LIETUVOS BANKAS
EUROSISTEMA

# Countercyclical Capital Buffer

**Background material for decision**

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COUNTERCYCLICAL CAPITAL BUFFER

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Background material for decision

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Periods indicated in charts include data for the respective year, quarter, etc.

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## DECISION BASIS FOR SETTING THE COUNTERCYCLICAL CAPITAL BUFFER RATE

On 25 June 2020, the Board of the Bank of Lithuania took a decision[1] to leave the countercyclical capital buffer (CCyB) rate unchanged at 0%, as set on 1 April 2020.

Such a decision was taken in view of the significant negative impact brought by the COVID-19 outbreak on the Lithuanian economy and financial system as a result of the nationwide lockdown[2] restrictions that were imposed on 16 March 2020. Under the baseline scenario[3], the country's GDP would contract by 9.7% in 2020, while the banking sector's capital adequacy ratio is expected to fall by roughly 4.9 percentage points, yet remain in line with the minimum requirement. A large bulk of firms directly or indirectly affected by the lockdown measures are already facing (or will soon face) demand and liquidity shocks. Financial hardships encountered by businesses only exacerbate the situation for households: with higher unemployment, some residents have lost or suffered a drop in income. Along with rising risks and escalating uncertainty credit institutions have also became more cautious, which in turn limited the availability of credit to the private non-financial sector. Reduced to 0%, the CCyB requirement is expected to not only help credit institutions absorb potential losses, but also give them a stronger footing in planning further lending as the economy transitions to the recession phase.

## CREDIT AND REAL ESTATE MARKET DEVELOPMENTS

**After a prolonged upswing, the economy is heading into a recession.** According to the available data (until the end of Q1 2020), the gap between the credit-to-GDP ratio and its long-term trend has turned even more negative, while the loan-to-GDP ratio gap has slightly contracted, yet remained negative. The loan-to-deposit ratio has decreased to 88%, the current account balance continued to grow, whereas the house price-to-income ratio declined. Credit assessments show that the volume of lending started shrinking even before the fallout from COVID-19; in the upcoming months, such trends are only bound to become even more pronounced.

**The flow of new loans has significantly weakened and is set to dampen the growth of the loan portfolio in the near future.** In Q1 2020, the portfolio of loans to the private non-financial sector continued to grow steadily and increased by 3.1% year on year (remaining unchanged on a quarterly basis). During the period under review, these developments were largely driven by the continued growth in the housing loan portfolio. However, since mid-March 2020, the value of new agreements on all types of loans has substantially decreased. The value of agreements on new housing loans, loans for consumption and other purposes as well as loans to non-financial corporations concluded over the eight weeks after the introduction of the nationwide lockdown fell by 30%, 45% and 30% respectively. Given the significantly lower rates of new loans, growth in the portfolio of loans to the private non-financial sector may turn negative in the remaining course of 2020.

**The contracting MFI corporate loan portfolio is set to shrink at an even faster pace on the back of weaker demand and heightened uncertainty, while close corporate financial interconnections point to increased risks.** According to the data as of the end of Q1 2020, the MFI corporate loan portfolio has declined by an annual 2.2% (at the end of Q4 2019 – 1.4%). Such trends are likely to have been driven by tighter lending conditions applied by some banks.[4] However, lending should be further constrained by COVID-19 related risks and more prudent lending policies adopted by credit institutions. The flow of new loans up to €1 million eight weeks before and after the start of the lockdown was 39% lower, while the amount of loans exceeding €1 million (up to €30 million) decreased by 21%. Moreover, the share of renegotiations has significantly increased and in March 2020 reached the highest level in the last five years. Interest rates on new corporate loans remained stable, with their annual average standing at 3.05% – a year-on-year increase of 0.22 percentage point. Despite the drop in bank lending to non-financial corporations observed over the

[1] Resolution No 03-91 of the Board of the Bank of Lithuania of 25 June 2020 on the application of the countercyclical capital buffer.

[2] The nationwide quarantine in Lithuania was lifted on 17 June 2020, following the decision of the Government of the Republic of Lithuania.

[3] Based on Bank of Lithuania macroeconomic projections for June.

