Basel II

We are familiar with new lending methods
We are able to offer stable processes
We know how to improve the rating of your firm

ČESKÁ SPOŘITELNA
Jsme Vám blíž.

Opening Statement

Dr. Heinz Knotzer
Member of the Board of Directors
And Deputy C.E.O.

Dear client,

New capital adequacy regulations for banking institutions, known as "Basel II", will come into force and effect in the year 2007. These regulations are addressed namely to banks. However, due to their impacts on the credit area they apply to you as well. Therefore, we would like to briefly inform you in this brochure about the most important points regarding Basel II.

What is governed by Basel II

Due to the new regulations, banks will calculate the required level of capital adequacy for loans based on the rating of the respective borrower. Instead of obligatory lump sum reserves, attention is brought to the individual specific credit risk.

In future, individual measurement methods, so-called internal models, will be used to determine the borrower's standing (rating). Rating will become the decisive criterion for granting loans.

The internal method used by Česká spořitelna for determining the rating serves as the basis for:

- the highest possible level of objectivity in the loan approval process
- formation of prices of loans
- loan portfolio management
- calculation of capital adequacy

What does this mean for you as a client and how can you improve your rating?

The general rule applies: The better rating you get, the lower the bank's cost of reserves is, which may be reflected in the cost of financing. Therefore, your rating is an important factor for the calculation of your terms and conditions of financing – and you can contribute to the better rating of your firm. The first step is open communication with your bank. This brochure, with a number of very practical tips, will show you what else you can do.

What is governed by Basel II

There have probably never been such intensive and controversial discussions about any other topic within the financial and banking world in recent years as about the Basel II accord. Some take it as another overdue and necessary step necessary in order to ensure stabilisation of the financial markets, some perceive it as a nightmare that may threaten our national economy due to increased costs of corporate financing. This information brochure will help you to understand the background and namely the impacts of the Basel II regulations on Česká spořitelna and its clients.

Basel II covers new recommendations to banks regarding the calculation of capital charge – client risk assessment.

The Swiss city of Basel is the seat of the Bank of International Settlements, which also contains the Banks Supervision Committee. This board was established in the year 1974 by the central banks of the G10 and consists of the representatives of central banks and bank supervision bodies of Germany, France, Great Britain, Belgium, Luxembourg, Netherlands, Switzerland, Italy, Spain, Sweden, Japan, Canada and USA.

About four years ago, the Committee started to discuss new terms for banking transactions; the conditions under which it would be possible to ensure or increase the stability of the international financial world with regard to the increasing interrelationship of the institutions involved ("globalisation of economy"). Based on the geographical location of the meetings of the Committee, the public started to call the new regulations regarding capital reserves for banks Basel II for short.

On the way from Basel I…

According to the new regulations, any bank must hold more of its own funds the higher risks it undertakes due to its involvement in certain credit transactions.

Efforts to introduce consistent rules for capital adequacy of banks started in the mid 1980s when the capital of various banks fell dangerously due to competition. This resulted in the regulations adopted in 1988 and in effect till today. In brief, the regulations stated that banks offering corporate financing must hold in reserve 8% of the amount of the granted loans. No differentiation of borrowers based on their rating is assumed.

This so-called Basel I accord achieved unification of regulations regarding capital charge and it became an important milestone leading to strengthening of the structure of the international financial system. However, various changes on financial markets resulted in a situation where the existing measures were not sufficient to ensure an economically reasonable ratio of the risk of loan default to the capital that had to be held as reserve for provision reasons.

…to Basel II

The main purpose of the new regulations regarding capital requirement for banks, Basel II for short, is to make banks hold capital reserves that correspond to their individual risk profile. In the end, the bank's capital serves to help its stability in critical situations. It is also a countervail source for future unexpected losses. The rule that applies to all banks is that the higher the risk the bank undertakes due to its involvement in certain loan transactions, the more of its own capital it must hold.

In order to be able to achieve these targets in the form of adequate capital, the respective bank must be able to assess its risk as precisely as possible. The assessment of the risk level of a specific loan is usually performed by using the bank's internal rating methods.

Contents of Basel II accord

The Basel II regulations not only define new obligations regarding capital adequacy, but they also cover the regulator's obligations in bank supervision and the scope of information to be disclosed by banks. These three chapters of the Basel II accord together form the "three pillars' principle", described in more details in the following chapter.

