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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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DECISION REGARDING THE COUNTERCYCLICAL CAPITAL BUFFER RATE

On 28 June 2021, the Board of the Bank of Lithuania took a decision[1] to leave the countercyclical capital buffer (CCyB) rate unchanged at 0%.

The decision to leave the CCyB rate unchanged was taken in view of the continuous negative impact of the COVID-19 pandemic on Lithuania's economy and financial system[2] as well as the latest credit and real estate market trends which point to no imbalances in the financial system and show that the financial cycle remains on a downward path. In Q1 2021, Lithuania's economy grew by 2% quarter on quarter, while on an annual basis – by 1.2%. With the gradual easing of containment measures, the recovering economy as well as higher corporate and household expectations, provision of new loans has also become more active. However, there are still certain negative repercussions from business restrictions imposed during the lockdown, especially in the most affected sectors (catering, accommodation, administrative and support services, entertainment and recreation). Although state aid measures contribute to maintaining corporate liquidity, it is likely that after they are lifted, corporate bankruptcies will go up, which may also have a negative impact on the household sector, leading to difficulties in meeting existing financial obligations. The CCyB rate, which remains unchanged at 0%, will help credit institutions withstand potential losses due to the deteriorating financial situation of some enterprises and households as well as plan future credit-granting activities.

CREDIT AND REAL ESTATE MARKET DEVELOPMENTS

The financial cycle remains on a downward path. At the end of 2020, the gap between the credit-to-GDP ratio and its long-term trend remained negative and slightly increased, fluctuating between -10.1 and -4.4 percentage points, depending on the assessment method (in the previous quarter it fluctuated between -9.9 and -4.0 percentage points, see Charts B and C of Annex 2). This increase was mainly determined by a decline in the corporate credit-to-GDP ratio. However, in case of households, the trends diverged, with the growing credit-to-GDP ratio and the household credit-to-GDP gap narrowing accordingly (see Chart D of Annex 2). Due to moderately recovery lending, the monetary financial institution (MFI) lending to the private non-financial sector-to-GDP ratio gap turned less negative at the end of Q1 2021 and stood at -4.8% (compared to -5.3% in the previous quarter). With the sharp increase in deposits, the loan-to-deposit ratio continued to decline and reached 68.6% (in the previous quarter it amounted to 71.5%). The current account balance further increased at the end of 2020 to stand at 8.3% of GDP (compared to -7.5% in the previous quarter, see Chart H of Annex 2), while the financial cycle index continued to shrink (see Chart I of Annex 2).

The portfolio of loans to the private non-financial sector contracted at a more moderate pace, while provision of new loans accelerated. At the end of Q1 2021, the portfolio of MFI loans to the private non-financial sector was 1.4% lower year on year (in the previous quarter it stood at -2.1%). These developments were mainly driven by the continuing, albeit slower, contraction in the portfolio of loans to non-financial corporations as well as the portfolio of consumer and other (non-housing) loans to households, whereas the annual growth of the housing loan portfolio remained robust. In Q1 2021, provision of loans to non-financial corporations and loans to households for house purchase intensified, with their flows surpassing the levels observed during the corresponding period last year. On the other hand, the volume of new loans for household consumption has not yet reached the previous year's level, yet gradual recovery in lending is currently observed in this segment as well.

In Q1 2021, the flow of new MFI loans to non-financial corporations increased, while their portfolio started contracting at a slower pace. At the end of Q1 2021, the MFI corporate loan portfolio declined by an annual 11.2% (at the end of the previous quarter it was 12.5% lower year on year). The loan portfolios of the majority of economic segments shrank, with trade (-4.7 percentage points), professional,

[1] Resolution No 03-107 of the Board of the Bank of Lithuania of 28 June 2021 on the application of the countercyclical capital buffer.

[2] Following the decision of the Government of the Republic of Lithuania, the second nationwide lockdown in the country was declared on 7 November 2020.

scientific and technical (-2.3 percentage points) as well as transportation and storage (-2.2 percentage points) activity portfolios contributing the most to the contraction in the total loan portfolio. Although the latter continued to decline, provision of new loans intensified: the net quarterly flow of new loans to non-financial corporations was 12.2% higher than the average quarterly flow in 2019. The annual flow of loans has been growing as well: due to more active provision of new loans observed over the last six months, the annual flow in March was 11.6% higher year on year. Interest rates on pure new loans to non-financial corporations were still stable – in March 2021, their annual average stood at 3.0%, remaining unchanged on a quarterly basis.

