LIETUVOS BANKAS
EUROSISTEMA

CREDIT AND REAL ESTATE MARKET REVIEW

June

2022

Credit and Real Estate Market Review ISSN 2783-6266 (online)

The publication was prepared by the Financial Stability Department of the Bank of Lithuania.
Unless stated otherwise, the cut-off date for the data used in the publication is 20 May 2022.

The period given in the sub-headings of the figure titles includes data for the year, quarter or other period indicated.

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SUMMARY OF THE REVIEW

The flow of new loans from monetary financial institutions (MFIs) to the private non-financial sector has picked up, but the development of lending to non-financial corporations is still surrounded by uncertainty. The provision of new MFI loans continued to be active, although the flow contracted compared to the previous quarter, mainly due to a slight slowdown in lending to non-financial corporations. On the other hand, growth in MFI loan portfolios remained strong and the portfolio of loans to non-financial corporations at nominal value has already reached pre-pandemic levels. Furthermore, credit, which covers all loans to non-financial corporations (including from the non-bank sector) and funding through debt securities continued to increase. However, rising energy and raw material prices and disruptions in supply chains may lead to lower corporate profitability, business expansion and weaker-than-expected economic growth, leaving the non-financial corporate sector still vulnerable. In addition, Russia's ongoing war against Ukraine and the increased uncertainty around it as well as the tightening constraints on businesses could worsen the outlook of corporate borrowing.

Sales in the residential real estate (RE) market are stabilising, but the pace of lending and price growth continues to increase. The pace of growth in the MFI housing loan portfolio continues to accelerate and the value of new housing loans granted was higher than a quarter earlier. The number of home sales is stabilising, but the pace of price growth remains accelerated, signs of price overvaluation are emerging and the choice of new housing remains limited. Although an increase in the granting of riskier housing loans has been observed recently, lending standards on average have not been easing and the share of home purchases with loans has not changed significantly. The outbreak of Russia's war against Ukraine brought a lot of uncertainty to the housing market in terms of the future development of prices for building materials and new housing supply, yet no significant drop in demand for housing was observed in the first months of the war. The situation in the commercial RE market remained unchanged during the quarter. Banks' expectations for commercial RE prices are good and banks do not expect prices to fall in the immediate future, while office vacancy rates declined during the quarter.

On 1 February 2022, a stricter down payment requirement for households taking out a second or subsequent loan came into force, and a new sectoral capital requirement for credit institutions will start to apply as of 1 July, in order to increase their resilience to risks related to the housing market. A higher down payment requirement of at least 30% will apply to second and subsequent credit agreements, while exceptions will be made for the residents whose balance on each previous loan is less than 50% of the value of the home 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. In addition, a further capital requirement – a 2% sectoral systemic risk buffer (SSR) for the housing loan portfolio – will apply from 1 July 2022 on a consolidated basis to banks and central credit union groups with housing loan portfolios comprised of at least €50 million.

The financial cycle is slowly picking up, being most affected by lending to households, but the countercyclical capital buffer rate (CCyB) is maintained at 0% amid the uncertainty about the recovery in lending to companies. Although credit to non-financial corporations has already contributed to the upturn in recent quarters, the outlook for this trend remains uncertain due to Russia's war against Ukraine and the business constraints around it. Risks of cyclical nature are currently mainly driven by the rapid crediting of house purchases, but the resilience of the financial system is being strengthened by the sectoral SRR that will enter into force soon, and there are no significant imbalances in the Lithuanian financial system, with the credit-to-GDP ratio gap being negative and various early warning indicators at sustainable levels. With property market and household credit remaining active and the strengthening of corporate credit and its outlook, an increase in the CCyB would be considered in order to further strengthen the resilience of the banking sector.

DEVELOPMENT OF CREDIT AND REAL ESTATE MARKETS

While the housing market is showing signs of emerging imbalances, other key indicators of imbalances in the financial system remain at sustainable levels and the financial cycle is in a post-pandemic recovery. The gap between credit-to-GDP ratio and its long-term trend turned more negative in the fourth quarter of 2021 as it stood at -10.6% or -5.6 percentage points according to the valuation method, while the gap between MFI loans to the private non-financial sector-to-GDP ratio and its long-term trend remained broadly unchanged and was -4.8 percentage points in the first quarter of 2022. This shows that there is no excess credit in the economy. In view of faster loan growth and a decline in deposits, the loan-to-deposit ratio increased to 78.1% during the quarter (from 74.1% in the previous quarter) but remains at a sustainable level. The ratio of the current account balance to GDP remained positive but declined to 1.4% of GDP at the end of 2021 (3.1% in the previous quarter). As a result of the ongoing particularly rapid rise in house prices, the house price-to-income ratio, which shows housing affordability, continued to deteriorate during the quarter to 90.1 (88.1 in the previous quarter), resulting in a positive gap with the long-term trend for the first time since 2008. Taking into account econometric models, gaps with long-term trends and relative indicators, the house price gap with fundamentals remained nearly the same at 8.8% in the fourth quarter of 2021. The financial cycle index continued to rise and is still in the stage of recovery.

