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CREDIT AND REAL ESTATE MARKET REVIEW

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SUMMARY OF THE REVIEW

Recent trends in lending and real estate (RE) markets do not currently point to imbalances in the financial system, but there is still considerable activity in the RE market and lending for house purchase.

The increase in new lending by monetary financial institutions (MFIs) is leading to a faster growth in their portfolio of loans to the private non-financial sector, while the financial cycle is gradually recovering and moving into a growth phase. On the other hand, credit market trends in the corporate and household sectors remain divergent, with the portfolio of MFI loans to households continuing to grow rapidly, while the volume of corporate loans has not yet reached pre-pandemic levels and is still in a recovery phase. However, the pandemic poses new challenges: rising energy and raw material prices as well as higher labour costs could lead to lower profitability of companies, slower business expansion and weaker-than-expected economic growth. In addition, the worsening epidemiological situation and the possible imposition of new restrictions may adversely affect the performance and financial position of some companies, therefore the non-financial corporate sector still remains more vulnerable.

Activity in the residential RE market remains strong. The pace of growth of the MFI housing loan portfolio continues to accelerate and, although they decreased during the quarter, the flow of new housing loans and the number of dwellings sold are still higher than before the pandemic. The pace of growth of housing prices continues to accelerate and signs of overvaluation are emerging. On the other hand, lending standards are not deteriorating, the share of home purchases with loans has decreased, so there are no imbalances in the housing market at the moment, but the market is heating up. Meanwhile, there are no significant changes in the commercial RE market, with banks' expectations for commercial property prices and commercial property rents remaining unchanged in the third quarter of 2021.

In November 2021, the Bank of Lithuania adopted resolutions on targeted measures to increase the resilience of the banking sector to the increasing risk of overheating in the housing market and to reduce further risk growth. From 1 July 2022, banks and central credit union groups will be subject to a 2% sectoral systemic risk buffer for the housing loan portfolio on a consolidated basis. It will be applied based on a similar principle as the countercyclical capital buffer, but the capital buffer will be calculated on the size of the existing exposures to residential RE mortgages of Lithuanian residents rather than on the size of all exposures[1]. In addition, the requirement will not apply to institutions with a housing loan portfolio of less than €50 million. From 1 February 2022, the down payment requirement for households taking out a housing loan other than the first one will also be tightened[2]. A higher down payment requirement of at least 30% will apply to the second and any subsequent credit agreements, while exceptions will be made for the residents with the outstanding amount of each previous loan lower than 50% of the value of the housing purchased with that loan; such residents will be subject to a down payment requirement of more than 15%, as is currently the case for the second and any subsequent housing loans.

The countercyclical capital buffer rate, which remains at 0%, is in line with the current credit market situation. As long as the situation in lending for house purchase and lending to non-financial corporations remains different and the volume of corporate loans does not reach pre-pandemic levels, the targeted measures introduced by the Bank of Lithuania will more effectively limit the risk of imbalances developing in the housing market.

DEVELOPMENT OF CREDIT AND REAL ESTATE MARKETS

Key indicators of imbalances remain at sustainable levels and the financial cycle is in an early stage of recovery. In the second quarter of 2021, the annual growth of credit to the private non-financial sector amounted to 2.5% in real terms (0.3% in the previous quarter), with credit to households and non-

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[1] 25 November 2021 Resolution of the Board of the Bank of Lithuania No 03-200 On Establishment of the Systemic Risk Buffer.

[2] 11 November 2021 Resolution of the Board of the Bank of Lithuania No 03-191 On Amendments to Resolution of the Board of the Bank of Lithuania No 03-144 of 1 September 2011 On the Provisions on Responsible Lending.

financial corporations increasing by 4.9% and 1% respectively. The gap between credit-to-GDP ratio and its long-term trend remained negative and widened slightly to -8.8 percentage points, or -3.6 percentage points according to the valuation method (previous quarter: -8.7 percentage points and -3.3 percentage points, respectively). The widening of the gap was mainly due to a slight decline in the corporate credit-to-GDP ratio, while the household credit-to-GDP ratio remained broadly unchanged over the quarter. The gap between MFI loan to the private non-financial sector-to-GDP ratio and its long-term trend narrowed slightly over the quarter, standing at -5 percentage points at the end of the third quarter of 2021 (compared to -5.3% in the previous quarter). In view of the slowdown in deposit growth and the acceleration in loan growth, the loan-to-deposit ratio increased to 69.4% during the quarter (68.3% in the previous quarter). The current account balance remained positive, but declined to 5% of GDP at the end of the second quarter of 2021 (6.9% in the previous quarter). The house price-to-income ratio remains elevated (85.8%) on the back of continued strong property price growth. The Financial Cycle Index continues to rise and is now in the early stage of recovery.

