK**  
**NOTES TO FINANCIAL STATEMENTS**  
**FOR THE YEAR ENDED 31 DECEMBER 2006**

**11 CURRENCY IN CIRCULATION**

	<u>31 December 2006</u> CZK million	<u>31 December 2005</u> CZK million
Notes in circulation	313,279	280,727
Coins in circulation	8,216	7,046
Cash in hand denominated in CZK	—	(11)
Total currency in circulation	<u>321,495</u>	<u>287,762</u>

**12 LIABILITIES TO FOREIGN COUNTRIES**

	<u>31 December 2006</u> CZK million	<u>31 December 2005</u> CZK million
Repo operations	81,107	86,621
Loans from the EIB (Note 6)	<u>27</u>	<u>48</u>
Total loans from foreign countries	81,134	86,669
Other liabilities to foreign countries	<u>492</u>	<u>408</u>
Total liabilities to foreign countries	<u>81,626</u>	<u>87,077</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.

**13 DUE TO DOMESTIC BANKS**

	<u>31 December 2006</u> CZK million	<u>31 December 2005</u> CZK million
Banks' monetary reserves	30,611	17,249
Repo operations	297,811	377,757
Other liabilities to domestic banks	<u>3,367</u>	<u>4,299</u>
Total liabilities to domestic banks	<u>331,789</u>	<u>399,305</u>

**CZECH NATIONAL BANK****NOTES TO FINANCIAL STATEMENTS****FOR THE YEAR ENDED 31 DECEMBER 2006****13 DUE TO DOMESTIC BANKS (continued)****Banks' monetary reserves**

Obligatory minimum reserves represent deposits of the banks in the CR held at the CNB which banks cannot dispose with. The CNB pays interest equal to the CZK two-week repo interest rate on these deposits, which has been 2.5% p.a. as at 31 December 2006 (2005: 2.0% p.a.). Obligatory minimum reserves are defined as 2% of received deposits and loans from non-banking clients or selected issued securities.

**Other liabilities to domestic banks**

Other liabilities to domestic banks represent deposits for handling cash and deposits used for inter-bank money transfers.

**14 DEPOSITS FROM CLIENTS**

	<u>31 December 2006</u>	<u>31 December 2005</u>
	CZK million	CZK million
Current accounts	9,079	9,260
Term deposits	16,849	46,957
Deposits of local government bodies	11,303	9,065
Other deposits	<u>2,902</u>	<u>2,812</u>
Total deposits from clients	<u>40,133</u>	<u>68,094</u>

**15 LIABILITIES TO THE STATE**

	<u>31 December 2006</u>	<u>31 December 2005</u>
	CZK million	CZK million
State funds' accounts	9,299	12,940
State assets denominated in CZK	102,801	89,365
State assets denominated in foreign currency	<u>6,879</u>	<u>10,358</u>
Total liabilities to the state	<u>118,979</u>	<u>112,663</u>

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**16 EQUITY**

Changes in equity during 2006 and 2005 were as follows:

	Share <u>capital</u> CZK million	<u>Funds</u> CZK million	Accumulate d <u>losses</u> CZK million	Revaluation <u>reserve</u> CZK million	Profit/(loss) <u>for the period</u> CZK million	<u>Equity</u> CZK million
Balance as at 1 January 2005	1,400	8,075	(71,953)	-	(53,717)	(116,195)
Transfer to accumulated losses	-	-	(53,717)	-	53,717	-
Usage of social fund	-	(31)	-	-	-	(31)
Revaluation reserve	-	-	-	(433)	-	(433)
Profit for the year 2005	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>19,957</u>	<u>19,957</u>
Balance as at 31 December 2005	<u>1,400</u>	<u>8,044</u>	<u>(125,670)</u>	<u>(433)</u>	<u>19,957</u>	<u>(96,702)</u>
Transfer to accumulated losses	-	-	19,957	-	(19,957)	-
Acquisition of fixed assets						
acquired free of charge	-	75	-	-	-	75
Allocation to funds	-	35	(35)	-	-	-
Usage of social fund	-	(31)	-	-	-	(31)
Revaluation reserve	-	-	-	(1,007)	-	(1,007)
Loss for the year 2006	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>(56,385)</u>	<u>(56,385)</u>
Balance as at 31 December 2006	<u>1,400</u>	<u>8,123</u>	<u>(105,748)</u>	<u>(1,440)</u>	<u>(56,385)</u>	<u>(154,050)</u>