[4] As evidenced by surveys of banks and non-financial corporations carried out by the Bank of Lithuania.

past several years, in 2019 firms opted for funding from alternative sources. According to financial account data, at the end of 2019 loans from other non-financial corporations recorded a year-on-year increase of 7.1% (€0.3 billion), debt securities – 13.9% (€0.2 billion), trade credit from other non-financial corporations – 3.4% (€0.3 billion). Such developments show that with stronger financial interconnections between companies, certain issues caused by COVID-19 can have negative spillover effects across different sectors.

**MFI lending for house purchase was not immediately affected by COVID-19: having still remained rapid in March 2020, it has only recently started contracting.** At the end of Q1 2020, the household loan portfolio recorded a year-on-year increase of 7.9%, as its growth accelerated by 0.7 percentage point compared to the previous quarter. The housing loan portfolio expanded by 9.4%, reaching the highest growth rate since the previous financial crisis. The annual flow of pure new housing loans grew at a more moderate pace (4%), remaining on an upward trajectory in March when it amounted to €1.4 billion. This may have been influenced by preliminary housing loan agreements that supported credit growth during the lockdown, although in April the flow of new loans significantly declined. Interest rates on new housing loans remained stable, with their annual average standing at 2.41% in March – a year-on-year increase of 0.1 percentage point. Moreover, after the imposed lockdown measures, the flow of renegotiated housing loans has substantially strengthened, and in March was 2.7 times higher than a month ago. With the recent deterioration in household finances, demand for credit has also declined, while credit institutions have become more prudent when providing new housing loans. All of these factors have led to a drop in new credit provision. Household sentiment has also significantly worsened – due to growing unemployment rates as well as COVID-19 related downtime and lower income, the consumer confidence index edged down to its lowest level over the last decade.

**In March 2020, the capitalisation of real estate funds traded on the Baltic stock exchanges markedly decreased due to an expected fall in the value of commercial real estate.** Based on the data provided by real estate market participants, the supply of office and storage facilities in major Lithuanian cities should increase by 13.1% and 13.8% respectively in 2020. However, with the contracting demand for commercial real estate due to the current economic downturn and rising unemployment, rental prices are also likely to fall. According to real estate market participants[5], the share of unoccupied offices in Vilnius are set to increase from 3% to 13% in 2020–2021, to reach a similar level as observed in 2008–2009. An even greater decline in demand will be recorded in terms of trade premises – the segment that has been significantly affected by overdue payments, provisions and rental discounts for firms unable to continue their activities due the imposed lockdown. In recent years, growth in this segment has been slower compared to that of office or storage facilities, yet the supply of modern trade premises per capita in Lithuania exceeds the average of developed Western European economies by 23.6%.

**Relative housing market indicators point to no inflation of house prices in Lithuania, while their potential decline will be mitigated by sufficient liquidity buffers accumulated by real estate developers.** In March–April 2020, Lithuania's housing market saw a significant drop in activity. According to the Centre of Registers, the number of houses sold during this period declined by an annual 28.4%. With a rapid slowdown in market activity, house prices are likely to follow a downward trend as well. However, the potential decline might be less pronounced due to the fact that, despite being relatively high, house price inflation previously corresponded to demographic, macroeconomic and household income developments, and was not a result of excessive lending. Moreover, short-term assets of real estate developers exceeded their current liabilities by more than half, while their equity was higher than the total amount of liabilities. The sustainable financial health of real estate developers will allow many of them to avoid forced property sales to meet short-term liabilities, and will reduce the risk and scale of a sudden drop in house prices.

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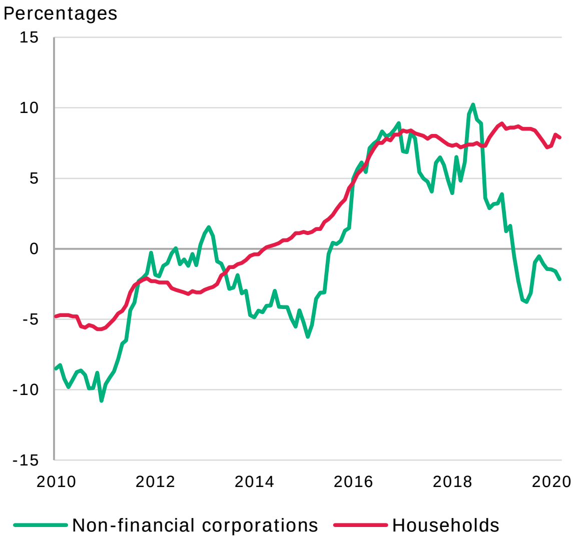
[5] CBRE.