Growth in the portfolio of MFI loans to non-financial corporations has accelerated and reached the pre-pandemic levels, but the outlook for further portfolio growth is surrounded by uncertainty due to the outbreak of the war and the end of the base effect. In March 2022, the MFI corporate loan portfolio was 16.2% (by €1.3 billion) higher than a year ago (a quarter ago it was 10.6% higher than a year earlier) and reached pre-pandemic levels by the nominal value. The main contributors to the growth of the total portfolio were transport and storage (3.4 percentage points), manufacturing (3.2 percentage points), trade (2.9 percentage points), RE transactions (2.6 percentage points) and administrative and service activities (2.1 percentage points). Although increased uncertainty following the outbreak of Russia’s aggression against Ukraine has dampened business expectations, so far new loan flows have not been significantly affected: in the first quarter of 2022, the flow of pure new loans to non-financial corporations remained buoyant, being 7.7% higher than in the same period a year before, although it was one-third lower than in the previous quarter. The flow of lower-value loans increased more rapidly: the quarterly flow of loans of up to €1 million (including renegotiated loans) increased by 37% compared to the corresponding period a year ago and by 10% compared to the previous quarter, while flows of loans of more than €1 million grew by 32% over the year and decreased by 34% over the quarter. Interest rates on pure new loans to non-financial corporations went up slightly, averaging 2.8% per annum in March 2022 (2.7% a quarter earlier). Undertakings also used more funding from sources other than banks. According to financial accounts, in the fourth quarter of 2021, trade credit increased by 8% year-on-year (€1.2 billion), debt securities went up by 34% (€0.6 billion), while long-term loans from other companies rose by 11% (€0.2 billion), even though short-term loans from other companies contracted by 22% (€0.6 billion).

The growth of MFI loans to households accelerated further, driven by continued active provision of new housing loans and strong recovery in consumer lending; the share of riskier loans also increased. In March 2022, the portfolio of loans to households was 11.3% larger than a year ago (or 0.6 percentage points larger than in the previous quarter). Growth in the total loan portfolio continued to be mainly supported by housing loans, with the annual growth rate of the housing loan portfolio accelerating to 12.3% (0.6 percentage points more compared to the previous quarter), which is one of the strongest growth rates since 2009. The number of new housing loans granted slightly decreased, with the number of loans granted in the first quarter of 2022 being 4.5% lower than in the same period last year and 7.3% lower than in the previous quarter, but the value of loans granted continued to grow, with the flow of pure new housing loans in the first quarter of 2022 being 17% higher than in the corresponding period a year earlier, but 3.7% lower than in the previous quarter. The average debt service-to-income (DSTI) and loan-to-value (LTV) ratios for new housing loans remained largely unchanged, fluctuating at around 28% and 78% respectively, although a slight growth in the DSTI ratio can be observed. Overall, there has been a recent upward trend in the provision of riskier loans with high LTV ratio (>80%) and longer loan duration (>25 years). The annual growth rate of the portfolio of consumer and other loans to households was higher and stood at 6.4% in March 2022 (5.5% in the previous quarter), driven by an increase in the flow of new consumer loans. The quarterly flow of pure new consumer loans was 88% higher than a year ago and 28% higher than in the previous quarter. Interest rates remained unchanged, with the annual average interest rate of 2.1% on new housing loans and 8.1% on consumer loans in March 2022.

In the first quarter of 2022, the number of home sales decreased but remains high, the supply of new homes is still limited, and the impact of the ongoing war on the housing market has so far been modest. According to the Centre of Registers, activity on the housing market is stabilising, and there is no sign of a major slowdown due to the war so far. In the first quarter of 2022, there were 16.9% fewer home sales than in the fourth quarter of 2021, almost as many (0.4% less) as in the first quarter of 2021, and 12.9% more than in the corresponding pre-pandemic period in 2019. According to more recent data, the number of homes sold in April 2022 was 10.6% lower than the average monthly figure for 2021 and the same as before the pandemic in April 2019. The share of homes bought with a loan[1] increased slightly during the quarter and accounted for 49.9% of the value of homes bought in the first quarter of 2022 (1.7% percentage points more than in the fourth quarter of 2021). Activity in the primary apartment market in Vilnius declined over the period, with one-third fewer reservations than in the fourth quarter of 2021, 58.9% fewer than in the first quarter of 2021 and 36.9% fewer than in the corresponding pre-pandemic period of 2019. The decrease in sales was mainly due to Russia's war against Ukraine, which negatively affected buyers' willingness to buy a home under construction. Reservations in April were 65.9% higher than in March, but 25.9% lower than in January before the outbreak of the war. The stock of new apartments in the largest primary market in Vilnius is not being significantly replenished, with around 3.1 thousand apartments currently unsold, 12.4% less than in April 2021. This level of stock was last observed in 2014. The historically fastest rate of growth in residential construction prices (19.2% in March) and the disruption of material supply chains due to Russia's war against Ukraine are hampering the construction of new housing, which will continue to constrain supply in the short term.