On the back of the recovery in new MFI loans, especially those above €1 million, the annual change in the portfolio of loans to non-financial corporations turned positive in the third quarter, but its volume has not yet reached pre-pandemic levels. In September 2021, the MFI corporate loan portfolio was 1.2% higher than a year ago (in the previous quarter, it was 3.8% lower year-on-year), but still 6.6% lower, compared to the pre-pandemic period[3], and 3.6% lower than the average value of the portfolio over the last 3 years. Loan portfolios for most economic activities have stopped shrinking or increased slightly. The main contributors to the growth of the total portfolio were RE activities (+2.4 percentage points), manufacturing (+0.7 percentage point) and administrative and service activities (+0.6 percentage point), while the trade sector had the biggest negative impact on the growth rate of the total portfolio (-2 percentage points). New lending remained active, with the flow of pure new loans to non-financial corporations almost unchanged during the quarter (0.2% lower than in the previous quarter) and 52.9% higher than in the corresponding period of the previous year. The growth of higher-value loans accelerated: the quarterly flow of loans of up to €1 million (including renegotiated loans) fell by 19% in the quarter, but increased by 25%, compared to the corresponding period in 2020, while the flow of loans over €1 million increased by 8% during the quarter and by 60% during the year. Depending on the size of the undertaking[4], in the third quarter of 2021, the flow of loans to SMEs fell by 11%, although it was almost 48% higher than in the corresponding quarter of the previous year. On the other hand, the quarterly flow of new loans to large undertakings fell by 31% during the quarter and by 4% during the year. Interest rates on pure new loans to non-financial undertakings fell slightly, averaging 2.8% per annum in September 2021 (2.9% in the previous quarter). Undertakings also used other alternative sources of finance. According to financial accounts, in the second quarter of 2021, loans from other companies grew by 17% year-on-year (€0.7 billion), trade credits – by 3% (€0.5 billion), while debt securities increased by 28% (€0.4 billion).

The portfolio of MFI loans to households increased even more rapidly, mostly due to active provision of housing loans and the recovery of new consumer loans, but the lending standards remained substantially unchanged. In September 2021, the portfolio of loans to households was 9.1% larger than a year ago and 0.9 percentage point larger than in the previous quarter. Growth in the total loan portfolio continued to be mainly supported by housing loans: due to active provision of new loans, the pace of growth in the housing loan portfolio accelerated to 11.3% (up by 0.7 percentage point, compared to the previous quarter) and was the highest since 2009. In the third quarter of 2021, the flow of pure new housing loans increased by 30% year on year, although it was down by 12%, compared to the previous quarter of this year. The average debt service-to-income (DSTI) and loan-to-value (LTV) ratios for new housing loans remained broadly unchanged, fluctuating around 28% and 76% respectively. On the other hand, a downward trend in the share of new loans with high LTVs (80-85%) has been observed recently. The portfolio of consumer and other loans to households continued to shrink, albeit at a slower pace: it decreased by 0.4% year on year in September (in the previous quarter, it was 2.2% lower than a year ago). The flow of pure new

[3] February 2020

[4] Based on data from the Loan Risk Database.

consumer loans was 5% higher than in the previous quarter and 23% higher year on year. Interest rates remained significantly unchanged during the quarter, with the annual average interest rate of 2.2% on new housing loans and 8.3% on consumer loans in September 2021. Consumer expectations have moderated somewhat, possibly in response to rising inflation and the likelihood of a new quarantine, with the consumer confidence index turning negative in October.

Due to limited supply and rising prices, activity in the housing market declined in the third quarter of 2021, but the market still remains more active than before the pandemic. According to the Centre of Registers, housing market activity is on the decline, but still higher than before the pandemic. In the third quarter of 2021, the number of home sales was 10.3% higher than in the corresponding period of 2020, and 11.4% higher than in the corresponding pre-pandemic period of 2019, but 8.1% lower than in the second quarter of 2021. Based on the recent data, the number of home sales in October was 1.2% lower than in September. The share of homes purchased with a loan has decreased over the year and in the third quarter of 2021 it accounted for 38.7% of the number of homes purchased (2.4 percentage points less than in the same period of the previous year) and 58.3% of the value of homes (1.5 percentage points less than in the same period of the previous year). In the third quarter of 2021, activity in the primary apartment market in Vilnius has also been shrinking, with 34% fewer reservations than in the record-breaking second quarter of this year, 14.9% more than in the third quarter of 2020, and 2.4% more than in the corresponding pre-pandemic period in 2019. The number of reserved apartments in October was 7.9% higher than in September. Although the volume of reservations is returning to pre-pandemic levels, the stock of apartments is not being significantly replenished, with around 3.5 thousand apartments currently unsold – until now, such a level of stock was last witnessed in 2016. In the recent months, the decline in housing market activity has been influenced by a faster rise in the prices of housing and deteriorating affordability, as well as reduced access to suitable housing due to insufficient replenishment of housing supply.