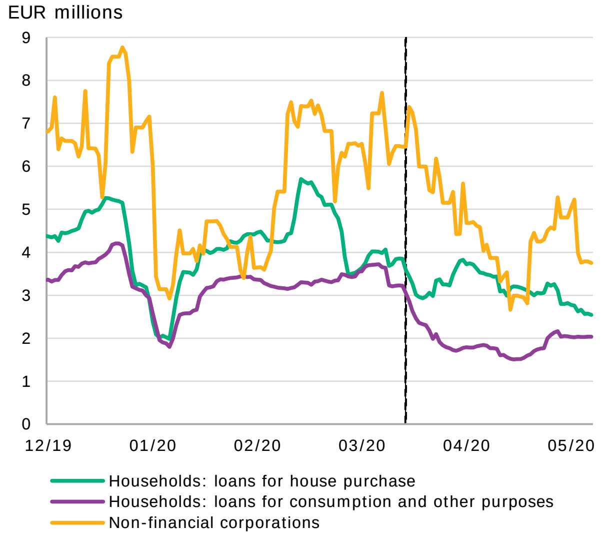
## ANNEX 1. CREDIT AND HOUSING MARKET TRENDS

Chart 1. Annual growth of the portfolio of MFI loans to non-financial corporations and households (January 2010–March 2020)



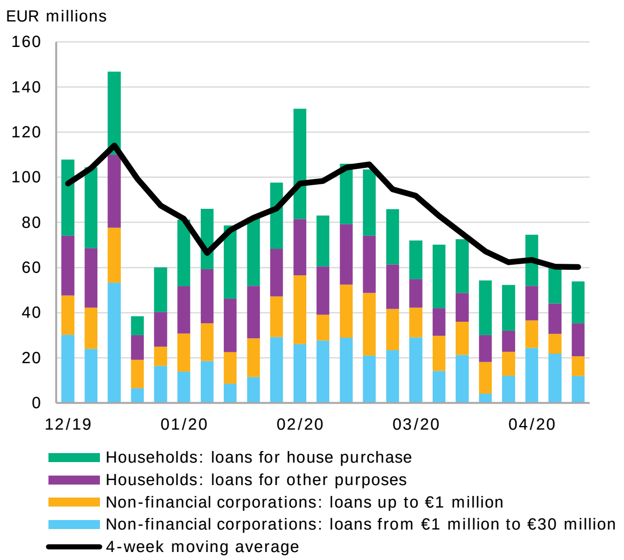

Source: Bank of Lithuania.

Chart 2. Value of new agreements between credit institutions and the private non-financial sector (December 2019–May 2020)



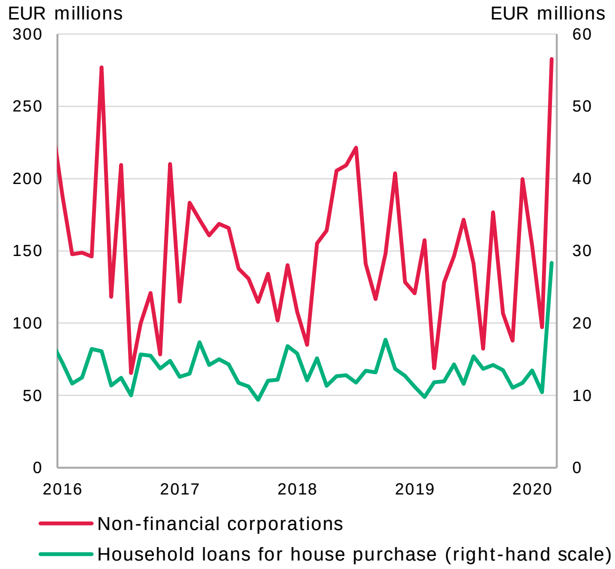

Source: Bank of Lithuania.
Note: 14-day moving average.

