Countercyclical Capital Buffer

Background material for decision

September

2020

DECISION REGARDING THE COUNTERCYCLICAL CAPITAL BUFFER RATE

On 29 September 2020, the Board of the Bank of Lithuania took a decision[1] to leave the countercyclical capital buffer (CCyB) rate unchanged at 0%.

Such a decision was taken in view of the significant negative impact of COVID-19 on Lithuania's economy and financial system.[2] Although to a lesser extent than expected, in the second quarter of 2020 the economy contracted by 5.1%. Some companies that have been directly or indirectly affected by lockdown restrictions have been suffering from shrinking domestic and foreign demand as well as 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. The sharp economic downturn and persisting uncertainty reduced the availability of credit to the private non-financial sector.

CREDIT AND REAL ESTATE MARKET DEVELOPMENTS

The financial cycle remains on a downward path. The gap between the credit[3]-to-GDP ratio and its long-term trend slightly reduced, fluctuating between -9.8 and -3.7 percentage points at the end of the first quarter of 2020 (depending on the method of assessment) (see Charts B and C in Annex 2). On the other hand, the gap between the ratio of MFI loans to the private non-financial sector to GDP and its long-term trend turned even more negative, reaching -5.2% at the end of the second quarter of 2020. This was mainly due to a contraction in lending volumes. The loan-to-deposit ratio continued to decrease and amounted to 80%, while the current account balance and the house price-to-income ratio increased.

New loan flows have still not reached their pre-lockdown levels. In the second quarter of 2020, the portfolio of loans to the private non-financial sector contracted, decreasing by 0.7% year on year (in the previous quarter it saw an annual increase of 3.1%). These developments were mainly driven by a significant contraction in the portfolio of loans to non-financial corporations and a decline in the portfolio of consumer and other loans for households. While the annual growth rate of the housing loan portfolio remained stable, the contraction of new loan flows has still been prevalent in all loan segments. The average weekly value of agreements on new mortgage, consumer and other loans as well as loans to non-financial corporations concluded after the introduction of the lockdown is still lower by 19%, 20% and 11% respectively.[4]

The MFI corporate loan portfolio continued to shrink at a significant rate. At the end of the second quarter of 2020, the MFI corporate loan portfolio declined by an annual 9.2% (at the end of the first quarter of 2020 – 2.2%). Although, due to the moratorium period, amortisation of some corporate loan portfolios was slower, the total portfolio of loans to non-financial corporations was shrinking as a result of a noticeable reduction in the flow of new loans and the structure of the corporate loan portfolio (at the beginning of the lockdown, roughly 20% of the portfolio of loans to non-financial corporations consisted of loans granted for a period of up to 2.5 years, while during the lockdown borrowers were more inclined to defer payments or reconsider the conditions of longer-term loans). The net annual flow of new loans to non-financial corporations decreased by -32.7%. The flow of renegotiated corporate loans, excluding loans converted under the terms of the moratorium, amounted to €344.8 million (2.6 times the average renegotiation rate in 2019). On the other hand, the reduced flow of credit for firms was largely offset by financial instruments applied during the COVID-19 crisis (€336 million)[5].

Growth in the portfolio of MFI loans to households has slowed down, mainly due to a decline in consumer and other loans, yet the flow of new loans has been recovering. At the end of the second quarter of 2020, the household loan portfolio increased by 6.9% year on year (a 1 percentage point decline

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[1] Resolution No 03-129 of the Board of the Bank of Lithuania of 29 September 2020 on the application of the countercyclical capital buffer.

[2] The temporary lockdown restrictions in Lithuania's territory, which entered into force on 16 March 2020, have been lifted by a Government decision on 17 June 2020.

[3] Credit is a cash obligation to be settled at a later date with a certain rate of interest. This may include loans and other deferred payment methods (source: Verslo žinios).

[4] Comparison of the average weekly value of new loans granted over 15 weeks prior to the lockdown and 20 weeks after the lockdown.

[5] Envelope of instruments implemented by INVEGA directly or through financial intermediaries up to 31 July.

compared to the previous quarter). The growth of the total loan portfolio was supported by housing loans, which continued to grow rapidly (8.8%) as a result of the slowdown in loan amortisation during the moratorium period and the gradual recovery of new loan flows. Despite the recent increase in mortgage lending volumes, the flows of new loans have not yet reached pre-pandemic levels. The annual flow of pure new housing loans at the end of the second quarter of 2020 was 0.8% lower, amounting to €1.3 billion. The introduction of lockdown restrictions has had a significant impact on the provision of consumer loans: the portfolio of consumer and other loans granted to households was 1.1% lower than a year ago, while the annual flow of pure new household loans contracted by 9.3% (albeit gradually recovering). Interest rates remained stable: in June 2020 the annual average of interest rates on new housing loans stood at 2.4%, remaining unchanged on a quarterly basis, while the annual average of interest rates on new consumer loans reached 9.4%, a quarter-on-quarter decrease of 0.4 percentage point. Once the lockdown was lifted, household expectations also improved: the recovering economy and labour market had a positive impact on household expectations, bringing consumer confidence closer to the levels observed in 2017.