The annual growth rate of house prices continues to accelerate and the gap between actual prices and their values implied by economic factors persists, signalling that imbalances are slowly developing in the market. According to Statistics Lithuania, the annual housing price growth accelerated and stood at 19.8% in the fourth quarter of 2021 (0.9 percentage points higher than in the third quarter and 10.4 percentage points higher than in the fourth quarter of 2020) and was the highest since 2007. According to the Repeat Sales House Price Index (RSHPI) of the Bank of Lithuania, the annual price growth rate continued to accelerate and reached 27.2% in April 2022, while the data of the real estate market participant UAB OBER-HAUS nekilnojamas turtas show that the prices rose by 21.4% during this period. The gap between actual housing prices and their fundamental values (based on the median of six indicators) was 8.8% in the fourth quarter of 2021. If prices continue to rise rapidly, this gap will widen further, possibly leading to overly optimistic expectations of residents regarding further price increases. This can lead to a gap between the housing market and the overall economic development and to the increasing risk of a market correction. According to the data of the bank survey conducted in the first quarter of 2022, all surveyed banks expect a rise in the prices of new housing, while eight out of nine expect a rise in the prices of old housing over the coming year. In addition, eight out of nine banks observe imbalances in the residential RE market.

In the first quarter of 2022, the banks surveyed did not observe any imbalances in commercial RE market, and the share of unlet office space decreased. Banks' expectations for commercial RE prices did not change significantly during the quarter. None of the commercial banks that participated in the survey

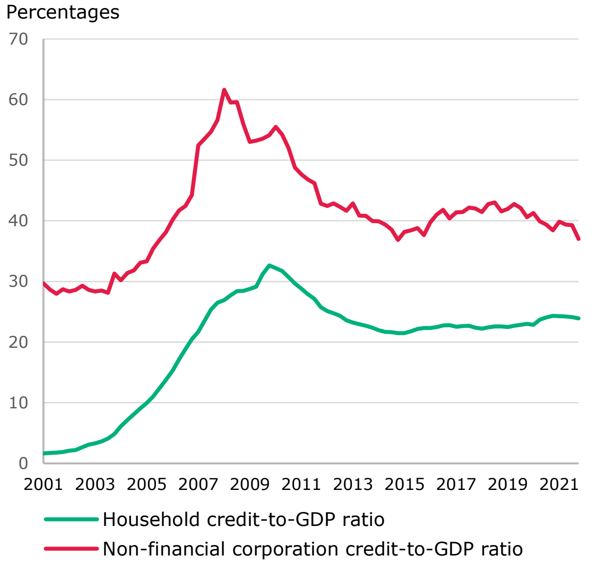
[1] Due to changes in the mortgage register, the share of home purchases with a loan is lower than described in the previous reviews throughout the whole analysis period.

conducted by the Bank of Lithuania in the first quarter of 2022 indicated that they expected commercial property prices to fall in the coming year, while the majority (78%) of the respondents expected the prices to rise. The office vacancy rate in Vilnius decreased by 1 percentage point to 6.8% in the first quarter of 2022.[2] Uncertainty in commercial RE market is slightly elevated due to the market's links to the overall economic development, with the risk of an economic slowdown being increased due to soaring inflation and the effect of Russia's war against Ukraine on the economy.

[2] Based on Newsec data.

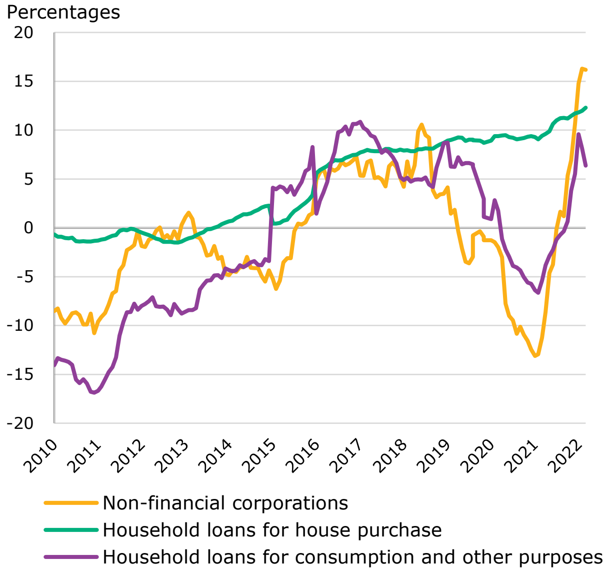
ANNEX 1. TRENDS IN CREDIT AND HOUSING MARKETS

Chart 1. Credit-to-GDP ratio of non-financial corporations and households
(Q1 2001 – Q3 2021)



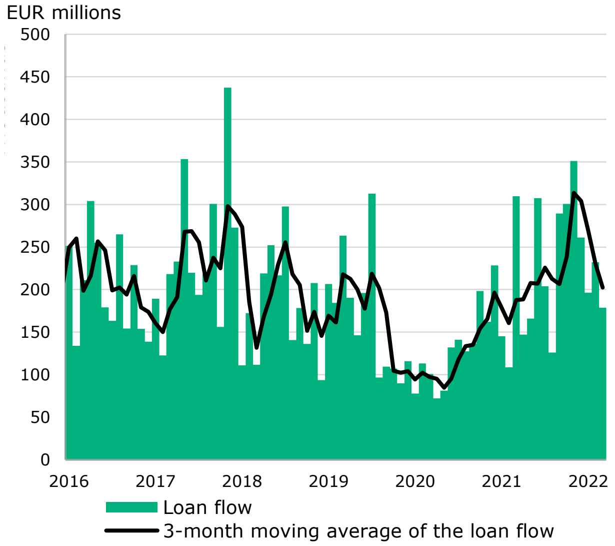
Sources: Statistics Lithuania and Bank of Lithuania calculations.