**Funds**

The major part of funds is represented by the General reserve fund of CZK 7,773 million existing at both year ends, which can be used to cover accumulated losses, increase share capital or for any other purpose approved by the Bank Board of the CNB, as well as the Special reserve fund (see below).

The Social fund of CZK 9 million as at 31 December 2006 (31 December 2005: CZK 6 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 previous year. If the CNB achieved a loss in the previous year, the allocation to the Social fund is made from the Special reserve fund.

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**17 PROVISIONS, SPECIFIC PROVISIONS AND WRITE-OFFS**

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

	<u>31 December 2006</u>	<u>31 December 2005</u>
	CZK million	CZK million
<b>Specific provisions</b>		
Non-performing loans due from domestic banks (Note 6)	14	14
Classified loans to clients (Note 7)	8,588	8,740
Other (Note 10)	<u>1,088</u>	<u>1,084</u>
Total specific provisions	<u>9,690</u>	<u>9,838</u>
<b>Provisions</b>		
Guarantee for CF (resulting from the Consolidation program)	-	3,815
Guarantees for clients (Note 19)	<u>240</u>	<u>282</u>
Total provisions	<u>240</u>	<u>4,097</u>

Česká Finanční, s.r.o. (hereinafter "CF") was wound up without liquidation by the take over of net assets by its sole shareholder, Česká konsolidační agentura, on 31 August 2006. Following the settlement of costs and losses resulting from assets taken over within the Consolidation program, the provision to the Guarantee for CF, created in the past, was released in 2006.

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**17 PROVISIONS, SPECIFIC PROVISIONS AND WRITE-OFFS (continued)**

**Specific provisions**

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

	Amounts due from banks	Classified loans	Other	Total
	CZK million	CZK million	CZK million	CZK million
As at 1 January 2005	14	9,080	574	9,668
Addition	-	-	510	510
Release	-	(340)	-	(340)
As at 31 December 2005	<u>14</u>	<u>8,740</u>	<u>1,084</u>	<u>9,838</u>
Addition	-	-	4	4
Utilisation	-	(17)	-	(17)
Release	-	(135)	-	(135)
As at 31 December 2006	<u>14</u>	<u>8,588</u>	<u>1,088</u>	<u>9,690</u>

**Provisions**

The movements in provisions can be analysed as follows:

	Standard loans	CF	Other guarantees	Total
	CZK million	CZK million	CZK million	CZK million
As at 1 January 2005	348	4,176	257	4,781
Addition	-	38	25	63
Release	(348)	(399)	-	(747)
As at 31 December 2005	<u>-</u>	<u>3,815</u>	<u>282</u>	<u>4,097</u>
Addition	-	-	6	6
Utilisation	-	(3,815)	-	(3,815)
Release	-	-	(48)	(48)
As at 31 December 2006	<u>-</u>	<u>-</u>	<u>240</u>	<u>240</u>

**CZECH NATIONAL BANK****NOTES TO FINANCIAL STATEMENTS****FOR THE YEAR ENDED 31 DECEMBER 2006****17 PROVISIONS, SPECIFIC PROVISIONS AND WRITE-OFFS (continued)**

Release of specific and general provisions for loans and guarantees, income from receivables already written off may be analysed as follows:

	<u>2006</u>	<u>2005</u>
	CZK million	CZK million
Release of specific provisions	135	340
Release of provisions	48	747
Income from receivables already written off	<u>1,200</u>	<u>-</u>
	<u>1,383</u>	<u>1,087</u>

Income from receivables already written off in 2006 represents partial compensation from Ministry of Finance of the CR for losses incurred on the dissolution of the State Bank of Czechoslovakia.