Chart 3. Value of new agreements between credit institutions and the private non-financial sector (December 2019–May 2020)



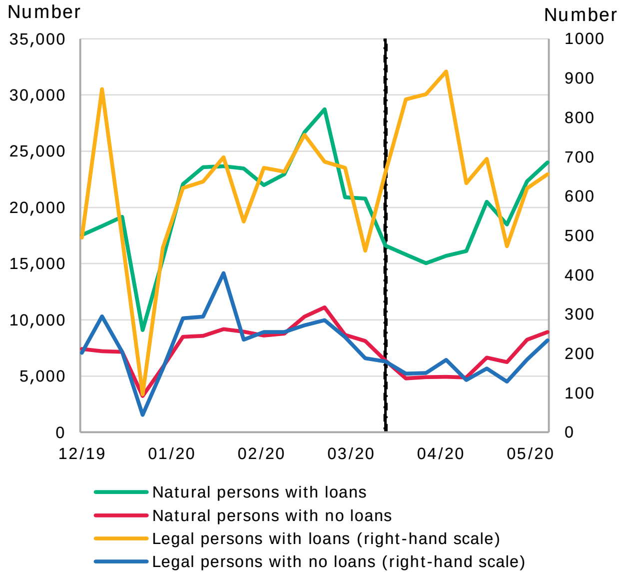

Source: Bank of Lithuania.
Note: Weekly flow.

Chart 4. Flow of renegotiated loans to households and non-financial corporations (January 2016–March 2020)




Source: Bank of Lithuania.

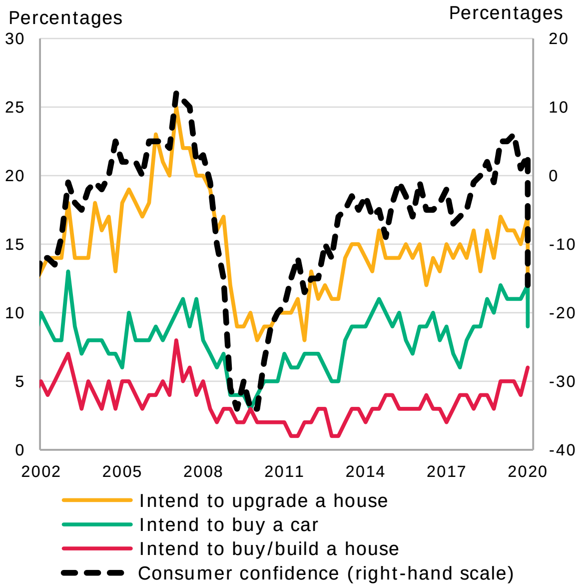
Chart 5. Number of inquiries in the credit register made by credit institutions on natural and legal persons
(December 2019–May 2020)




Source: Bank of Lithuania.

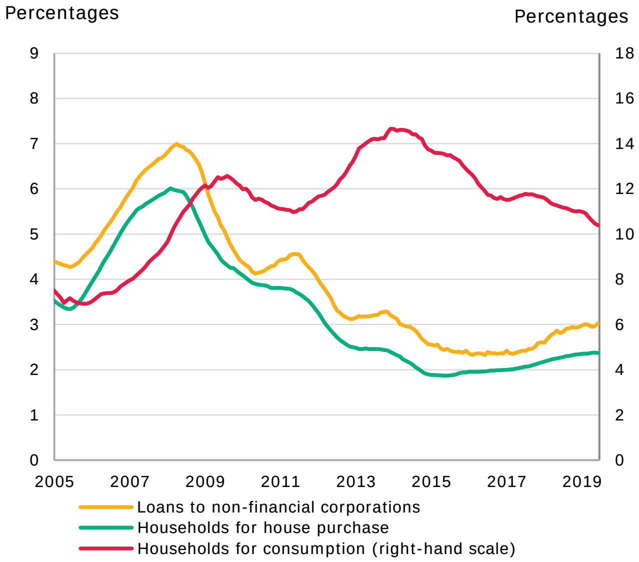
Chart 6. Consumer survey results

(January 2002–April 2020)



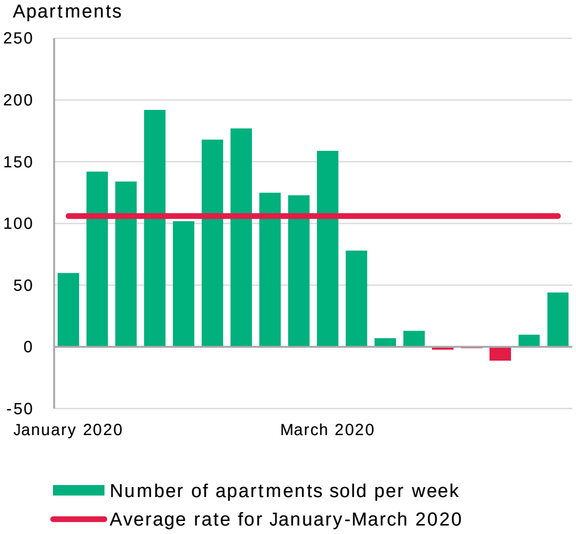

Sources: Statistics Lithuania and Bank of Lithuania.