Chart 2. Annual growth of the portfolio of MFI loans to non-financial corporations and households
(January 2010 – March 2022)



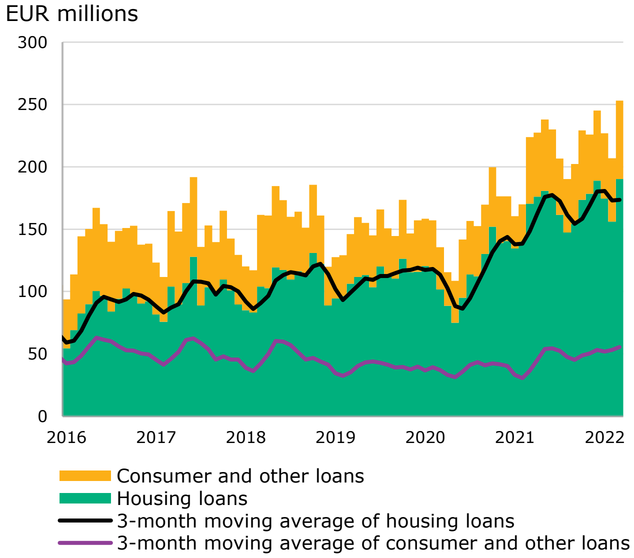
Source: Bank of Lithuania.

Chart 3. Monthly flow of pure new MFI loans to non-financial corporations
(January 2016 – March 2022)



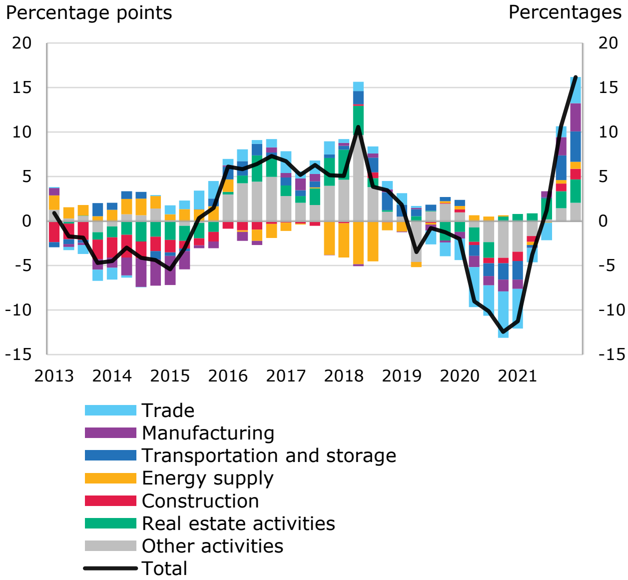
Source: Bank of Lithuania.

Chart 4. Monthly flow of pure new MFI loans to households
(January 2016 – March 2022)



Source: Bank of Lithuania

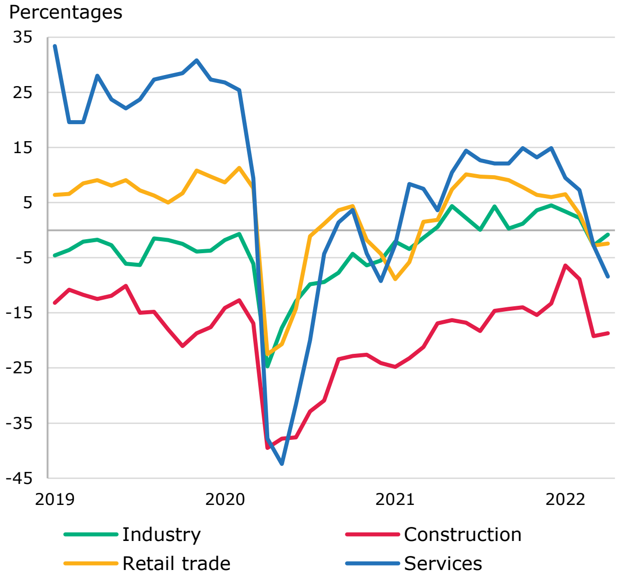
Chart 5. Annual change in the portfolio of MFI loans to non-financial corporations by economic activity
(Q1 2013 – Q1 2022)



Source: Bank of Lithuania calculations.