Currently, housing prices in Lithuania are not highly overvalued and are about 7% above fundamental values, but prices are growing at an accelerating rate, which, if prolonged, could lead to imbalances in RE market. According to Statistics Lithuania, in the second quarter of 2021, the annual housing price growth accelerated and stood at 13.3% (6.3 percentage points higher than in the same period of the previous year and 1.3 percentage points higher than in the second quarter of 2021) and was the highest since 2008. According to the Repeat Sales House Price Index (RSHPI) of the Bank of Lithuania, the annual price growth rate continued to accelerate and reached 19.6% in October 2021 (2.3% percentage points more than in September 2021), while the most recent data from the property market participant *Ober-Haus* show that in October 2021 the annual growth rate of apartment prices amounted to 20.8%. According to the data of the bank survey conducted in the third quarter of 2021, all surveyed banks expect a rise in the prices of new housing, while eight out of nine banks expect a rise in the price of old housing in the coming year. Housing prices are currently not highly overvalued, with a gap of 7% from fundamental values, and with prices continuing to grow rapidly, the gap between housing prices and fundamental values is likely to widen further, potentially leading to overly optimistic expectations of the public regarding further price increases. This can lead to a gap between the housing market and the overall economic development and create imbalances in the market. Nonetheless, the level and growth of housing prices since the 2008-2009 financial crisis has so far been in line with personal income, demographics and macroeconomic developments and is not based on excessive lending.

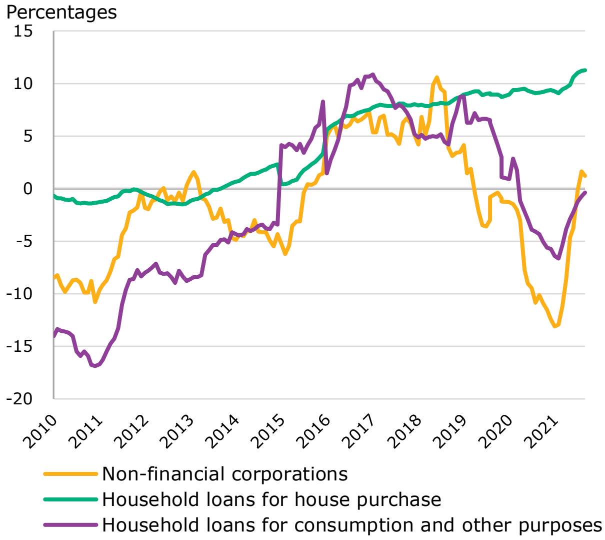
In the third quarter of 2021, banks' expectations for future developments in commercial RE values did not deteriorate, while the share of unlet office space fell due to a recovery in demand. As in the previous quarter, only one of the commercial banks participating in the survey conducted by the Bank of Lithuania in the third quarter of 2021 indicated that they expected commercial property prices to fall in the coming year, while slightly more than a half of the respondents expected the prices to rise. Due to a recovery in demand, the office vacancy rate in Vilnius decreased by 1.3 percentage points to 5.3%[5], but office vacancy

[5] *Newsec* data.

rates have increased over a period of more than one year, particularly in the class B segment. In the meantime, office rents remained largely unchanged over the period. Going forward, there is still a risk that technological and social developments (the advancement of e-commerce, remote work) will reduce the demand for office space and increase the amount of vacant offices.

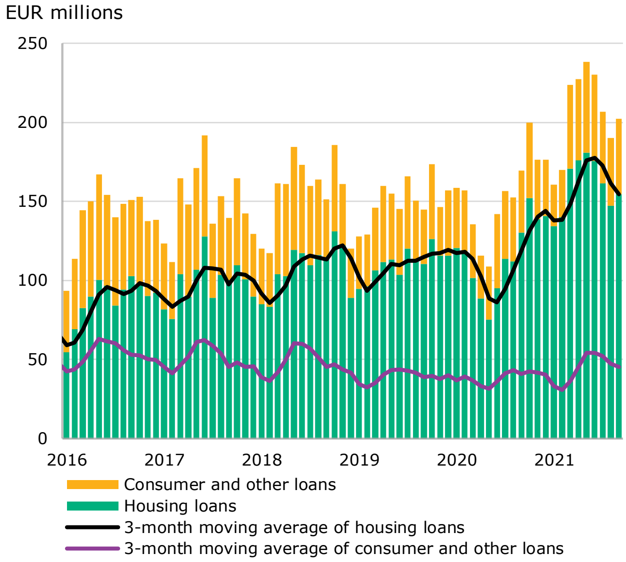
ANNEX 1. TRENDS IN CREDIT AND HOUSING MARKETS