**18 OTHER LIABILITIES**

	<u>31 December 2006</u>	<u>31 December 2005</u>
	CZK million	CZK million
Negative fair value of foreign currency forwards (Note 24)	541	170
Advance received in relation to the State guarantee (Note 29)	2,955	2,433
Liabilities to the European Community	1,768	5,919
Other liabilities	<u>324</u>	<u>312</u>
Total other liabilities	<u>5,588</u>	<u>8,834</u>

**19 CONTINGENCIES AND COMMITMENTS**

<b>Issued guarantees</b>	<u>31 December 2006</u>	<u>31 December 2005</u>
	CZK million	CZK million
Clients	267	313
CF by virtue of Consolidation program (Note 17)	-	3,815
In relation to the Agreement and Indemnity letter (Note 29)	157,007	157,529
For IPB deposits (Note 29)	309	361
Consolidation of the banking sector – sale of part of the business (AGB)	<u>4,000</u>	<u>4,000</u>
Total issued guarantees	<u>161,583</u>	<u>166,018</u>

**CZECH NATIONAL BANK****NOTES TO FINANCIAL STATEMENTS****FOR THE YEAR ENDED 31 DECEMBER 2006****19 CONTINGENCIES AND COMMITMENTS (continued)**

The identified need for provisions for expected losses on the issued guarantees to clients was CZK 240 million as at 31 December 2006 (2005: CZK 282 million) (Note 17).

<b>Received guarantees</b>	<u>31 December 2006</u> CZK million	<u>31 December 2005</u> CZK million
From the Czech Government for impaired assets taken over by the Bank within the Consolidation programme (Note 29)	-	8,317
From the Ministry of Finance of the CR in relation to the State guarantee (Note 29)	<u>157,007</u>	<u>157,529</u>
Total guarantees received	<u>157,007</u>	<u>165,846</u>

<b>Off-balance sheet receivables and payables from option transactions</b>	<u>31 December 2006</u> CZK million	<u>31 December 2005</u> CZK million
The agreement about the sale option resulting from the sale of part of business of Agrobanka Praha a.s. (Note 24)	<u>38,687</u>	<u>31,092</u>

Receivables and payables from option operations represent the notional value of options issued in 1998 in favour of GE Capital International Holdings Corporation in connection with the sale of part of business of Agrobanka Praha a.s. to GE Capital Bank.

**Legal suits**

Pursuant to its role in supporting and maintaining the stability of the banking sector, the CNB or third parties became defendants in several legal suits. Negative results of these legal suits could impact the operations of the Bank. Based on the consultation with external law firms and internal analyses, the CNB does not consider probable that the outcome of these legal cases will result in any material outflow of the CNB resources and therefore has not recognised any provision.

**Assets held in custody**

The Bank has not received any financial assets from third parties to be held in custody in 2006 and 2005.



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**20 INTEREST MARGIN**

	<u>2006</u>	<u>2005</u>
	CZK million	CZK million
Interest income and similar income	27,906	20,587
Interest expense and similar expense	<u>(14,269)</u>	<u>(11,819)</u>
Interest margin	<u>13,637</u>	<u>8,768</u>

**Interest income and similar income**

	<u>2006</u>	<u>2005</u>
	CZK million	CZK million
Treasury bills and other discounted securities	5,097	3,863
Bonds	<u>17,110</u>	<u>13,310</u>
Total interest from securities	<u>22,207</u>	<u>17,173</u>
Inter-bank deposits	5,581	2,961
Receivables from the clients	36	286
Other	<u>82</u>	<u>167</u>
Total other interest income	<u>5,699</u>	<u>3,414</u>
Total interest income and similar income	<u>27,906</u>	<u>20,587</u>