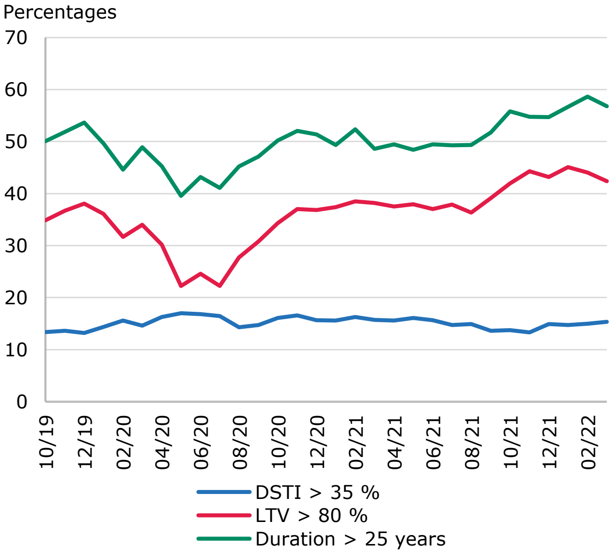
Chart 6. Business confidence indicator

(January 2019 – April 2022)



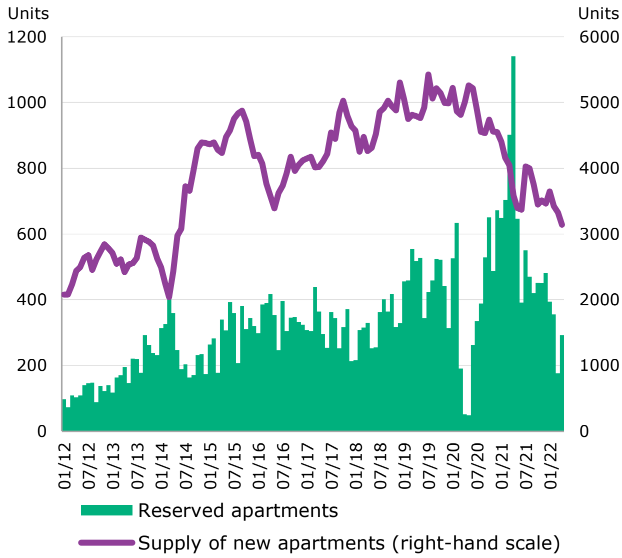
Source: European Commission.

Chart 7. Share of loans with high LTV, DSTI ratio and long loan duration
(October 2019 – March 2022)



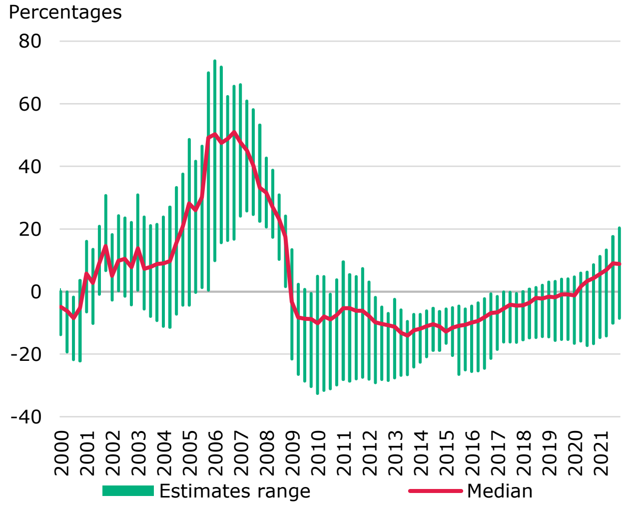
Source: Bank of Lithuania.

Chart 8. Number of new apartments reserved in Vilnius primary market and supply of apartments
(January 2012 – April 2022)



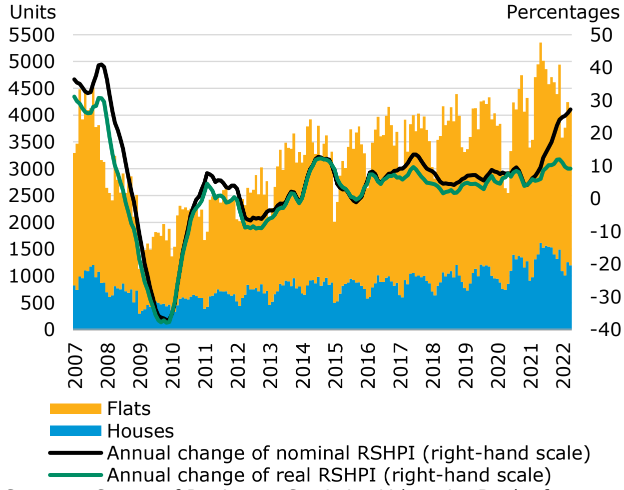
Source: Inreal.

Chart 9. Gap between actual house prices and their fundamental values
(Q1 2005 – Q4 2021)



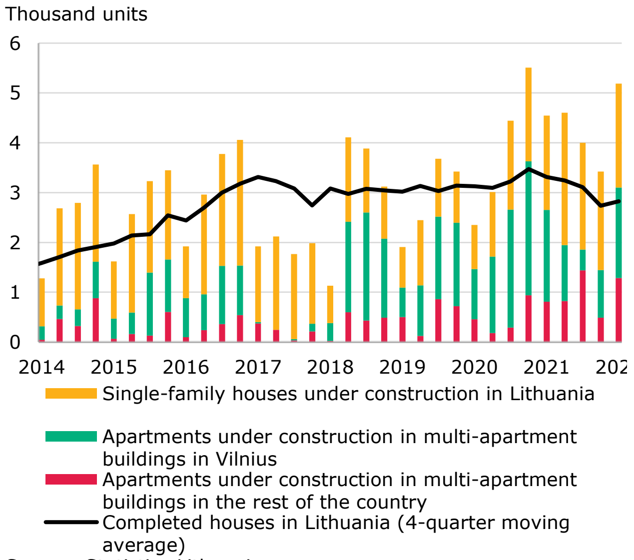
Sources: Statistics Lithuania and Bank of Lithuania calculations.
Note: Calculated based on the house price-to-rent ratio, house price-to-income ratio, econometric models and the HP filter