Growth in the portfolio of MFI loans to households remained stable, mainly supported by active provision of housing loans. At the end of Q1 2021, the household loan portfolio recorded a year-on-year increase of 6.6%, as its growth accelerated by 0.1 percentage point compared to the previous quarter. Growth in the total loan portfolio continued to be supported by housing loans which continued to grow at a rapid pace and stood at 9.4% as a result of the increased flow of new loans (although it remained unchanged on a quarterly basis). In Q1 2021, the flow of pure new housing loans was almost one third (30.7%) higher year on year. The average of the debt service-to-income (DSTI) and loan-to-value (LTV) ratios of new housing loans have not significantly changed, fluctuating at around 28% and 78% respectively. On the other hand, the portfolio of consumer and other loans to households continued to shrink, albeit at a slower pace. At the end of Q1 2021, it declined by 5.5% year on year (in the previous quarter it was 5.8% lower on an annual basis). The flow of pure new consumer loans is gradually recovering, although in Q1 it recorded a year-on-year decline of 5.9%. Interest rates remained rather stable: in March 2021, the annual average of interest rates on new housing loans stood at 2.3% (and was 0.1 percentage point lower compared to the previous quarter), while the annual average of interest rates on new consumer loans fell to 8.2% – a quarter-on-quarter decrease of 0.2 percentage point. However, interest rates on these loans have shown to be on a downward path. Household expectations have been gradually improving – having declined since the onset of the second lockdown, in April 2021 consumer confidence turned positive again.

In Q1 2021, activity of the housing market was high even during the second lockdown, it has been supported by higher household income, savings and the recovering economy. According to the Centre of Registers, in Q1 2021 there was a 10.1% increase in the number of housing sales compared to the corresponding period of 2020, when the first lockdown was introduced and the market was stalled due to the imposed restrictions, yet sales were 11.4% lower compared to Q4 2020. The latest data shows that the housing market in April 2021 was active (the number of housing sales remained broadly unchanged since March 2021). The share of housing transactions with mortgage did not change significantly over the year and in Q1 2021 accounted for 44.1% of all housing transactions (a year-on-year decrease of 1.0 percentage point). Activity in Vilnius primary market during the review period was historically high, recording a year-on-year increase of 66.9% in the number of reserved apartments. The significantly higher demand for new apartments compared to supply has led to the historically low liquidity ratio of apartments. The robust activity of the housing market is supported by increased household income (the average net wage in Lithuania in Q4 2020 was 12.9% higher year on year), growing deposits with banks and the improving general economic situation in the country (with annual growth of Lithuania's GDP in Q1 2021 reaching 1.0%).

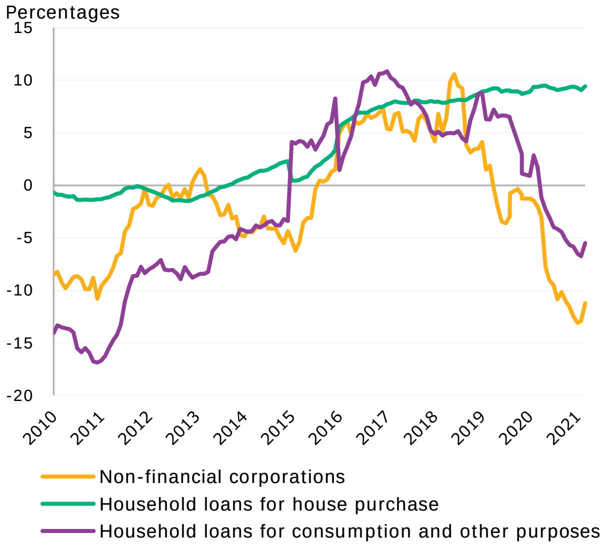
Relative indicators suggest that house prices in Lithuania remain at a sustainable level, yet acceleration in price growth is observed; however, sufficient liquidity buffers accumulated by real estate developers should mitigate a potential fall in prices. According to Statistics Lithuania, annual growth of house prices in late 2020 accelerated to 9.4%. Preliminary estimates point to the fact that price growth in April 2021 continued to gain momentum, reaching 8.6% (1.4 percentage points more than in March 2021 and 4.5 percentage points more compared to December 2020). However, house price levels and their growth have been in line with household income, demographic and macroeconomic developments since the 2008–2009 financial crisis and are not the result of excessive lending. Moreover, short-term assets of real estate developers exceed their current liabilities by 1.5 times, while the value of their equity is higher than the total amount of liabilities. The sustainable financial health of real estate developers would allow many of them to avoid forced property sales to meet their current liabilities, which would in turn reduce the risk and scale of a sudden drop in house prices. On the other hand, further robust growth in the housing market may increase the risk of house price inflation, especially in case of unreasonable expectations regarding growth of house prices and higher investment activity.