**Interest expense and similar expense**

	<u>2006</u>	<u>2005</u>
	CZK million	CZK million
Liabilities to the state	131	204
Liabilities to banks	13,998	11,285
Liabilities to clients	<u>140</u>	<u>330</u>
Total interest expense and similar expense	<u>14,269</u>	<u>11,819</u>

**CZECH NATIONAL BANK****NOTES TO FINANCIAL STATEMENTS****FOR THE YEAR ENDED 31 DECEMBER 2006****21 GAINS LESS LOSSES FROM FINANCIAL OPERATIONS**

Gains less losses from financial operations can be analysed as follows:

	<u>2006</u>	<u>2005</u>
	CZK million	CZK million
Foreign exchange gains less losses	(66,994)	8,734
Foreign exchange spread	<u>995</u>	<u>1,533</u>
Net foreign exchange gains/(losses) and foreign exchange spread	(65,999)	10,267
Realised gain from sales of securities	353	2,511
Realised loss from sales of securities	(4,204)	(2,647)
Net gains/(losses) from currency forwards	(12)	1,790
Net gains/(losses) from interest futures	<u>(12)</u>	<u>36</u>
Total gain/(loss) from financial operations	<u>(69,874)</u>	<u>11,957</u>

The foreign exchange spread represents the difference between the bid or ask foreign exchange rate and the mid foreign exchange rate used for purchases and sales of the cash and non-cash of the Bank's clients.

**22 ADMINISTRATION EXPENSES**

The administration expenses can be analysed as follows:

	<u>2006</u>	<u>2005</u>
	CZK million	CZK million
Wages and salaries	722	627
Social security and health insurance	253	219
Training and other expense	<u>52</u>	<u>45</u>
Total personnel costs	<u>1,027</u>	<u>891</u>
Rent	17	13
Other	<u>489</u>	<u>428</u>
Total other administration expenses	<u>506</u>	<u>441</u>
Total administration expenses	<u>1,533</u>	<u>1,332</u>

**CZECH NATIONAL BANK****NOTES TO FINANCIAL STATEMENTS****FOR THE YEAR ENDED 31 DECEMBER 2006****22 ADMINISTRATION EXPENSES (continued)****Staff statistics**

	<u>2006</u>	<u>2005</u>
Average number of employees	1,458	1,433
From which: Number of members of the Bank Board	7	7

**23 OTHER OPERATING INCOME**

	<u>2006</u>	<u>2005</u>
	CZK million	CZK million
Income from issuing of bank notes and coins	327	28
Other	<u>84</u>	<u>597</u>
Total other operating income	<u>411</u>	<u>625</u>

**24 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 25 analyses and assigns assets and liabilities of the Bank into relevant maturity bands based on the remaining period as 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 losses resulting from changes in interest rates. The table in Note 26 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, categorised by the earlier of contractual, re-pricing or maturity dates.

**24 FINANCIAL RISKS (continued)****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 reflects the main functions of the central bank and foreign currency reserves, i.e. support for the ability of CNB to perform intervention, insurance against a Balance of Payments crisis and reflects the basic principle of management of assets, being diversification. Due to the necessity to keep foreign currency reserves, the CNB cannot reduce the risk of the strengthening of the Czech currency against major foreign currencies. The table in Note 27 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, categorised 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 28.

**Spot transactions and derivative financial instruments**

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

<u>Off-balance sheet receivables:</u>	<u>31 December 2006</u>	<u>31 December 2005</u>
	CZK million	CZK million
- from future transactions	224	3,862
- from unsettled spot transactions	12,014	15,893
- from forward transactions	59,554	58,825
- from option transactions (Note 24)	<u>38,687</u>	<u>31,092</u>
	<u>110,479</u>	<u>109,672</u>
<u>Off-balance sheet payables:</u>		
- from future transactions	224	3,862
- from unsettled spot transactions	2,172	12,768
- from forward transactions	59,515	58,478
- from option transactions (Note 24)	38,687	31,092
- securities received in reverse repo operations	<u>-</u>	<u>29,000</u>
	<u>100,598</u>	<u>135,200</u>