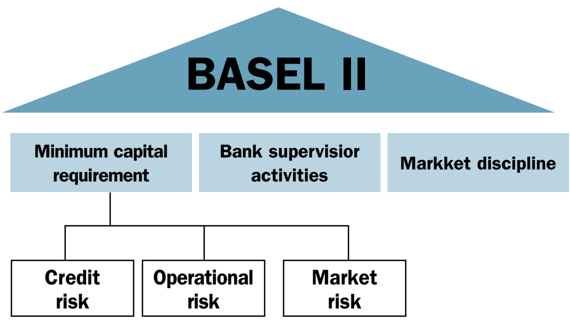
According to Basel II, for the calculation of capital charge it is necessary to take into account credit risk, market risk and operational risk.

The aims of Basel II may be summarised as follows:

- support of security and stability of the financial sector, greater ability to compete
- capital charges corresponding to risks
- all risks are taken into account
- acknowledgement of bank's internal methods of risk assessment
- application to banks worldwide, internationally consistent system
- enhancement of bank supervision and market

As the list above shows, Basel II regulations not only define new obligations regarding capital adequacy, but they also cover the regulator's obligations in bank supervision and the scope of information to be disclosed by banks. These three chapters of the Basel II accord together form the "three pillars' principle".

Fig. 1: Basel II structure



Pillar 1: Capital requirement

According to Basel II, for the calculation of capital charge it is necessary to take into account credit risk, market risk and operational risk.

1. Credit risk and its measurement is the main topic of this information brochure and directly relates to clients and their financing.

2. Market risks result from fluctuations in interest rates, exchange rates, quotation of shares or commodities. They apply to both business transactions with daily rates (trading book) as well as to traditional banking business (banking book).

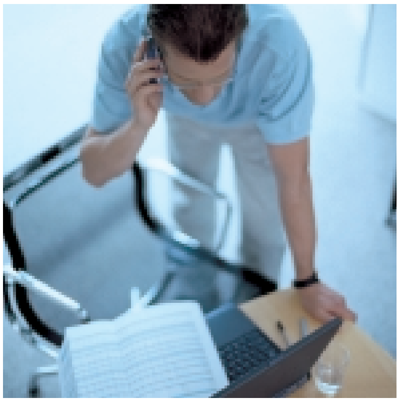
3. Operational risk is defined by Basel II as "the risk of losses resulting from inadequacy or failure of internal mechanisms, persons and systems or external events".

The bank's capital charge is calculated based on the sum of the three risk categories.

Pillar 2: Bank supervision activities

This regulation defines the rights and obligations of national regulators (supervisory bodies). In the Czech Republic it is the Czech National Bank that is equipped with a number of information rights, regulatory and sanction powers. One of the most important tasks of the bank supervision is to control the reliability and predictive efficiency of the respective bank's internal methods of risk measurement.

Basel II extends the arsenal of measures that can be undertaken to lower the risks connected with loans.



In future each bank will have to inform and document how it measures its risk.

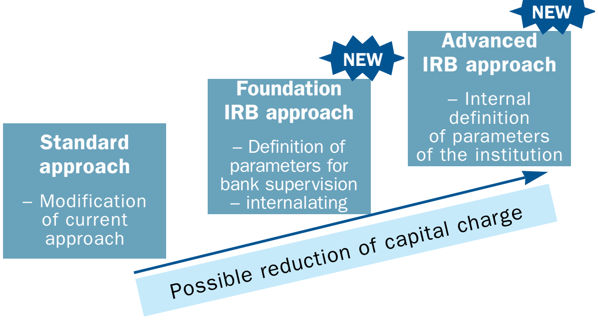
Pillar 3: Market discipline

Market discipline means the disclosure of relevant risk indicators. In future, each bank will have to inform about and document the detailed risk profile and how much of its own capital it holds as reserve in proportion to the accepted risks. This required transparency should be reflected in the medium term perspective also in the area of competition. Credit institutions will be forced to implement modern risk management systems and to keep enhancing them. In the end, a credit portfolio managed by advanced methods and with a risk level clearly recognizable to an observer will be appreciated by the market (shareholders, clients).