In Q1 2021, bank expectations regarding potential changes in the value of commercial real estate slightly improved, yet the office vacancy rate continued to grow. Half of commercial banks surveyed by the Bank of Lithuania in Q1 2021 indicated that they expected a fall in commercial real estate prices during the upcoming year, although the share of those expecting that they will moderately grow increased. At the beginning of 2021, prices of real estate funds traded on the Baltic stock exchanges started to rise and in early May reached their pre-pandemic levels. Such trends reflect recovering investor expectations regarding the future prospects of commercial real estate, but the gap between the Baltic equity index and the real estate fund index has been widening, which may indicate lower expectations in terms of commercial real estate. With an increase in the supply of offices, the office vacancy rate in Vilnius continues to grow and stands at 9.8%, although rental prices remained broadly unchanged over the period under review. Looking ahead, however, there remains a risk that commercial real estate demand will fall and the office vacancy rate will increase due to technological and social developments[3].

[3] With growing e-commerce and remote work trends.

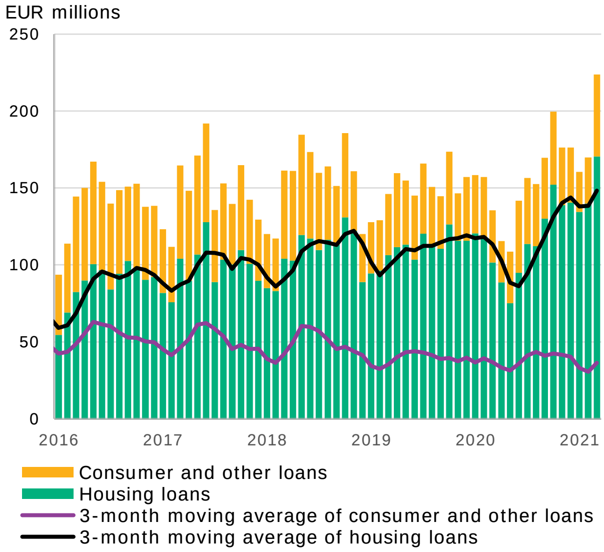
ANNEX 1. CREDIT AND HOUSING MARKET TRENDS

Chart 1. Annual growth of the portfolio of MFI loans to non-financial corporations and households (January 2010–March 2021)



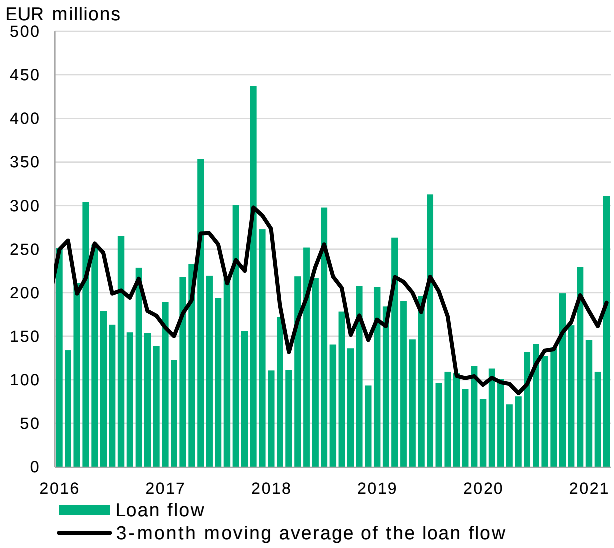
Source: Bank of Lithuania.

Chart 2. Monthly flow of pure new MFI loans to households (January 2016–March 2021)



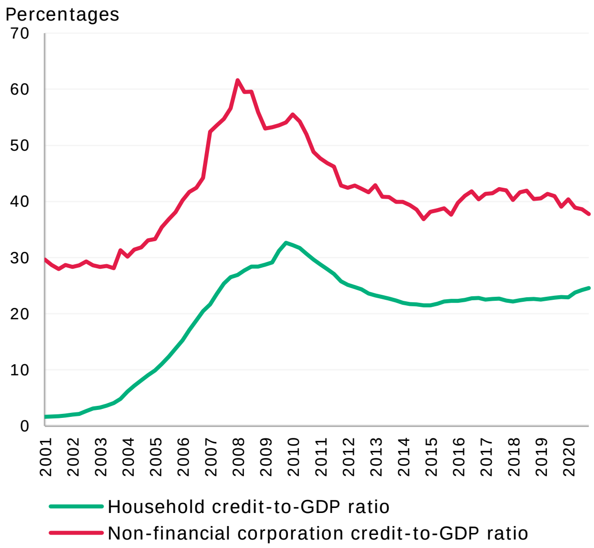
Source: Bank of Lithuania.