Chart 10. Apartments sold in a month in Lithuania and annual change in house prices
(January 2007 – April 2022)



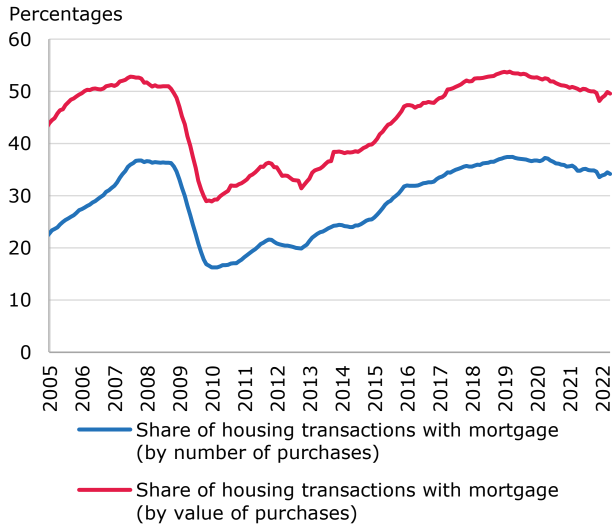
Sources: Centre of Registers, Statistics Lithuania, Bank of Lithuania calculations.
Note: real RSHPI calculated by deflating nominal RSHPI using the HICP.

Chart 11. Number of under-construction and completed houses in Lithuania
(Q1 2014 – Q1 2022)



Source: Statistics Lithuania.

Chart 12. Share of housing transactions with mortgage against all purchases
(January 2006 – April 2022)

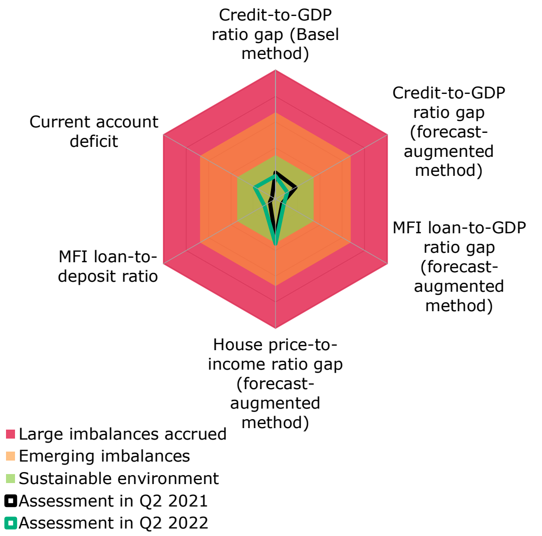


Source: Centre of Registers.
Note: 12-month moving average.

ANNEX 2. INDICATORS OF CREDIT AND HOUSING MARKET IMBALANCES

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

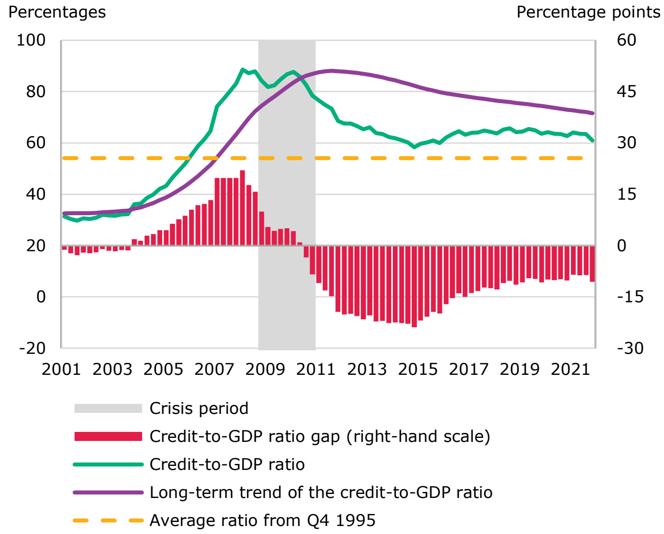
(Q2 2022)



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.