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



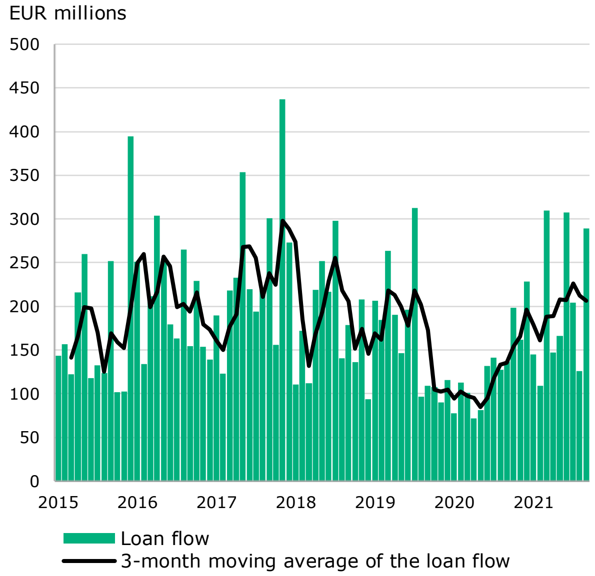
Source: Bank of Lithuania.

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



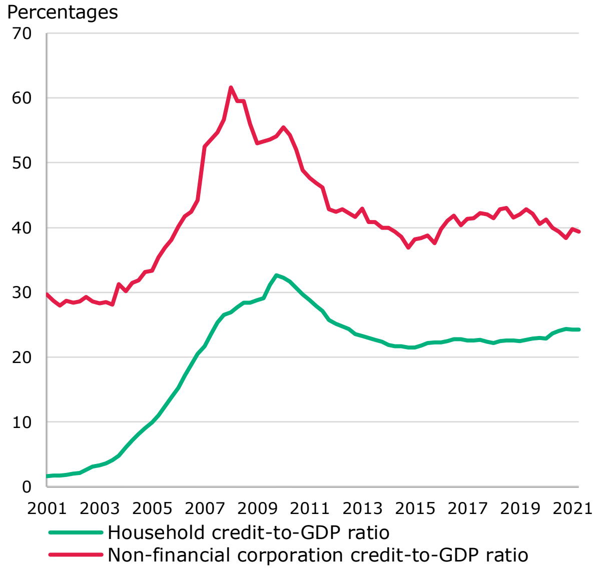
Source: Bank of Lithuania

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



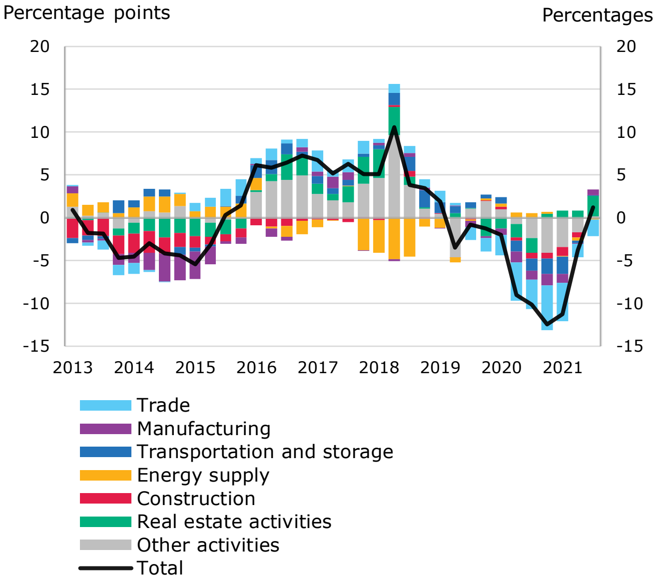
Source: Bank of Lithuania.

Chart 4. Credit-to-GDP ratio of non-financial corporations and households (Q1 2001–Q2 2021)



Sources: Statistics Lithuania and Bank of Lithuania calculations.

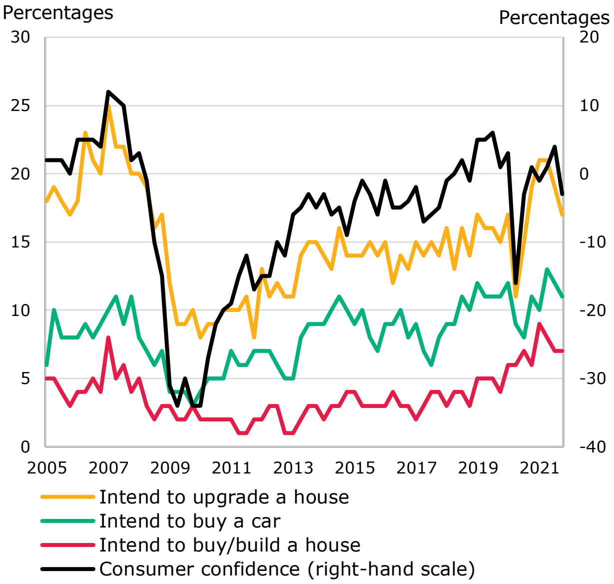
Chart 5. Annual change in the portfolio of MFI loans to non-financial corporations by economic activity (Q1 2013–Q3 2021)



Source: Bank of Lithuania calculations.