Chart 3. Monthly flow of pure new MFI loans to non-financial corporations (January 2016–March 2021)



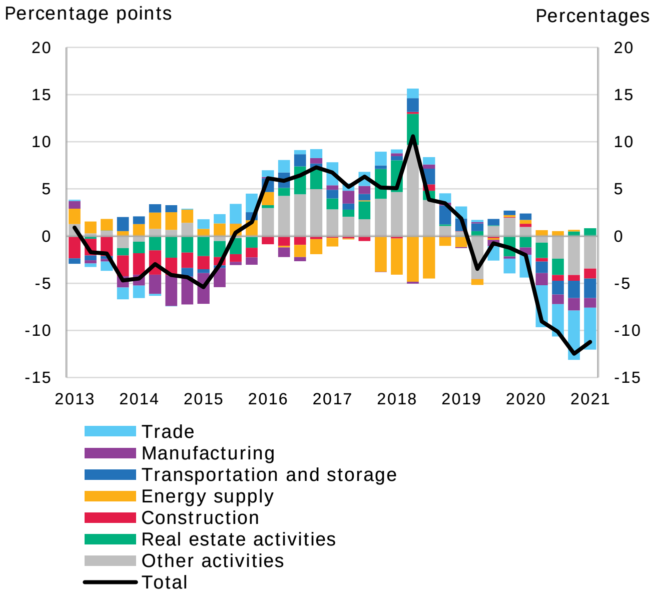
Source: Bank of Lithuania.

Chart 4. Credit-to-GDP ratio of non-financial corporations and households (Q1 2001–Q4 2020)



Source: Bank of Lithuania.

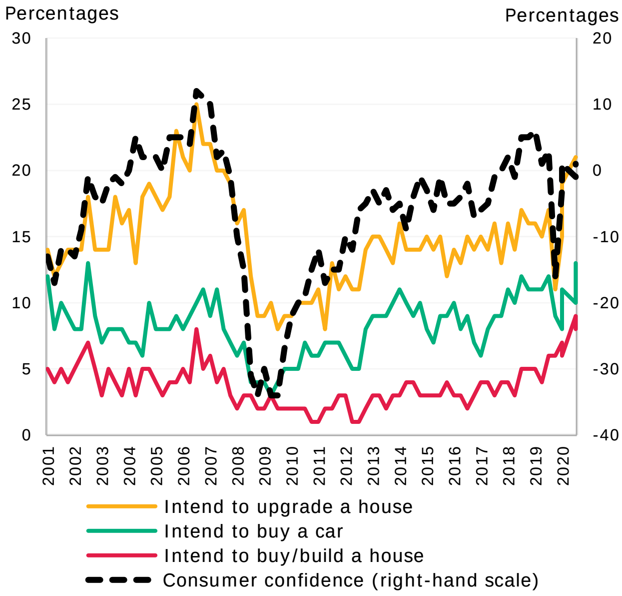
Chart 5. Annual change in the portfolio of MFI loans to non-financial corporations by economic activity (Q1 2013–Q1 2021)



Source: Bank of Lithuania calculations.

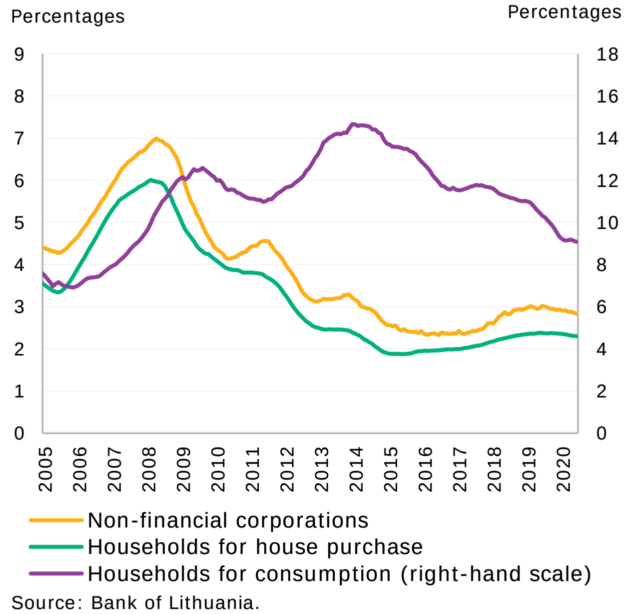
Chart 6. Consumer survey results

(July 2001–April 2021)