Chart 7. Average weighted interest rates on new loans to non-financial corporations and households
(October 2005–March 2020)



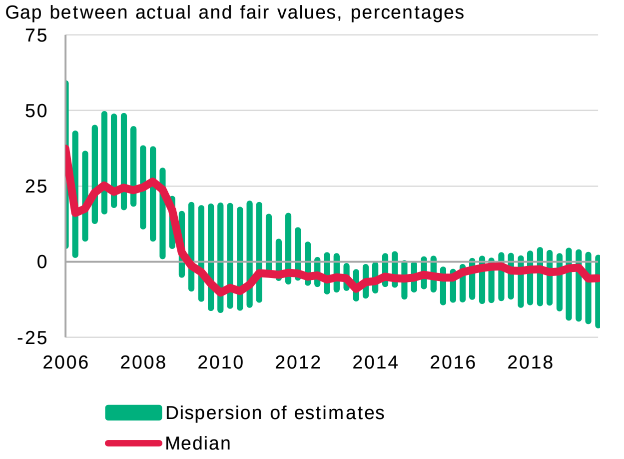

Source: Bank of Lithuania.
Note: 12-month moving average.

Chart 8. Number of new apartments sold in Vilnius primary market
(January 2020–April 2020)



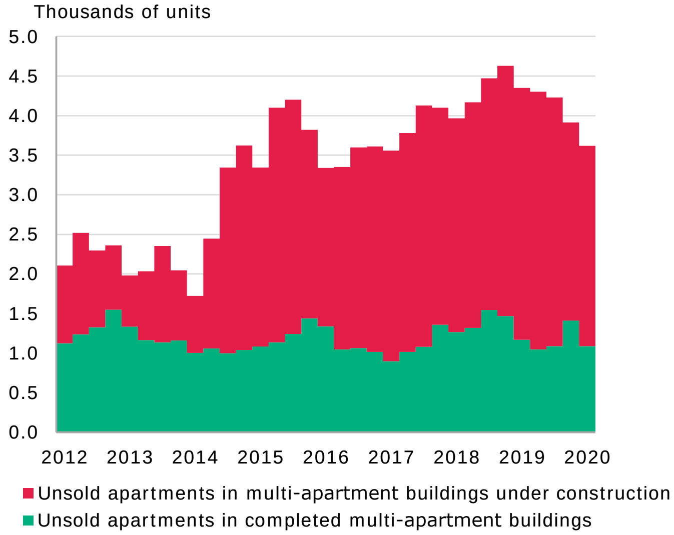

Source: REALDATA.

Chart 9. Gap between actual house prices and their fundamental values
(Q1 2006–Q4 2019)



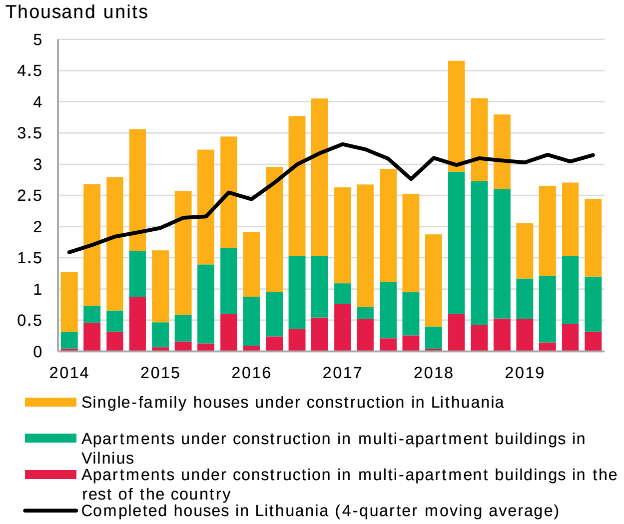

Source: Bank of Lithuania calculations.
Note: Estimates were made using the price-to-rent ratio, the price-to-income ratio, the econometric model and the HP filter.