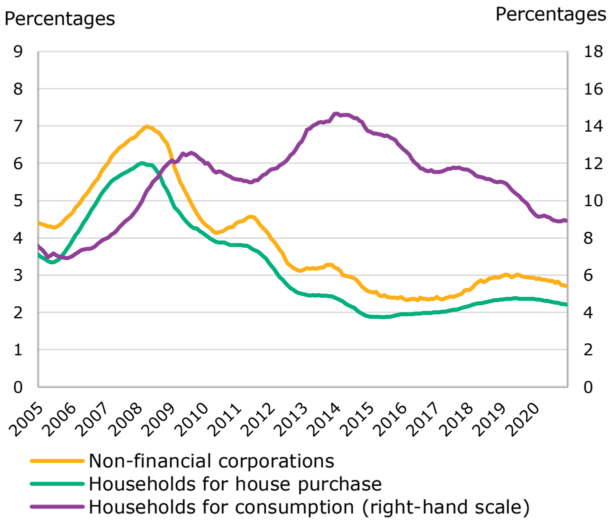
Chart 6. Consumer survey results

(July 2001–October 2021)



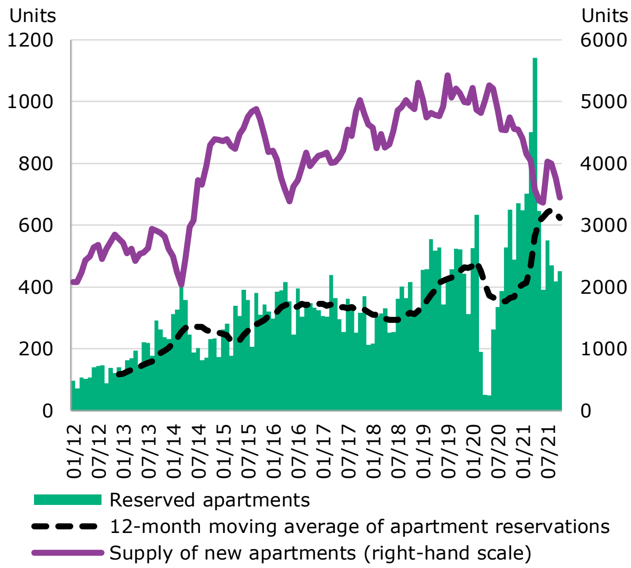
Sources: Statistics Lithuania and Bank of Lithuania calculations.

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



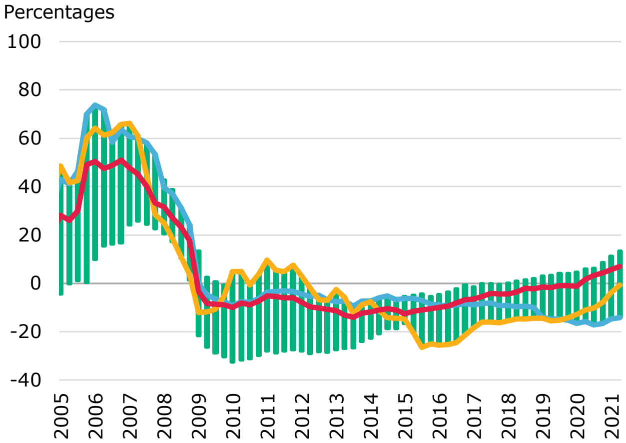
Source: Bank of Lithuania.
Note: 12-month moving average.

Chart 8. Number of new apartments reserved in Vilnius primary market and supply of apartments (January 2010–October 2021)



Source: Inreal.

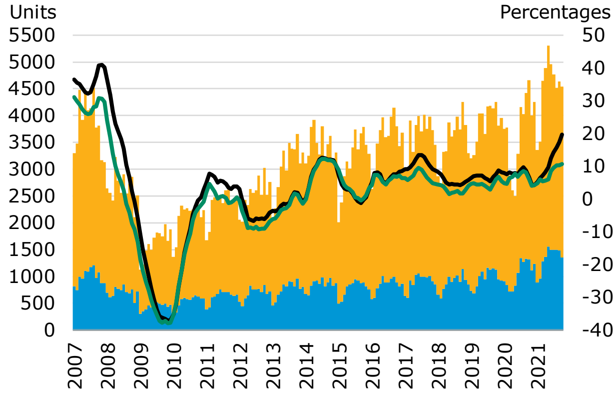
Chart 9. Gap between actual house prices and their fundamental values
(Q1 2006–Q2 2021)