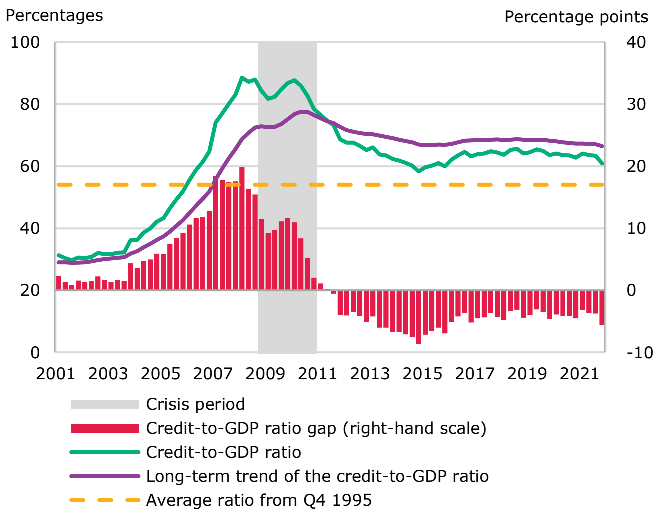
Chart B. Core indicator I: Credit to the private nonfinancial sector-to-GDP gap (based on the standardised Basel model)

(Q1 2001 – Q4 2021)



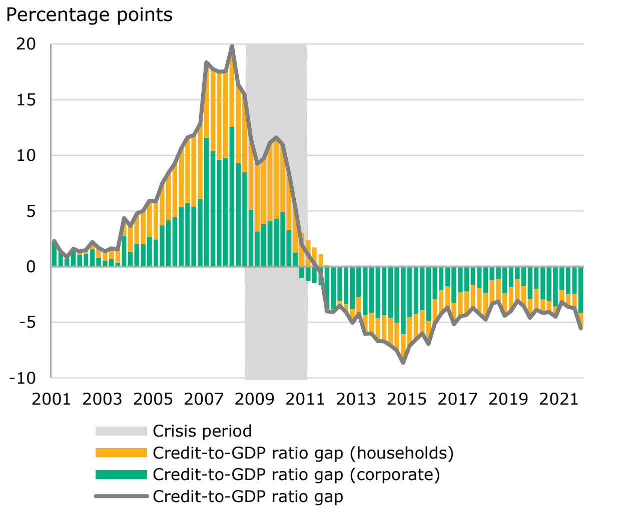
Sources: Statistics Lithuania and Bank of Lithuania calculations.
Note: The long-term trend is computed using a one-sided HP filter with a smoothing parameter of 400,000.

Chart C. Core indicator II: Credit to the private nonfinancial sector-to-GDP ratio gap (based on the forecast-augmented method)
(Q1 2001 – Q4 2021)



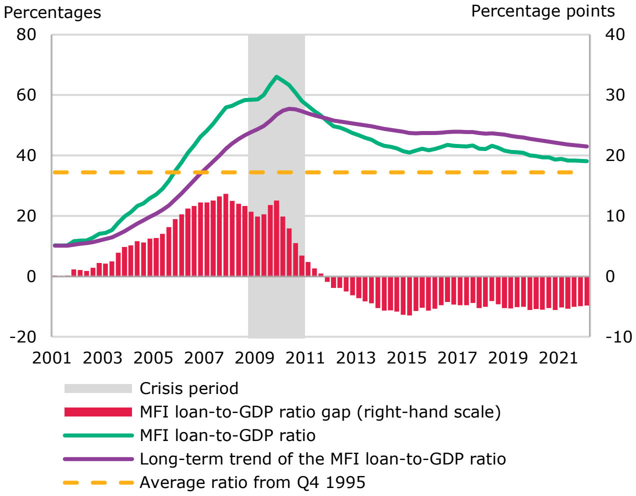
Sources: Statistics Lithuania and Bank of Lithuania calculations.
Note: the long-term trend is computed by applying a one-sided HP filter with a smoothing parameter of 400,000; before applying the filter, the ratio is modelled for the next 5-year window using a 4-quarter weighted average.

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

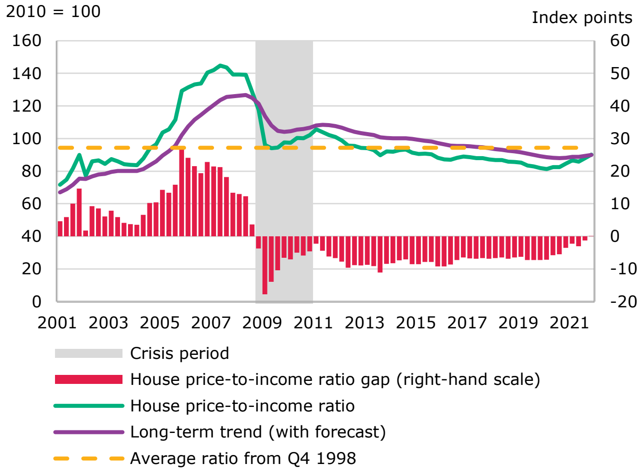
Chart E. Additional indicator I: MFI loan to the private non-financial sector-to-GDP ratio gap (based on the forecast-augmented method)
(Q1 2001 – Q1 2022)



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.