Chart 10. Number of unsold apartments in under-construction and completed multi-apartment buildings in Vilnius
(Q1 2012–Q1 2020)



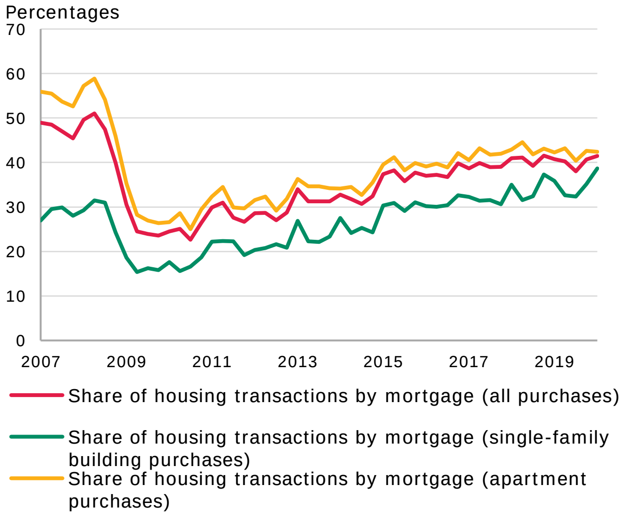

Sources: OBER-HAUS and EIKA.

Chart 11. Number of under-construction and completed houses in Lithuania
(Q1 2014–Q4 2019)




Source: Statistics Lithuania.

Chart 12. Share of housing transactions by mortgage
(Q1 2007–Q1 2020)

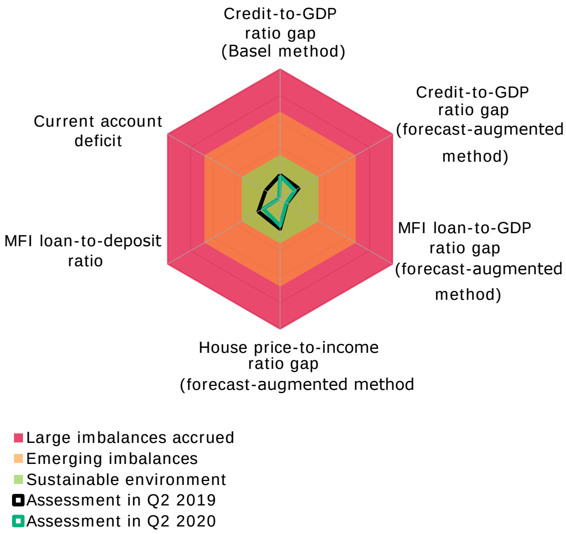



Source: Centre of Registers.

## ANNEX 2. CREDIT AND HOUSING MARKET IMBALANCES

Chart A. Evaluation of credit market imbalances based on core and additional indicators

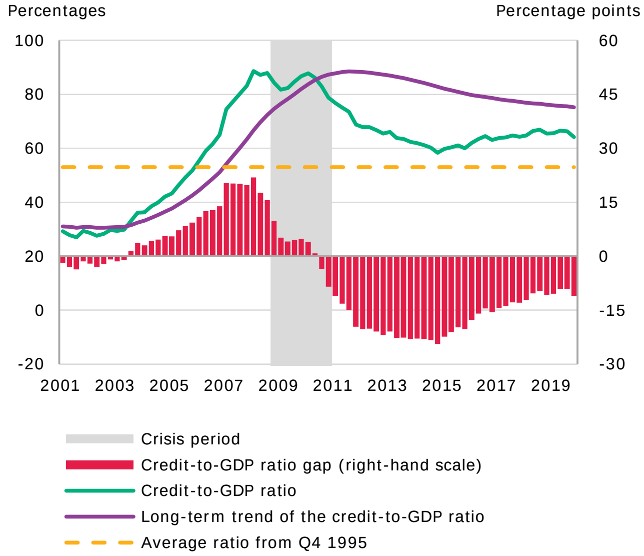
(Q2 2020)




Sources: Statistics Lithuania and Bank of Lithuania calculations.
Note: Axes are scaled according to the range of a particular indicator: from its minimal value up to the maximal value.