Estimates range
Price-to-income ratio
Price-to-rent ratio
Median

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

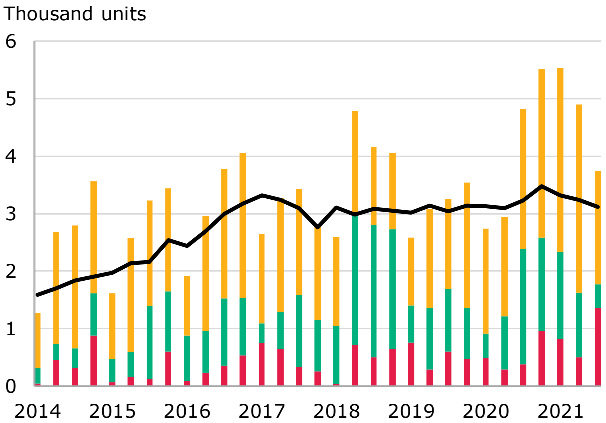
Chart 10. Apartments sold in a month in Lithuania and annual change in house prices
(January 2005–October 2021)



Flats
Houses
Annual change of nominal RSHPI (right-hand scale)
Annual change of real RSHPI (right-hand scale)

Sources: Centre of Registers, Statistics Lithuania, Bank of Lithuania calculations.
Note: real RSHPI calculated by deflating nominal RSHPI using the HICP.

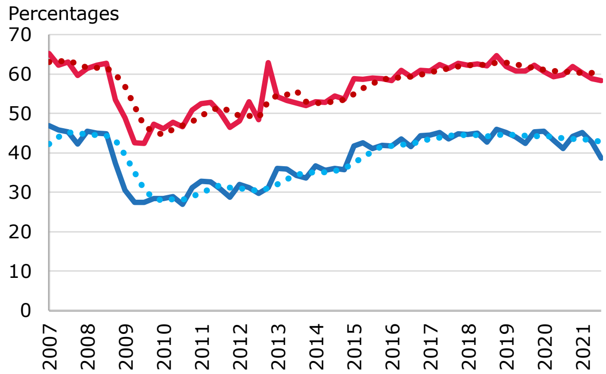
Chart 11. Number of under-construction and completed houses in Lithuania
(Q1 2014–Q3 2021)



Single-family houses under construction in Lithuania
Apartments under construction in multi-apartment buildings in Vilnius
Apartments under construction in multi-apartment buildings in the rest of the country

Source: Statistics Lithuania.

Chart 12. Share of housing transactions with mortgage against all purchases
(Q1 2007–Q3 2021)



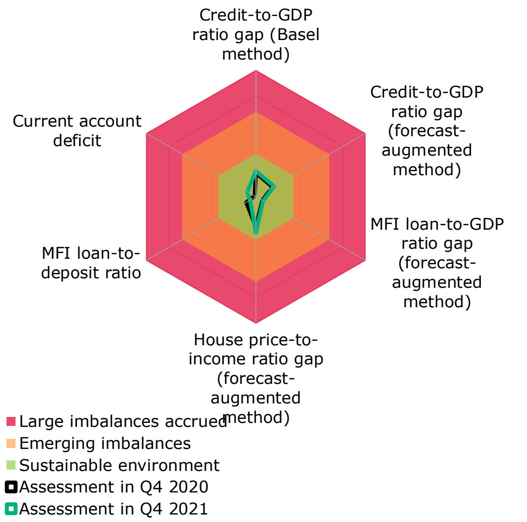
Share of housing transactions with mortgage (by number of purchases)
4-quarter moving average (by number of purchases)
Share of housing transactions with mortgage (by value of purchases)
4-quarter moving average (by value of purchases)

Source: Centre of Registers.

ANNEX 2. CREDIT AND HOUSING MARKET IMBALANCES

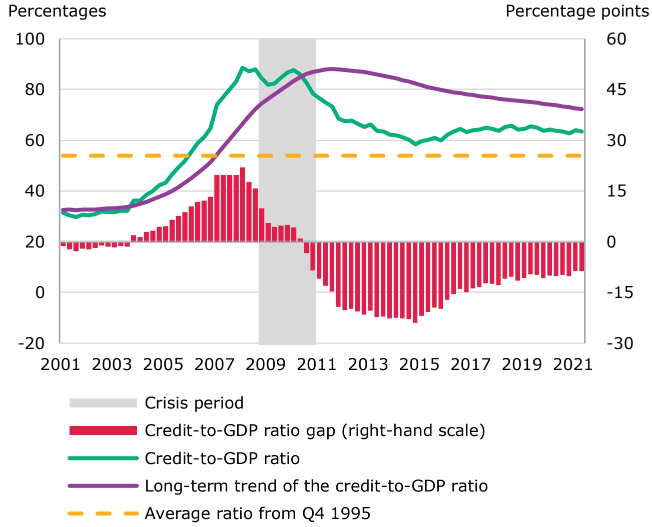
Chart A. Evaluation of credit market imbalances based on core and additional indicators

(Q4 2021)