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**24 FINANCIAL RISKS (continued)**

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

	<u>31 December 2006</u>	<u>31 December 2005</u>
	CZK million	CZK million
Off-balance sheet receivables from forward transactions	59,554	58,825
Off-balance sheet payables from forward transactions	59,515	58,478
Positive fair value (Note 10)	766	364
Negative fair value (Note 18)	541	170

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

The foreign currency forwards do not fulfil the criteria for hedge accounting required by the Czech accounting rules, so 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 gain less loss from financial operations (Note 21).

The Bank has outstanding futures as at the balance sheet date:

	<u>31 December 2006</u>	<u>31 December 2005</u>
	CZK million	CZK million
Off-balance sheet receivables and payables from futures transactions	224	3,862
Net gain/(loss) from change in fair values of futures transactions open at the year-end	(12)	3

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 2006</u>	<u>31 December 2005</u>
	CZK million	CZK million
Net gain/(loss) from change in fair values of futures transactions open at the year-end	(12)	3
Cash on margin account	<u>34</u>	<u>50</u>
Margin account including settled change in fair value of futures (Note 10)	<u>22</u>	<u>53</u>
		(27)

**CZECH NATIONAL BANK**

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**25 LIQUIDITY RISK**

<b>As at 31 December 2006</b>	<u>Up to 1 month</u> CZK mil.	<u>1-3 months</u> CZK mil.	<u>3-12 months</u> CZK mil.	<u>1-5 years</u> CZK mil.	<u>Over 5 years</u> CZK mil.	<u>Un- specified</u> CZK mil.	<u>Total</u> CZK mil.
<b>Assets</b>							
Gold	533	-	283	-	-	-	816
Receivables from IMF	-	-	-	-	-	26,614	26,614
Treasury bills and other discounted securities	45,537	37,713	46,050	-	-	-	129,300
Bonds and other coupon securities	24,054	36,666	42,199	228,676	147,541	-	479,136
Deposits, loans and other receivables from foreign countries	121,019	-	-	-	-	-	121,019
Receivables from domestic banks	-	10	10	7	-	-	27
Receivables from clients	-	-	-	5	87	-	92
Fixed assets	-	-	-	-	-	5,885	5,885
Other assets	<u>565</u>	<u>323</u>	<u>27</u>	<u>-</u>	<u>2,945</u>	<u>2,816</u>	<u>6,676</u>
<b>Total assets</b>	<u>191,708</u>	<u>74,712</u>	<u>88,569</u>	<u>228,688</u>	<u>150,573</u>	<u>35,315</u>	<u>769,565</u>
<b>Liabilities and equity</b>							
Currency in circulation	-	-	-	-	-	321,495	321,495
Liabilities to IMF	-	-	-	-	-	23,765	23,765
Liabilities to foreign countries	80,393	1,216	10	7	-	-	81,626
Liabilities to domestic banks	331,789	-	-	-	-	-	331,789
Deposits from clients	39,564	-	340	229	-	-	40,133
Liabilities to the state	118,979	-	-	-	-	-	118,979
Provisions	-	-	-	-	-	240	240
Equity	-	-	-	-	-	(154,050)	(154,050)
Other liabilities	<u>2,258</u>	<u>355</u>	<u>5</u>	<u>14</u>	<u>-</u>	<u>2,956</u>	<u>5,588</u>
<b>Total liabilities and equity</b>	<u>572,983</u>	<u>1,571</u>	<u>355</u>	<u>250</u>	<u>-</u>	<u>194,406</u>	<u>769,565</u>
<b>Net liquidity gap</b>	<u>(381,275)</u>	<u>73,141</u>	<u>88,214</u>	<u>228,438</u>	<u>150,573</u>	<u>(159,091)</u>	<u>-</u>
<b>Balance as at 31 December 2005</b>							
<b>Total assets</b>	289,293	80,227	118,379	254,961	114,694	37,786	895,340
<b>Total liabilities</b>	<u>626,458</u>	<u>29,278</u>	<u>377</u>	<u>16,235</u>	<u>1,186</u>	<u>221,806</u>	<u>895,340</u>
<b>Net liquidity gap</b>	<u>(337,165)</u>	<u>50,949</u>	<u>118,002</u>	<u>238,726</u>	<u>113,508</u>	<u>(184,020)</u>	<u>-</u>