Different approaches to risk measurement method

According to Basel II, capital charge can be calculated either based on the "standard approach" defined by the Basel accord, or based on the so-called IRB approaches ("internal rating based" approaches), i.e. risk measurement methods developed by the banks themselves based on statistical data regarding risks.

Fig. 2: Possible approaches according to Basel II



Standard approach

Unlike IRB approaches (see below) where the bank's internal ratings are decisive, in order to determine the risk weight in case of standard approach the ratings of renowned rating agencies are used exclusively (Standard & Poor's, Moody's, Fitch Ratings etc.). Borrowers who do not have any rating are assigned the risk weight 100 % (corresponds to a capital charge of 8 %).

Fig. 3: Calculation of obligatory capital reserve (capital charge) based on the standard approach

Capital charge = loan amount x risk weight x capital adequacy = 8 %

In the Czech Republic there are very few firms that have external rating. For the prevailing part of corporate clients applying for a loan this means a unified risk weight of 100 %. And this is the weak point of this approach: due to insufficient differentiation of the standing of borrowers it is practically impossible to calculate adequate capital reserve corresponding with the individual risk profile of the respective bank. In the end, the standard approach based calculation of the capital charge is only slightly different from the calculation based on the regulations in effect (Basel I).

"Internal rating based" approach

IRB ("internal rating based") approaches – fundamental and advanced – allow banks that are

According to Basel II, a client should be correctly categorised. Regulations basically assume that loans into the Retail sector need less counter-guarantees that loans into the production sector. This is justified by the lower risk associated with greater diversification and generally smaller sized loans.

Česká spořitelna, a.s., will use internal methods for credit risk measurement.

able to perform statistical measurement of the respective risk of particular financing to adjust their capital adequately to their individual risk. Assuming a "good" loan portfolio (good standing of clients, sufficient security) this means for the banks – in comparison to the standard approach – a lower capital charge.

Česká spořitelna, a. s., will use internal methods for credit risk measurement and therefore it will apply the IRB approach in practice. With that approach the bank determines the above-described risk parameters itself. The pre-requisites are detailed data for at least three years; therefore, the Basel II requirements are already relevant now.

Example: Default and loss

The bank must statistically monitor and perform prognosis of the following parameters decisive for the internal measurement of credit risk:

- Probability of Default: To what level is it probable that the borrower will default during the next 12 months (insolvency, default payment exceeding 90 days, etc.)?
- Loss Given Default: How big is the expected loss incurred by the bank should the borrower default?
- Exposure at Default: How big will the expected drawn loan amount in case of default by the client be?

Client segmentation and their capital adequacy

Basel II assumes client classification in five classes.

Retail	private clients, self-employed persons and small enterprises with liability, with the financing bank lower than EUR 1 mio.
Corporate	medium-sized and big enterprises and specialized lending
Institutions	(namely) banks
Sovereigns	(namely) countries
Equity	shares in other companies

According to Basel II, each client must be assigned the correct category. In principle, the regulations are based on the fact that for loans in the Retail category it is necessary to hold as reserve less capital than for corporate loans. This is due to the lower risk resulting from higher diversification and lower loan amounts.

Under certain conditions, banks may treat small and medium-sized enterprises (SME) with liability lower than EUR 1 mio as private clients for the purpose of capital adequacy, and therefore they may hold lower capital charges for SME loans.

Example: Recognition of collateral

Collateral represents an important factor in determining the bank's risk in financing. It is

Basel II expands the area of eligible collateral for the reduction of credit risk.

assessed based on the bank's internal criteria and based on that assessment, the bank reduces the risk – thereby it also reduces the basis for the calculation of capital adequacy.

According to Basel II, depending on the method of risk measurement (standard approach or IRB approach) the collateral is fully recognised. In principle, the following rule applies: the more sophisticated the approach, the wider the scale of eligible collateral types.

Eligible collateral types when standard approach is applied:

- cash deposits
- securities issued by sovereigns and banks
- securities quoted in any of the main stock exchange indexes (e.g. ATX, DAX)
- gold
- residential real estate

Eligible collateral types when IRB approach is applied:

- collateral types that are eligible when the standard approach is applied
- commercial real estate
- specific physical pledges, cars, shares – including those not quoted in the main indexes
- receivables resulting from business transactions

Eligible collateral types when advanced IRB approach is applied:

- all types of collateral that have a permanent effect on the reduction of risk; the permanent effect must be evidenced by the bank via sufficient statistical time lines

The rating process and the rating system of Česká spořitelna

Rating means assessment of the borrower in terms of his/her ability to meet his/her (loan) obligations in time.