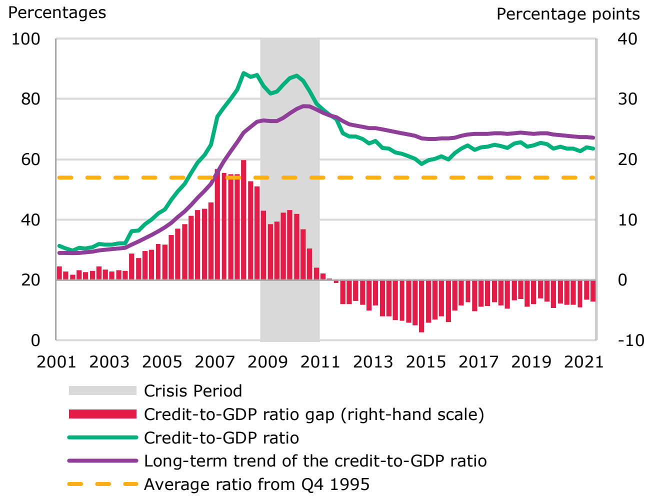
Sources: Statistics Lithuania and Bank of Lithuania calculations.
Note: Axes are scaled according to the range of a particular indicator: from its minimal value up to the maximal value.

Chart B. Core indicator I: Credit to the private non-financial sector-to-GDP ratio gap (based on the standardised Basel method)
(Q1 2001–Q2 2021)



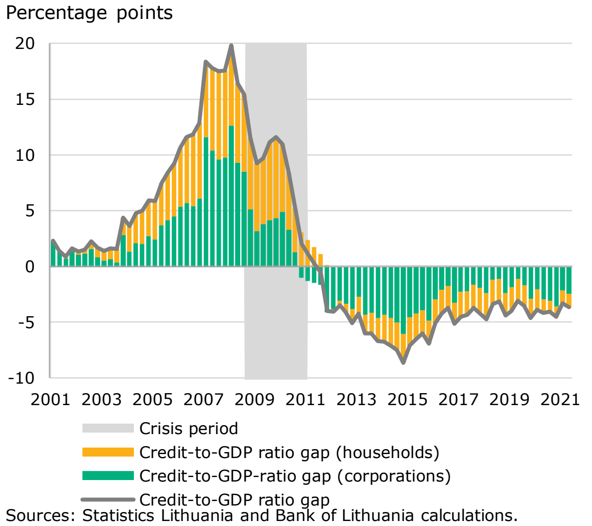
Sources: Statistics Lithuania and Bank of Lithuania calculations.
Note: The long-term trend is computed using a one-sided HP filter with a smoothing parameter of 400,000.

Chart C. Core indicator II: Credit to the private non-financial sector-to-GDP ratio gap (based on the forecast-augmented method)
(Q1 2001–Q2 2021)



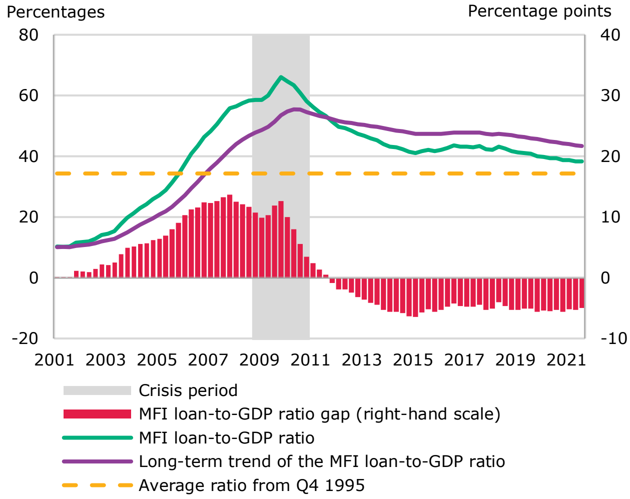
Sources: Statistics Lithuania and Bank of Lithuania calculations.
Note: The long-term trend is computed by applying a one-sided HP filter with a smoothing parameter of 400,000; before applying the filter, the ratio is modelled for the next 5-year window using a 4-quarter weighted average.

Chart 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–Q2 2021)



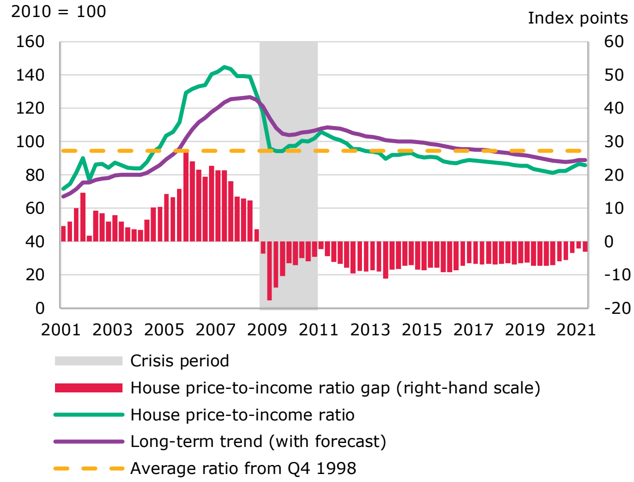
Sources: Statistics Lithuania and Bank of Lithuania calculations.
Note: The long-term trend is computed by applying a one-sided HP filter with a smoothing parameter of 400,000; before applying the filter, the ratio is modelled for the next 5-year window using a 4-quarter weighted average.