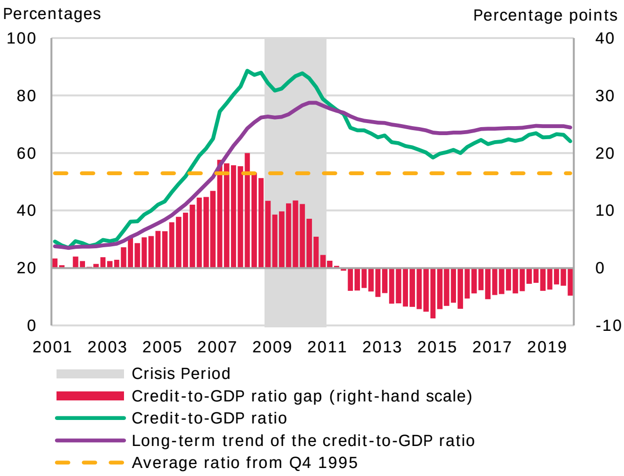
Chart B. Core indicator I: Credit to the private non-financial sector-to-GDP ratio gap (calculated using the standardised Basel method)

(Q1 2001–Q4 2019)



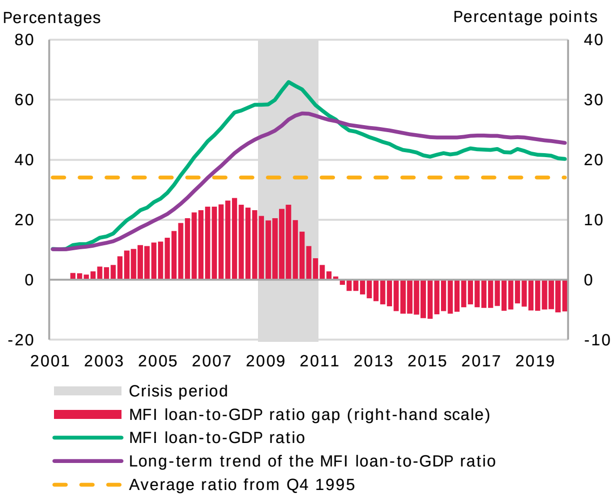

Sources: Statistics Lithuania and Bank of Lithuania calculations.
Note: The long-term trend is computed using a one-sided HP filter with a smoothing parameter of 400,000.

Chart C. Core indicator II: Credit to the private non-financial sector-to-GDP ratio gap (based on the forecast-augmented method)
(Q1 2001–Q4 2019)



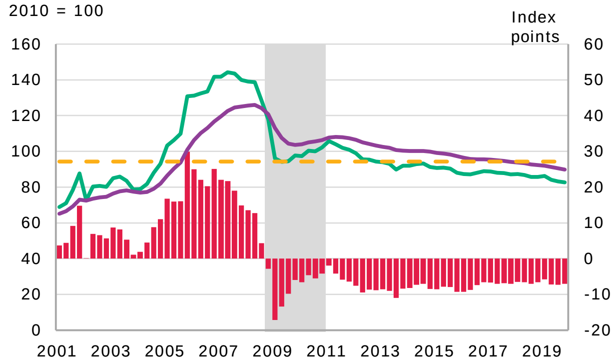

Sources: Statistics Lithuania and Bank of Lithuania calculations.
Note: The long-term trend is computed by applying a one-sided HP filter with a smoothing parameter of 400,000; before applying the filter, the ratio is modelled for the next 5-year window using a 4-quarter weighted average.

Chart D. Additional indicator I: MFI loan to the private non-financial sector-to-GDP ratio gap (calculated using the forecast-augmented method)
(Q1 2001–Q1 2020)




Sources: Statistics Lithuania and Bank of Lithuania calculations.
Note: The long-term trend is computed by applying a one-sided HP filter with a smoothing parameter of 400,000; before applying the filter, the ratio is modelled for the next 5-year window using a 4-quarter weighted average.