**CZECH NATIONAL BANK**

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**26 INTEREST RATE RISK**

<b>As at 31 December 2006</b>	<b>Up to <u>1 month</u> CZK mil.</b>	<b>1-3 <u>months</u> CZK mil.</b>	<b>3-12 <u>months</u> CZK mil.</b>	<b>1-5 <u>years</u> CZK mil.</b>	<b>Over <u>5 years</u> CZK mil.</b>	<b>Un- <u>specified</u> CZK mil.</b>	<b><u>Total</u> CZK mil.</b>
<b>Assets</b>							
Gold	-	-	-	-	-	816	816
Receivables from IMF	-	2,671	-	-	-	23,943	26,614
Treasury bills and other discounted securities	45,537	37,713	46,050	-	-	-	129,300
Bonds and other coupon securities	73,493	184,863	220,780	-	-	-	479,136
Deposits, loans and other receivables from foreign countries	121,019	-	-	-	-	-	121,019
Receivables from domestic banks	-	10	10	7	-	-	27
Receivables from clients	-	-	-	5	87	-	92
Fixed assets	-	-	-	-	-	5,885	5,885
Other assets	<u>465</u>	<u>323</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>5,888</u>	<u>6,676</u>
<b>Total assets</b>	<u>240,514</u>	<u>225,580</u>	<u>266,840</u>	<u>12</u>	<u>87</u>	<u>36,532</u>	<u>769,565</u>
<b>Liabilities and equity</b>							
Currency in circulation	-	-	-	-	-	321,495	321,495
Liabilities to IMF	-	-	-	-	-	23,765	23,765
Liabilities to foreign countries	80,393	1,216	10	7	-	-	81,626
Liabilities to domestic banks	331,789	-	-	-	-	-	331,789
Deposits from clients	39,565	568	-	-	-	-	40,133
Liabilities to the state	118,979	-	-	-	-	-	118,979
Provisions	-	-	-	-	-	240	240
Equity	-	-	-	-	-	(154,050)	(154,050)
Other liabilities	<u>181</u>	<u>354</u>	<u>5</u>	<u>14</u>	<u>-</u>	<u>5,034</u>	<u>5,588</u>
<b>Total liabilities and equity</b>	<u>570,907</u>	<u>2,138</u>	<u>15</u>	<u>21</u>	<u>-</u>	<u>196,484</u>	<u>769,565</u>
<b>Net interest sensitivity gap</b>	<u>(330,393)</u>	<u>223,442</u>	<u>266,825</u>	<u>(9)</u>	<u>87</u>	<u>(159,952)</u>	<u>-</u>
<b>Balance as at 31 December 2005</b>							
<b>Total assets</b>	292,613	90,392	115,095	245,668	114,694	36,878	895,340
<b>Total liabilities</b>	<u>667,335</u>	<u>10</u>	<u>10</u>	<u>28</u>	<u>-</u>	<u>227,957</u>	<u>895,340</u>
<b>Net interest sensitivity gap</b>	<u>(374,722)</u>	<u>90,382</u>	<u>115,085</u>	<u>245,640</u>	<u>114,694</u>	<u>(191,079)</u>	<u>-</u>