In the second quarter of 2020, investor and bank expectations regarding possible changes in the value of commercial real estate diverged, the commercial property vacancy rate increased, whereas rental income dropped. The capitalisation of exchange-traded real estate funds in the Baltic States increased by 18.2% over the respective period after a sharp fall in March. Such rapid growth has reflected the rapid price increase in other asset classes. However, the number of those commercial banks surveyed by the Bank of Lithuania that see imbalances in the commercial real estate market increased. In addition, the share of unleased commercial real estate also grew: the office vacancy rate in Vilnius increased by 0.6 percentage point, to 3.3%, and remained at historically low levels, while in the case of storage facilities the vacancy rate increased by 1.0 percentage point, to 6%.[6] Some commercial real estate managers also reported an increase in the vacancy of retail space in Vilnius.[7] In the second quarter of 2020, there were signs that income from renting commercial real estate fell in all commercial real estate segments. Reports on real estate funds traded on Baltic stock exchanges showed a decline of 6.7%, 32.2% and 24.3% respectively in funds' net rental income from office, retail and storage facilities operated in Lithuania.[8] While commercial real estate rent prices remained stable over the respective period, there remains a risk that the economic contraction will lead to a decrease in commercial real estate demand and an increase in unemployment. In such a case, rental prices may also fall and lead to higher liquidity risk for commercial real estate managers.

After the recession, housing market activity largely recovered in the period between June and July 2020. According to the Centre of Registers, house sales during these two months were 3.6% lower compared to last year, when real estate market activity was historically high. In the respective period, activity levels in the primary apartment market also increased, although they did not exceed the 2018–2019 average: in June and July the number of new apartments sold in Vilnius was 29.0% and 9.2% lower respectively, compared to the average for the last two years.

Relative housing market indicators point to no inflation of house prices in Lithuania, while their potential decline will be halted by sufficient liquidity buffers accumulated by real estate developers. Should market activity start to rapidly slow down, house prices would likely also follow a downward trend. However, the potential decline might be less pronounced due to the fact that, despite being relatively high, house price inflation had been previously in line with demographic, macroeconomic and household income developments, and did not result from excessive lending. Moreover, short-term assets of real estate developers exceeded their current liabilities by more than 50%, 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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[6] Newsec and Inreal.

[7] The vacancy rate in the supermarkets in Vilnius managed by the Baltic Horizon Fund increased by 1.4 percentage points over the quarter.
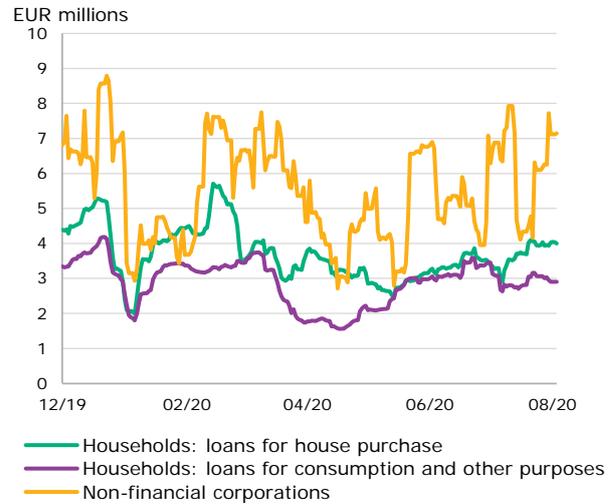
[8] Baltic Horizon Fund and Eften Real Estate Fund III.

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–June 2020)

Percentages

- Non-financial corporations
- Households for house purchase
- Households for consumption and other purposes
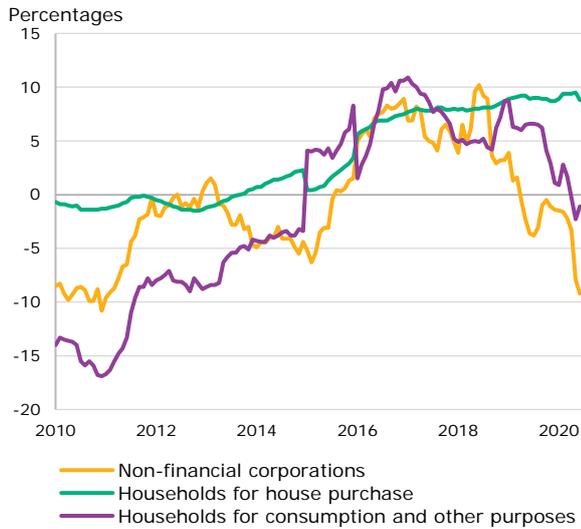
Source: Bank of Lithuania.
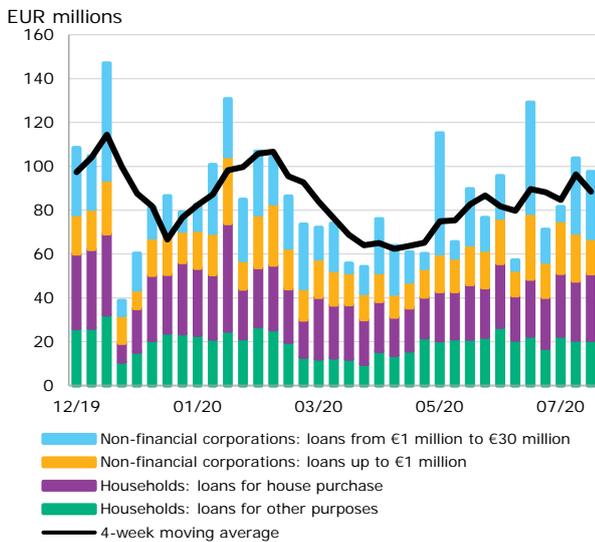
Chart 2. Value of new agreements between credit institutions and the private non-financial sector (December 2019–August 2020)