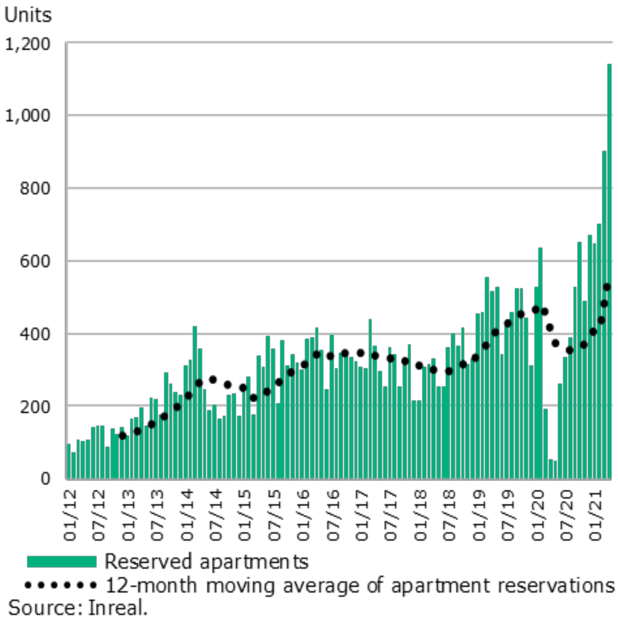
Sources: Statistics Lithuania and Bank of Lithuania calculations.

Chart 7. Average weighted interest rates on new loans to non-financial corporations and households (October 2005–March 2021)



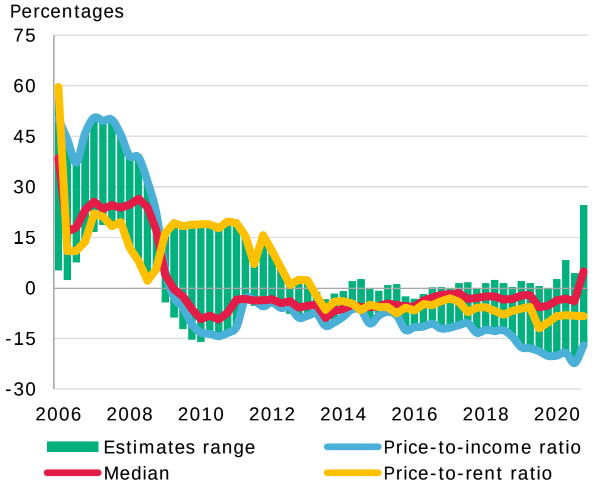
Source: Bank of Lithuania.

Chart 8. Number of new apartments reserved in Vilnius primary market (April 2012–April 2021)



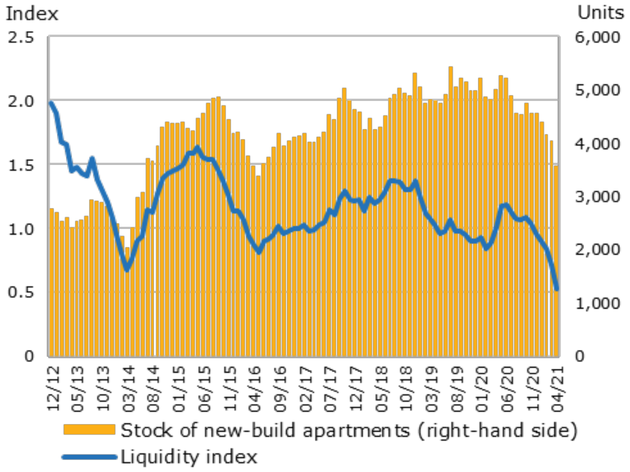
Source: Inreal.

Chart 9. Gap between actual house prices and their fundamental values (Q1 2006–Q4 2020)



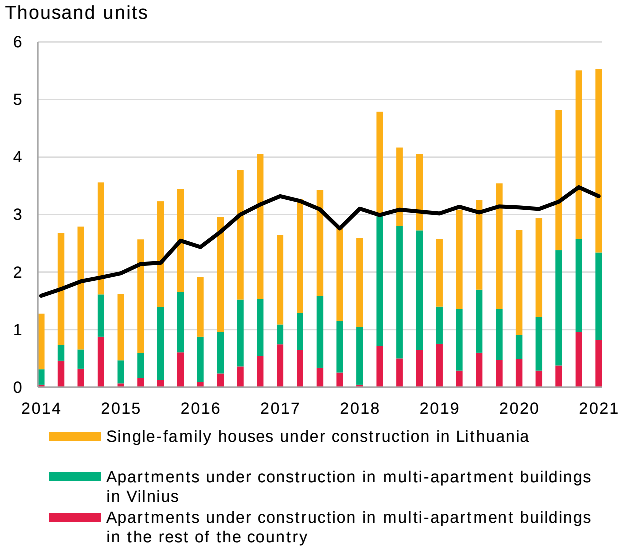
Sources: Statistics Lithuania and Bank of Lithuania calculations.
Note: Calculated based on the house price-to-rent ratio, house price-to-income ratio, an econometric model and the HP filter.