**CZECH NATIONAL BANK**

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**27 CURRENCY RISK**

<b>As at 31 December 2006</b>	<u>CZK</u>	<u>EUR</u>	<u>USD</u>	<u>JPY</u>	<u>Other</u>	<u>Total</u>
	CZK mil.	CZK mil.	CZK mil.	CZK mil.	CZK mil.	CZK mil.
<b>Assets</b>						
Gold	-	-	-	-	816	816
Receivables from IMF	23,765	-	-	-	2,849	26,614
Treasury bills and other discounted securities	-	72,075	57,225	-	-	129,300
Bonds and other coupon securities	-	260,511	218,625	-	-	479,136
Deposits, loans and other						
receivables from foreign countries	-	41,807	79,163	1	48	121,019
Receivables from domestic banks	-	27	-	-	-	27
Receivables from clients	92	-	-	-	-	92
Fixed assets	5,875	-	-	-	10	5,885
Other assets	<u>3,747</u>	<u>263</u>	<u>-</u>	<u>-</u>	<u>2,666</u>	<u>6,676</u>
<b>Total assets</b>	<u>33,479</u>	<u>374,683</u>	<u>355,013</u>	<u>1</u>	<u>6,389</u>	<u>769,565</u>
<b>Liabilities</b>						
Currency in circulation	321,495	-	-	-	-	321,495
Liabilities to IMF	23,765	-	-	-	-	23,765
Liabilities to foreign countries	492	5,088	76,046	-	-	81,626
Liabilities to domestic banks	331,789	-	-	-	-	331,789
Deposits from clients	23,841	16,255	37	-	-	40,133
Liabilities to the state	112,100	6,878	1	-	-	118,979
Provisions	240	-	-	-	-	240
Other liabilities	<u>3,866</u>	<u>1,722</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>5,588</u>
<b>Total liabilities</b>	<u>817,588</u>	<u>29,943</u>	<u>76,084</u>	<u>-</u>	<u>-</u>	<u>923,615</u>
<b>Net assets / (liabilities)</b>	(784,109)	344,740	278,929	1	6,389	(154,050)
<b>Net off-balance sheet assets / (liabilities)</b>	<u>17</u>	<u>8,001</u>	<u>(55,536)</u>	<u>27,387</u>	<u>30,012</u>	<u>9,881</u>
<b>Net foreign exchange position</b>	<u>(784,092)</u>	<u>352,741</u>	<u>223,393</u>	<u>27,388</u>	<u>36,401</u>	<u>(144,169)</u>
<b>Balance as at 31 December 2005</b>						
<b>Total assets</b>	83,333	354,209	390,194	58,482	9,122	895,340
<b>Total liabilities</b>	<u>842,751</u>	<u>62,358</u>	<u>86,933</u>	<u>-</u>	<u>-</u>	<u>992,042</u>
<b>Net assets / (liabilities)</b>	(759,418)	291,851	303,261	58,482	9,122	(96,702)
<b>Net off-balance sheet assets / (liabilities)</b>	<u>(29,000)</u>	<u>48,837</u>	<u>13,113</u>	<u>(58,478)</u>	<u>-</u>	<u>(25,528)</u>
<b>Net foreign exchange position</b>	<u>(788,418)</u>	<u>340,688</u>	<u>316,374</u>	<u>4</u>	<u>9,122</u>	<u>(122,230)</u>

**CZECH NATIONAL BANK**

**NOTES TO FINANCIAL STATEMENTS**

**FOR THE YEAR ENDED 31 DECEMBER 2006**

**28 CREDIT RISK AND CONCENTRATION OF LIABILITIES**

**Geographical concentrations of assets**

	<u>31 December 2006</u>	<u>31 December 2005</u>
	CZK million	CZK million
Czech Republic	10,352	59,810
Germany	119,184	139,889
France	84,680	74,959
Italy	57,538	51,654
Other Euro zone countries	116,652	130,043
Switzerland	23,757	15,882
Great Britain	90,386	76,167
Other European countries	6,243	4,766
USA and Canada	239,999	275,938
Japan	2	58,482
Other countries	<u>20,772</u>	<u>7,750</u>
	<u>769,565</u>	<u>895,340</u>
From which:		
Central governments	360,212	385,376
Government agencies	31,858	39,802
Securities hedged by other assets (pfandbriefs)	76,499	77,616
Commercial banks	171,375	201,737
BIS	<u>8,132</u>	<u>11,131</u>
	<u>648,076</u>	<u>715,662</u>