What is the difference between external and internal ratings?

External ratings are assigned by international rating agencies (Moody_s, Standard & Poor_s, Fitch Ratings) and these agencies are requested to do so by the enterprise to be rated. Assignment of external rating means high requirements and costs for the enterprise. The purpose of the external rating is usually the desire of the enterprise to gain access to the capital market.

In comparison, internal ratings are assigned by banks when granting a loan and during regular checkups; therefore, financial statements must be presented to the bank on a regular basis. The bank performs risk assessment based on its own internal rating methods.

Rating process – client rating elements

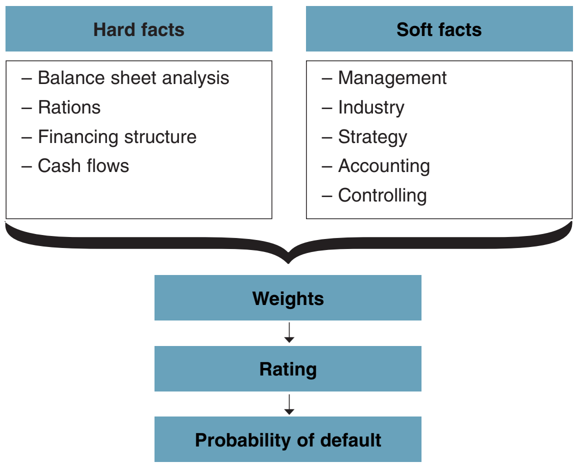
Within the rating process both the information regarding business development in the past as well as the future prospects are processed systematically. It also takes into account such criteria as the size of the company, the industry, and facts about the relevant markets (e.g. different accounting regulations in the countries of Central Europe).

The bank performs risk assessment based on the bank's internal rating methods.

Collateral is not considered in the rating process, however, it is taken into account in the loan approval process and it affects the loan terms. The rating system itself serves exclusively to determine the standing of the client.

Namely in corporate client rating there are distinguished quantitative (financial rating = "hard facts") and qualitative criteria (qualitative rating = "soft facts").

Fig. 4: Depiction of the rating process



When weighting "hard facts" compared to "soft facts", the following principle applies in general: The bigger the firm, the greater the importance of "hard facts", i.e. the business figures of the firm. The smaller the firm, the greater the importance of "soft facts". In small enterprises information regarding the personality of the entrepreneur is of special importance because positive development of the enterprise often depends on that person.

Hard facts, i.e. financial rating

This means financial indicators that form the basis for internal rating. The indicators are determined

A rating system is divided into a financial and a qualitative rating parts.

based on the last three to five years of financial statements, interim financial data and planning; namely the annual financial statements and the quarterly results that are currently available are analysed. The indicators describe the financial and business status of the enterprise and are expressed by the "balance worthiness indicator".

The following indicators are of special importance:

- share of own capital in the total balance sheet amount
- duration of debt repayments
- return on capital
- cash flow

These indicators provide a fair overview of the financial situation of the enterprise. They give a reliable account of the financial stability (share of own capital and the duration of debt repayment) and also about the profitability of the enterprise (the total return on investment and net cash flow). They provide maximum empirical quality of estimates regarding future default.

During assessment and weighting of these indicators, additional criteria such as the size of the enterprise, the industry and place of business are included.

The values determined based on assessment of the indicators are then combined and according to their importance converted in an internal rating scale. This value then serves as the financial rating.

Soft facts, i.e. qualitative rating

Unlike "hard facts", "soft facts" focus on future aspects. They describe the potentials, opportunities and risks that are expected to sooner or later affect the financial statements.

The following factors are analysed:

Management

- **The logic of the long-term concept of the enterprise:** Is there a formalised written strategy of the enterprise that defines the plans and targets for successful operation on the market?

- **Regulation of succession/representation:** To what extent is further smooth management of the enterprise ensured?

- **Willingness to provide information:** Are the annual financial statements and other reports submitted in time? Is all information about the operation of the company provided promptly?