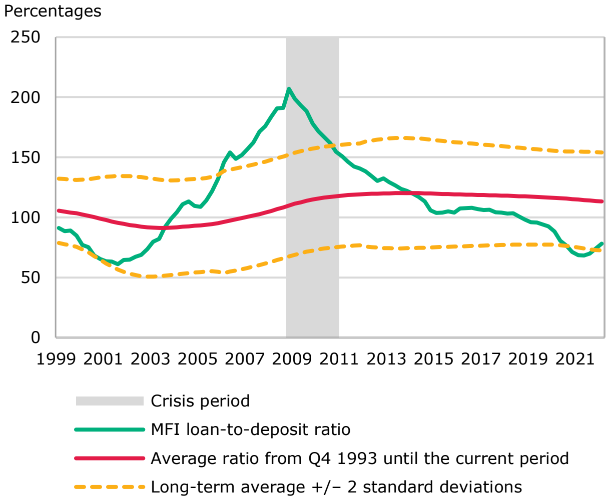
Chart F. Additional indicator II: House price-toincome ratio gap (based on the forecast-augmented method)

(Q1 2001 – Q4 2021)



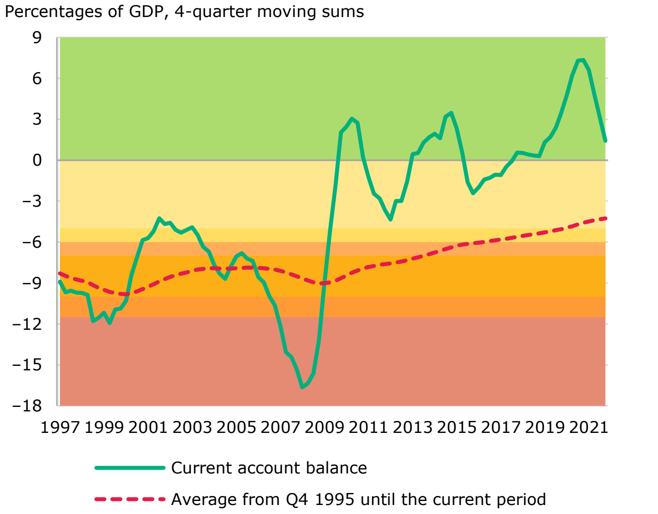
Sources: Statistics Lithuania and Bank of Lithuania calculations.
Notes: 1) income – household wages and salaries; 2) the long-term trend is estimated by applying a one-sided HP filter with a smoothing parameter of 400,000; before applying the filter, the ratio is modelled for the next 5-year window 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 – Q1 2022)



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.

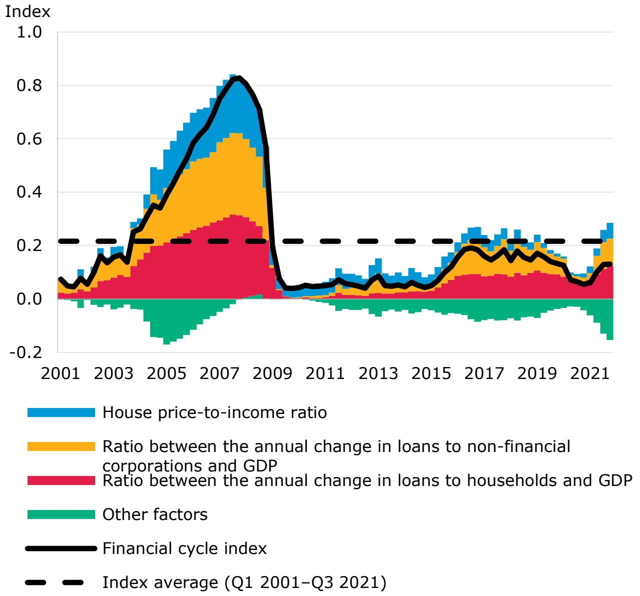
Chart H. Additional indicator IV: Ratio between the current account balance (4-quarter moving sums) and GDP
(Q1 1997 – Q4 2021)



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. Lithuania's financial cycle index and its drivers (total credit to non-financial corporations and households)

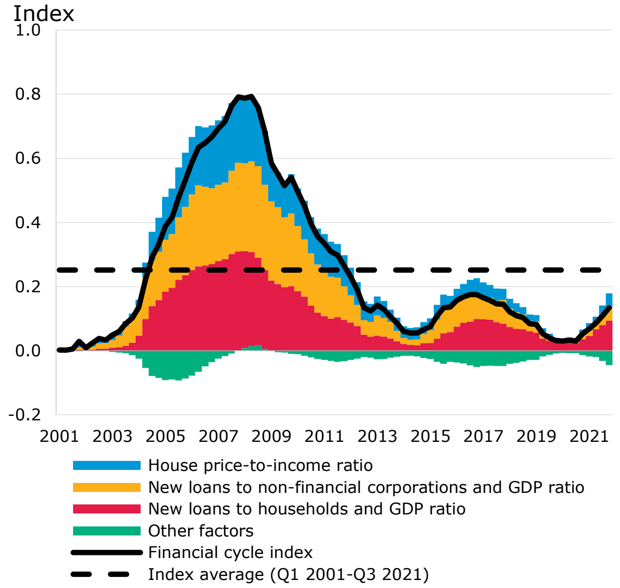
(Q1 2001 – Q4 2021)



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).

Chart J. Lithuania's financial cycle index and its drivers (MFI loans to non-financial corporations and households)

(Q1 2001 – Q4 2021)



Sources: Statistics Lithuania and Bank of Lithuania calculations.
Note: the financial cycle index is calculated having regard to MFI loans granted to non-financial corporations and households.