**Geographical concentrations of liabilities**

	<u>31 December 2006</u>	<u>31 December 2005</u>
	CZK million	CZK million
Czech Republic	662,433	778,134
Euro zone countries	5,623	5,970
Other European countries	1,217	5
USA and Canada	<u>100,292</u>	<u>111,231</u>
	<u>769,565</u>	<u>895,340</u>

**CZECH NATIONAL BANK**

**NOTES TO FINANCIAL STATEMENTS**

**FOR THE YEAR ENDED 31 DECEMBER 2006**

**29 CONSOLIDATION OF THE BANKING SECTOR**

**Government guarantee received from banking sector consolidation**

Pursuant to its role in supporting and maintaining the stability of the banking sector and monitoring the security of the clients' deposits in the 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 to cover the exposure of the Bank arising as a consequence of these activities. The Guarantee was issued on 19 March 1997 and was valid for ten years from that date. The CNB did fully provide for the residual portion of these assets not covered by this Guarantee in the past. In 2006, the CNB received the final repayment of this Guarantee.

The Guarantee receivable can be analysed as follows:

	<u>31 December 2006</u>	<u>31 December 2005</u>
	CZK million	CZK million
Total Guarantee issued by the Czech Government	22,500	22,500
Total cumulative payments received from Ministry of Finance of the CR (Note 8)	<u>(22,500)</u>	<u>(5,500)</u>
Guarantee receivable	<u>—</u>	<u>17,000</u>
Represented by:		
- Net book value of loss loans (Notes 7 and 19)	-	8,317
- Receivables from state (Note 8)	-	8,683

**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.

**29 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 2006 was CZK 309 million (31 December 2005: CZK 361 million).

The forced administrator of IPB concluded a contract with CSOB 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 State 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 binding 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.

**CZECH NATIONAL BANK****NOTES TO FINANCIAL STATEMENTS****FOR THE YEAR ENDED 31 DECEMBER 2006****29 CONSOLIDATION OF THE BANKING SECTOR (continued)****Investiční a Poštovní banka, a.s. (continued)**

The advances and final payments to CSOB and potential amounts covered under the Indemnity letter can be analysed as follows:

	<u>31 December 2006</u>	<u>31 December 2005</u>
	CZK million	CZK million
Total potential claims under the Indemnity Letter	160,000	160,000
Advances paid to CSOB (Note 10)	(2,946)	(2,430)
Foreign exchange differences	(9)	-
Settlement to CSOB	<u>(38)</u>	<u>(38)</u>
Potential future claims under the Indemnity Letter (Note 19)	<u>157,007</u>	<u>157,532</u>

The advances and final payments received from the State Guarantee and available State Guarantee can be analysed as follows:

	<u>31 December 2006</u>	<u>31 December 2005</u>
	CZK million	CZK million
Total State Guarantee received	160,000	160,000
Advances received from the State Guarantee (Note 18)	(2,955)	(2,433)
Final settlement from the State Guarantee	<u>(38)</u>	<u>(38)</u>
State Guarantee receivables at year end (Note 19)	<u>157,007</u>	<u>157,529</u>

The CNB has not recognised 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, then claimed from the CNB, which would not be covered by State Guarantee and would therefore become an expense of CNB.

**30 RELATED PARTY TRANSACTIONS**

Related parties and parties with special relations to the Bank are members of the Bank Board, other senior management and their relatives.

CNB grants members of the Bank Board and senior management in accordance with internal rules special purpose loans, especially for housing. These loans are financed from special reserve fund set aside from the profits of previous periods of the CNB. The loans to the members of the Bank Board and senior management are provided under the same conditions as loans to other employees.

**31 SUBSEQUENT EVENTS**

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