Chart E. Additional indicator I: MFI loan to the private non-financial sector-to-GDP ratio gap (based on the forecast-augmented method)
(Q1 2001–Q3 2021)



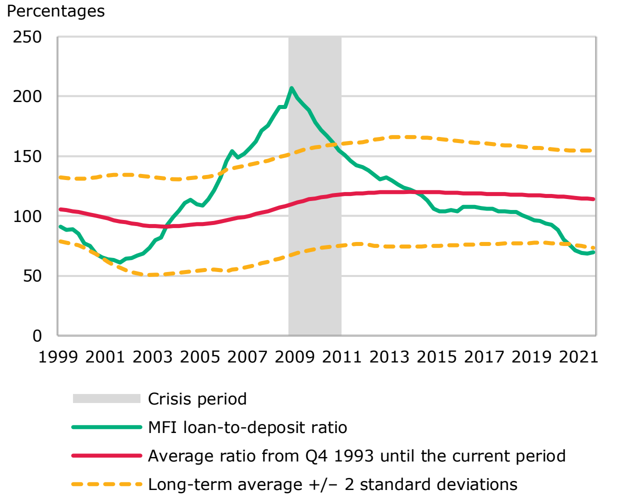
Sources: Statistics Lithuania and Bank of Lithuania calculations.
Note: The long-term trend is computed by applying a one-sided HP filter with a smoothing parameter of 400,000; before applying the filter, the ratio is modelled for the next 5-year window using a 4-quarter weighted average.

Chart F. Additional indicator II: House price-to-income ratio gap (based on the forecast-augmented method)
(Q1 2001–Q2 2021)



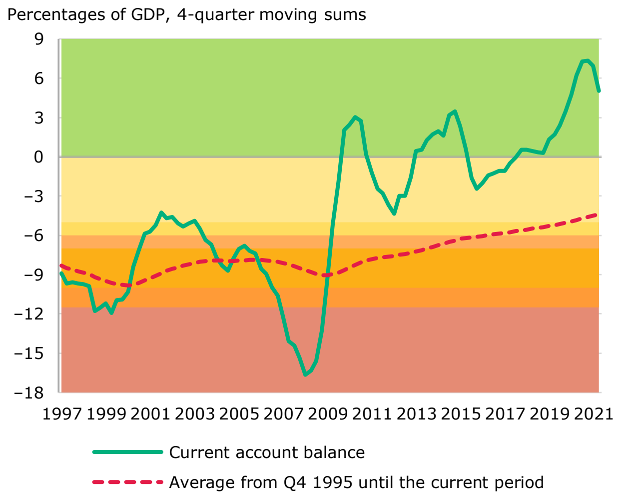
Sources: Statistics Lithuania and Bank of Lithuania calculations.
Notes: 1) Income – household wages and salaries; 2) The long-term trend is estimated by applying a one-sided HP filter with a smoothing parameter of 400,000; before applying the filter, the ratio is modelled for the next 5-year window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

Chart G. Additional indicator III: Ratio of MFI loans to the private sector and private sector deposits (seasonally adjusted)
(Q1 1999–Q3 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.

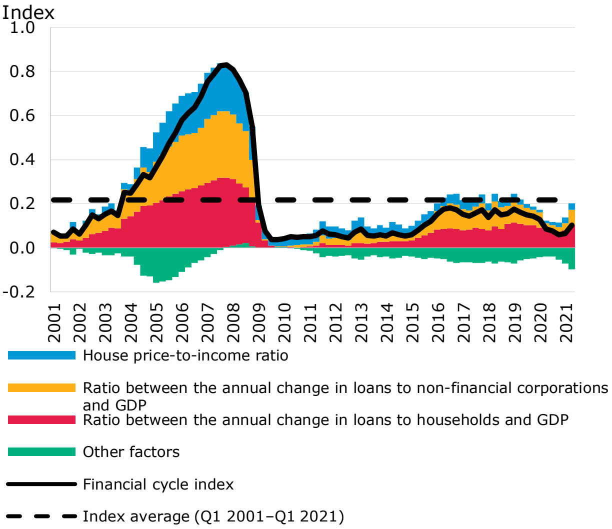
Chart H. Additional indicator IV: Ratio between the current account balance (4-quarter moving sums) and GDP
(Q1 1999–Q2 2021)



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–Q2 2021)



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).