Chart 10. Number of unsold new-build apartments and stock liquidity index in Vilnius (December 2012–April 2021)



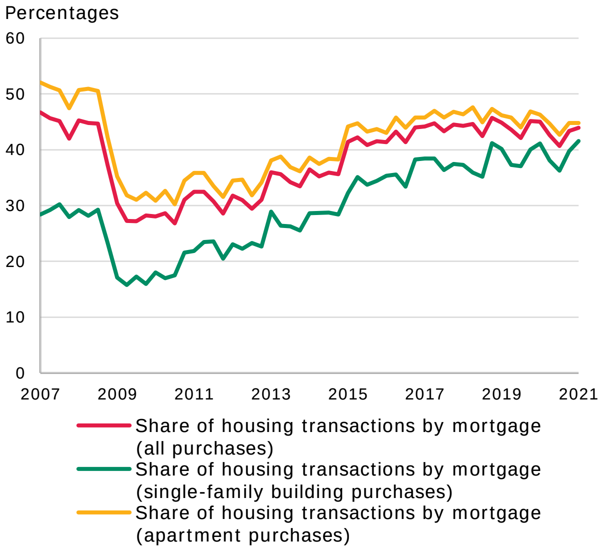
Sources: Inreal and Bank of Lithuania calculations.
Note: The liquidy index is a ratio of the stock of new-build apartments over the total number of reservations over the last 12 months.

Chart 11. Number of under-construction and completed houses in Lithuania (Q1 2014–Q1 2021)



Source: Statistics Lithuania.

Chart 12. Share of housing transactions with mortgage (Q1 2007–Q1 2021)

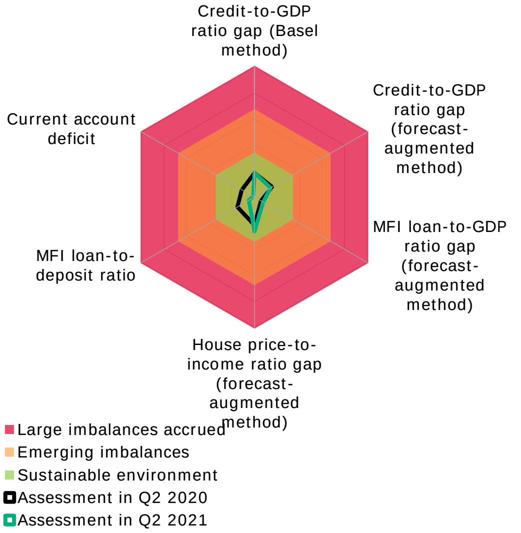


Source: Centre of Registers.

ANNEX 2. CREDIT AND HOUSING MARKET IMBALANCES

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

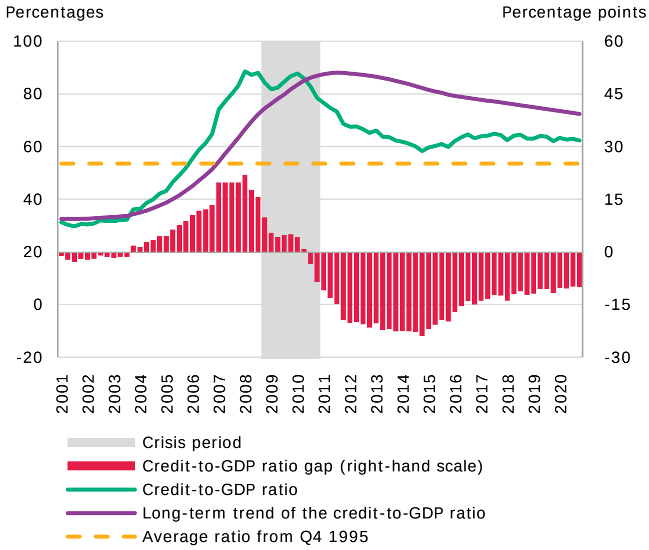
(Q2 2021)



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.