Accounting

- **Quality of accounting:** Are audited and confirmed yearly annual financial statements available?

- **Quality of planning:** To what extent is the planning realistic, are the plans observed (comparison of plans with reality)? Is the quality of planning for the management of the company sufficient?

Information gathered in the process of qualitative rating should be classified using quantifiable measurements, interconnected, weighted, and, finally, together with the financial rating, used to calculate the rating of a client.

Products and place of business

- **Product quality:** Of what quality are the products and services, are they potentially replaceable?

- **Quality of the business location:** Is the place where the business is carried out a competitive advantage or disadvantage?

Market and its development

- **Development of boom:** How is the enterprise developing in a booming environment?

- **Development of industry:** Assessment of future market development.

- **Market position:** Analysis of position on the relevant market (e.g. leading company on national or international market).

- **Dependency on clients and suppliers.**

Special risks

- **Environmental risks:** Are all obligations set forth by authorities met?

- **Legal disputes** (if they have permanent impact on the development of the company).

Česká Spořitelna, a.s., uses rating systems that are frequently innovated and currently adjusted to new requirements.

Payment history

- **Account service:** Are there any (unauthorised) overdrafts of the account, or are there any liquidity problems? Are agreements observed?

Warning signals

- Warning signals are any circumstances that in the short-term perspective threaten the situation of the company. For example, late payments, increasing delays in deliveries or ownership disputes. The occurrence of these signals indicates a higher risk of default.

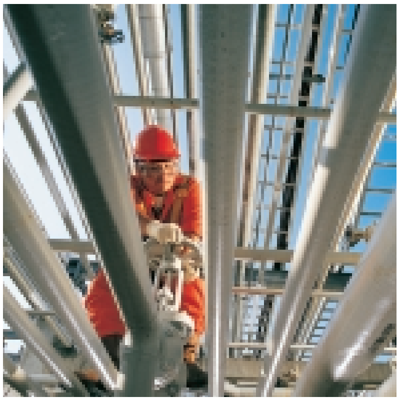
The information obtained within qualitative rating is transformed into measurable values, they are interrelated, weighted and in the end, in connection with the financial rating, they result in the calculated client rating.

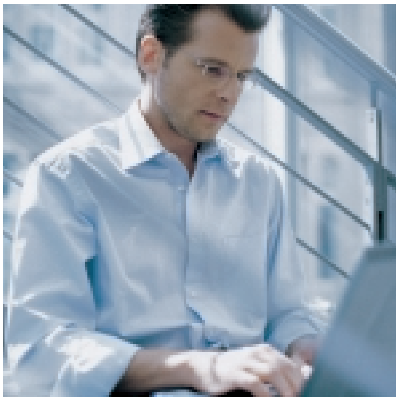
Rating system of Česká spořitelna, a.s.

Česká spořitelna, a. s. uses rating systems that are continuously innovated and are currently being adjusted to new requirements. With certain modifications these rating tools are used by the bank's subsidiaries as well.

The rating system serves Česká spořitelna as the basis for

- as objective a loan decision as possible
- creation of loan prices depending on the solvency of the client
- loan portfolio management
- calculation of the bank's capital charge depending on the loan risk





Values affecting the loan terms

Determining of a loan price adequate to the risk – this is part of Basel II requirements as well – depends on several factors. The most important ones are:

- risk cost calculated based on the rating and the provided collateral
- refinancing cost
- transaction cost
- own capital

To determine a loan price adequate to the risk means that clients with good standing are "awarded" better interest rates. On the other hand, clients with worse standing should expect higher interest rates because the bank must compensate the higher risk by a higher level of reserve capital. This will also apply to clients who do not provide sufficient information for assessment of the company; in such case the risk is higher as well (because it cannot be assessed fairly).

The rating system includes financial and qualitative rating.

Information for small and medium-sized enterprises (SME)

In this material we have prepared for you several useful recommendations on the best approach to the preparation of information and documents for the bank that would also lead to better rating of your company.

Provide your banking advisor at Česká spořitelna, a.s. with as fresh and detailed information about your company as possible.