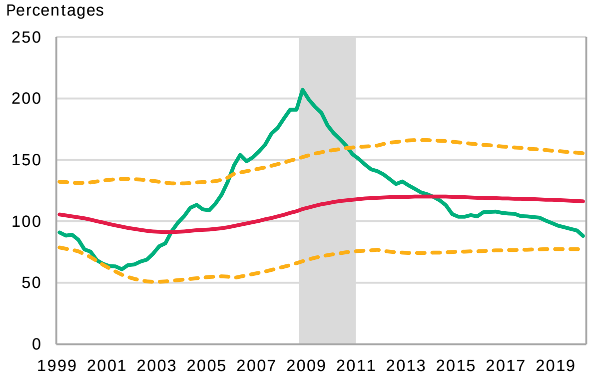
## Chart E. Additional indicator II: House price-to-income ratio gap (calculated using the forecast-augmented method) (Q1 2001–Q4 2019)




Crisis period
House price-to-income ratio gap (right-hand scale)
House price-to-income ratio
Long-term trend (with forecast)
Average ratio from Q4 1998

Sources: Statistics Lithuania and Bank of Lithuania calculations.
Notes: 1) income – household wages and salaries; 2) the long-term trend is estimated by applying a one-sided HP filter with a smoothing parameter of 400,000; before applying the filter, the ratio is modelled for the next 5-year window using a 4-quarter weighted average.

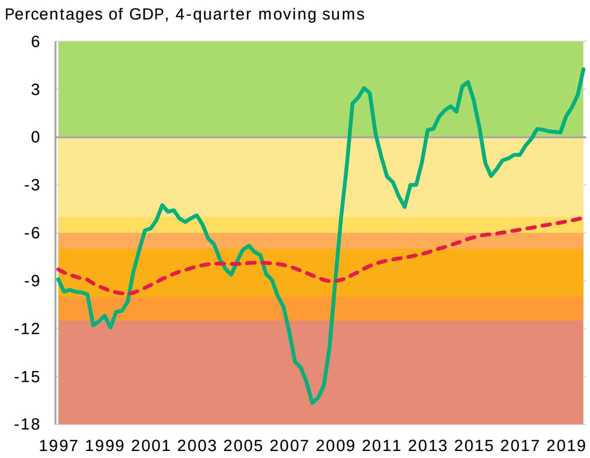
## Chart F. Additional indicator III: Ratio between MFI loans to the private sector and private sector deposits (adjusted for seasonal effects) (Q1 1999–Q1 2020)




Crisis period
MFI loan-to-deposit ratio
Average ratio from Q4 1993 until the current period
Long-term average +/– 2 standard deviations

Source: Bank of Lithuania calculations.
Note: The ratio develops in a balanced way if it does not deviate from its long-term average by more than two standard deviations. Standard deviation is computed on the basis of data covering the period of moderate changes in the ratio, excluding data for Q2 2006-Q4 2011.

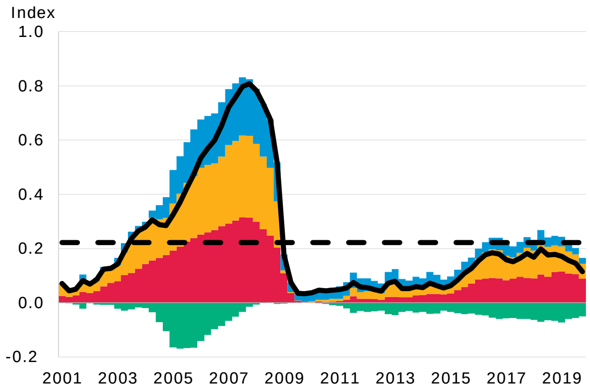
## Chart G. Additional indicator IV: Ratio between the current account balance (4-quarter moving sums) and GDP (Q1 1997–Q4 2019)




Current account balance
Average from Q4 1995 until the current period

Sources: Statistics Lithuania and Bank of Lithuania calculations. Note: Different colours indicate different levels of risk which have been set based on Reinhart S. M. and V. R. Reinhart (2008): "Capital flow bonanzas: An encompassing of the past and present", NBER working paper, 14321.

## Chart H. Contributions to Lithuania's financial cycle index (Q1 2001–Q4 2019)




Other factors
House price-to-income ratio
Ratio between the annual change in loans to non-financial corporations and GDP
Ratio between the annual change in loans to households and GDP
Financial cycle index
Index average (Q1 2001–Q4 2019)

Sources: Statistics Lithuania and Bank of Lithuania calculations.
Note: Since 2020, the financial cycle index has been calculated following a broader definition of credit (covering all credits granted to non-financial corporations and households regardless of the credit provider).