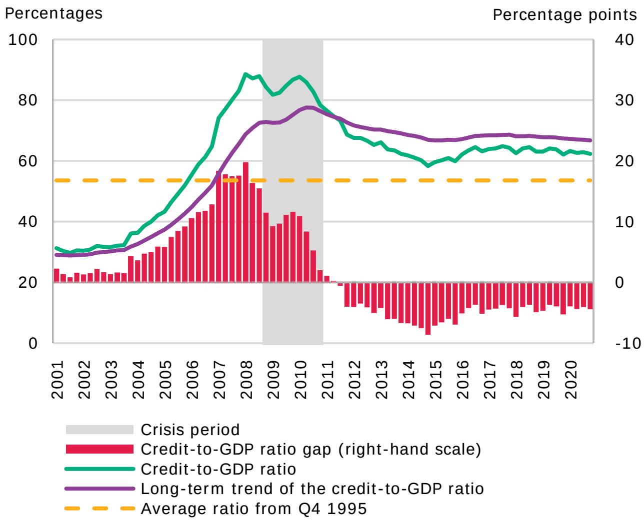
Chart B. Core indicator I: Credit to the private non-financial sector-to-GDP ratio gap (based on the standardised Basel method)

(Q1 2001–Q4 2020)



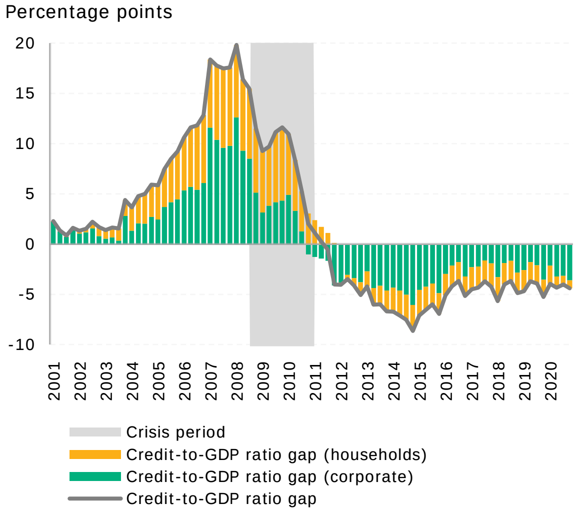
Sources: Statistics Lithuania and Bank of Lithuania calculations.
Note: The long-term trend is computed using a one-sided HP filter with a smoothing parameter of 400,000.

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 2020)



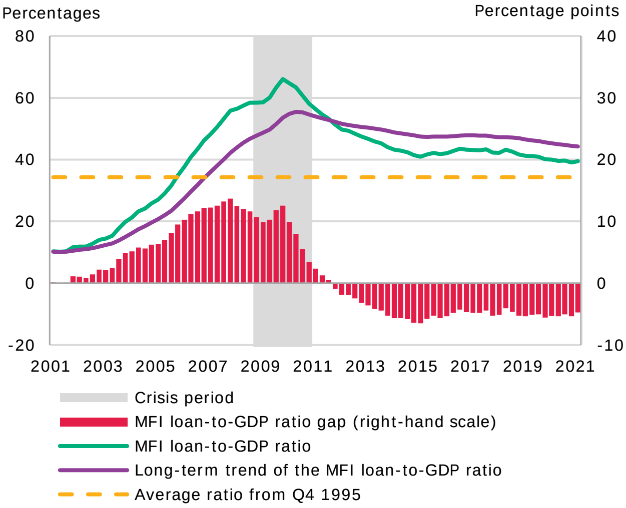
Sources: Statistics Lithuania and Bank of Lithuania calculations.
Note: The long-term trend is computed by applying a one-sided HP filter with a smoothing parameter of 400,000; before applying the filter, the ratio is modelled for the next 5-year window using a 4-quarter weighted average.

Chart D. Core indicator II: Credit to the private non-financial sector-to-GDP ratio gap (based on the forecast-augmented method) by sector
(Q1 2001–Q4 2020)



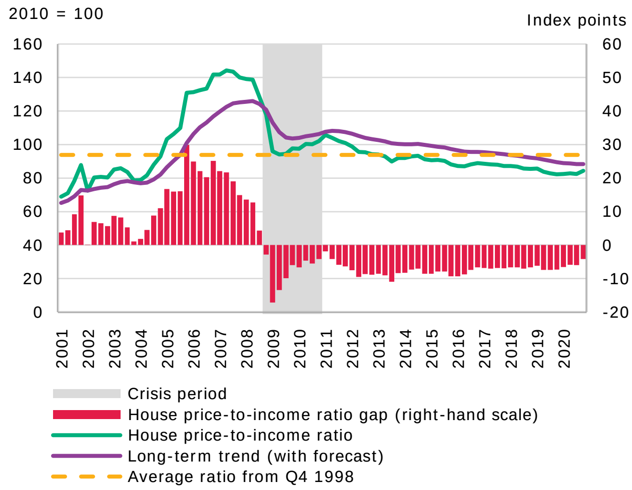
Sources: Statistics Lithuania and Bank of Lithuania calculations.
Note: The long-term trend is computed by applying a one-sided HP filter with a smoothing parameter of 400,000; before applying the filter, the ratio is modelled for the next 5-year window using a 4-quarter weighted average.