Apply an open information and communication policy

Provide your banking advisor at Česká spořitelna, a.s. with as fresh and detailed information about your company as possible. Only in such case is the advisor able to provide you with adequate advice and support. Useful are general descriptions of your company (namely the place of business, organisational structure, scope of business), disclosure of the business strategy, etc. In connection with the business indicators, Česká spořitelna a.s. as the lender will be able to get a detailed and true picture of your company.

Develop efficient accounting and controlling tools

The bank should receive information about the economic development of the company on a continuous basis and it should be informed about any changes in the environment and any additional financing needs as soon as possible. For investments it is suitable to submit the plan and calculation of amortisation.

The size of the company affects the differences in the scope and quality of accounting, however, each firm should have available, in compliance with its resources, accounting, reporting and planning that will enable the lender to obtain an overview of the economic reality of the firm as quickly as possible.

Plan the financial needs of your company

Clients with good standing will be “awarded” better interest rates.

Thoroughly thought out and logical planning, including the estimate of loan needs for the subsequent period, will enable you to meet the agreed account terms and to agree with us the financing of future investments already today. A number of companies are stuck in a critical situation because they were not able to identify liquidity problems in time. This can be avoided by provident planning of liquidity.

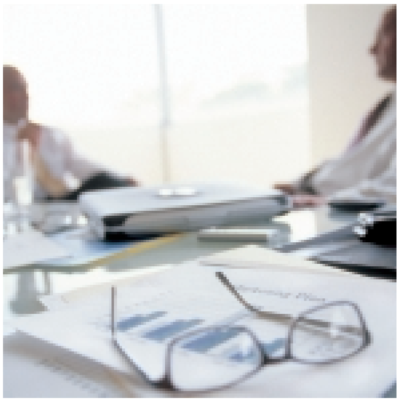
Business plan: This plan summarizes the key capabilities, business strategy, target group, description of the position of the company and competition situation (in the industry).

Budget plan: Each firm should prepare a budget plan according to yearly targets. By comparing the yearly plans with reality it is possible to identify deviations from the budget plan; such differences serve the entrepreneur as an important management tool.

Secure the stability of your company by own capital

Each lender focuses first of all on available own capital. The level of such capital enables the bank to establish whether the owner, partner or shareholders trust the company. Therefore, the profit should at least be partly kept in the company in order to increase its own capital as this means securing of economic risks. The share of own capital in the total balance sheet sum represents an important indicator within the financial rating ("hard facts").

Compared internationally, small and medium-sized enterprises in the Czech Republic are equipped with a low level of own capital. On the one hand this is due to great competition, while on the other hand it is due to taxation.



A professionally structured high quality presentation will help your advisor to understand your company.

To improve the level of own capital, you can use the following tools, for example:

- **sale** of assets that **are not necessary** for the company
- **private borrowings** that are often of the nature of own capital should as such be invested in the company immediately

However, own capital for small enterprises, or venture intentions, can also come from alternative financing sources, for example, from venture capital funds or private equity.

Reduce receivables from business transactions, i.e. outstanding receivables

Receivables from third parties should be settled as soon as possible. Outstanding receivables result in interest loss and they reduce the liquidity of your company. Any company that depending on the season (e.g. at the end of the year) reports high receivables from business transactions, should take appropriate measures in time, for example, introduce a strict system of reminders. Receivables from business transactions increase the balance sheet sum and reduce the share of own capital.

Transfer of receivables from clients to a **factoring company** becomes more attractive thanks to Basel II accord. Within a factoring agreement the company transfers all its receivables – or only their part – to a factoring company. This form of financing is offered by our subsidiary, Factoring České spořitelny, a.s.

Pay attention to the structure of financing in compliance with the terms

The structure of financing of your company should be continuously optimised, i.e. long-term investments should be financed by long-term loans and short-term capital by short term-loans. Also pay attention to the planning of your liquidity and inform the financing bank in time about any possible liquidity problems. Thereby you can overcome short-term fluctuations in payments.

Collateral improves the loan terms and conditions

According to Basel II, certain collaterals are recognized depending on the risk measurement method. In principle, collateral reduces the risk of the lender, which leads to lower capital charge for such financing. Usually it means better loan conditions for the client.

Present your company

A professionally structured high quality presentation enables your banking advisor to understand your company, its environment, opportunities, and the risks threatening further development of the firm and the industry. Submission of complete documents, overviews and plans enables the bank to assess the quality of management and consequently of the stability of the company.

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