Chart E. Additional indicator I: MFI lending to the private non-financial sector-to-GDP ratio gap (based on the forecast-augmented method) (Q1 2001–Q1 2021)



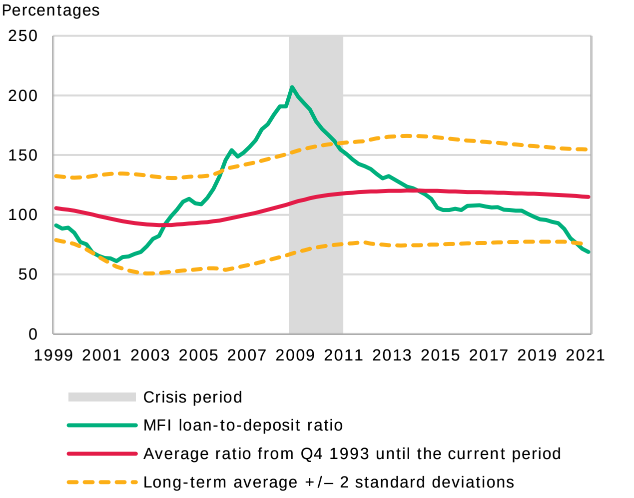
Sources: Statistics Lithuania and Bank of Lithuania calculations.
Note: The long-term trend is computed by applying a one-sided HP filter with a smoothing parameter of 400,000; before applying the filter, the ratio is modelled for the next 5-year window using a 4-quarter weighted average.

Chart F. Additional indicator II: House price-to-income ratio gap (based on the forecast-augmented method) (Q1 2001–Q4 2020)



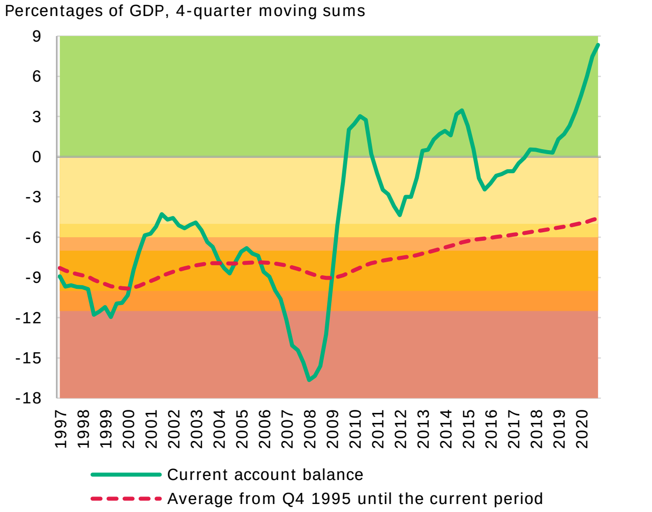
Sources: Statistics Lithuania and Bank of Lithuania calculations.
Notes: 1) income – household wages and salaries; 2) the long-term trend is estimated by applying a one-sided HP filter with a smoothing parameter of 400,000; before applying the filter, the ratio is modelled for the next 5-year window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

Chart G. Additional indicator III: Ratio between MFI lending to the private sector and private sector deposits (seasonally adjusted) (Q1 1999–Q1 2021)



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.

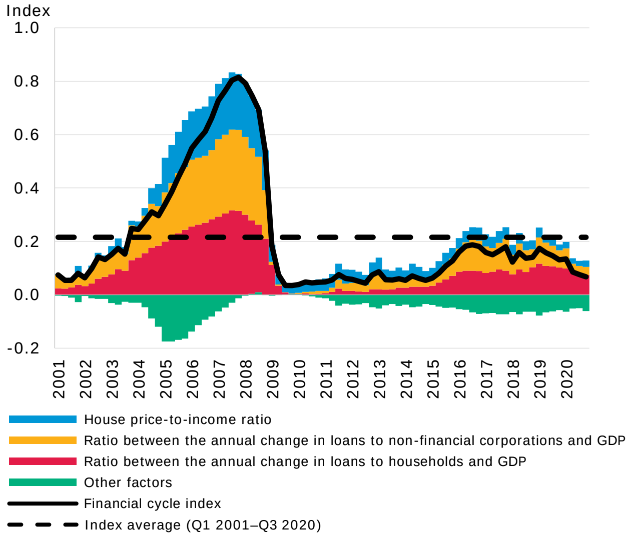
Chart H. Additional indicator IV: Ratio between the current account balance (4-quarter moving sums) and GDP (Q1 1997–Q4 2020)



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 I. Contributions to Lithuania's financial cycle index

(Q1 2001–Q4 2020)



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).