EUR millions

- Households: loans for house purchase
- Households: loans for consumption and other purposes
- Non-financial corporations

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–July 2020)

EUR millions

- Non-financial corporations: loans from €1 million to €30 million
- Non-financial corporations: loans up to €1 million
- Households: loans for house purchase
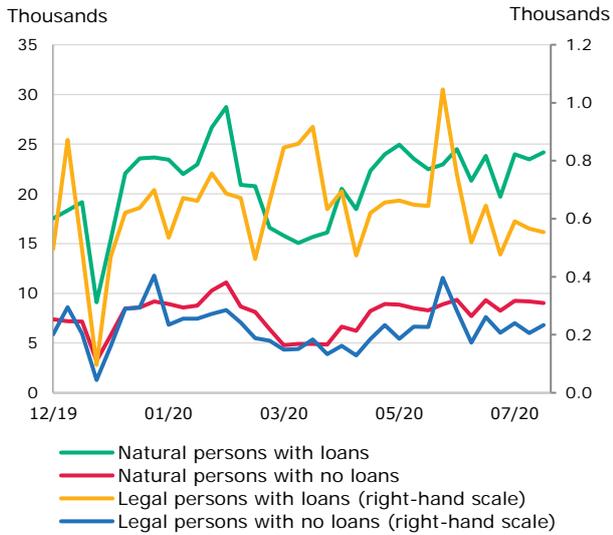- Households: loans for other purposes
- 4-week moving average

Source: Bank of Lithuania.

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

EUR millions   EUR millions

- Non-financial corporations
- Household loans for house purchase (right-hand scale)
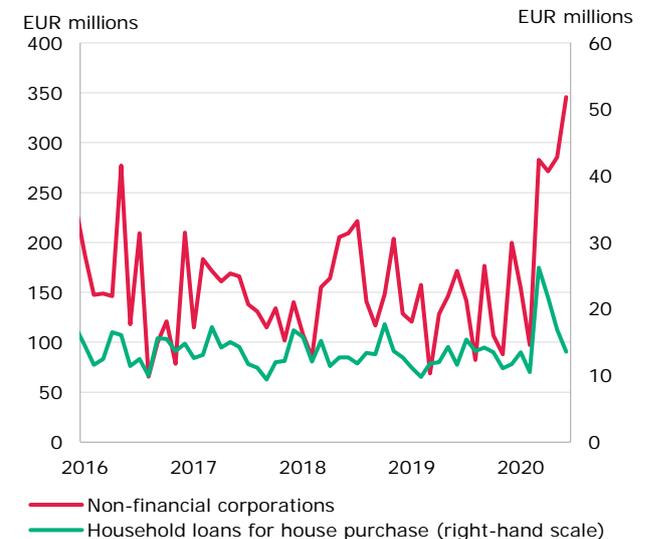
Source: Bank of Lithuania.

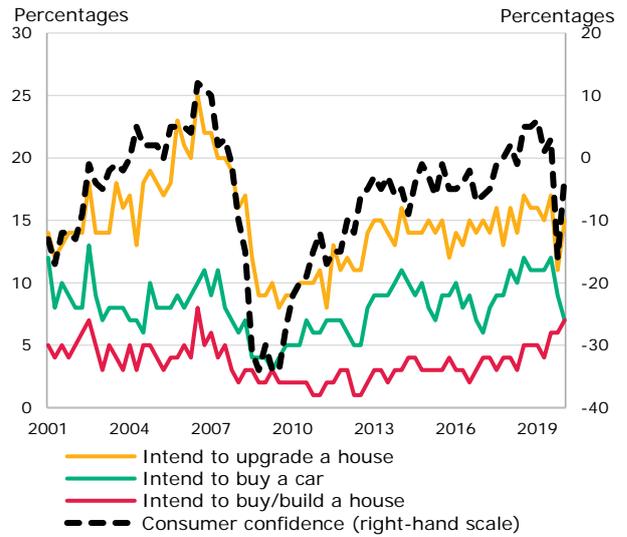**Chart 5. Number of inquiries in the credit register made by credit institutions on natural and legal persons**
(December 2019–July 2020)
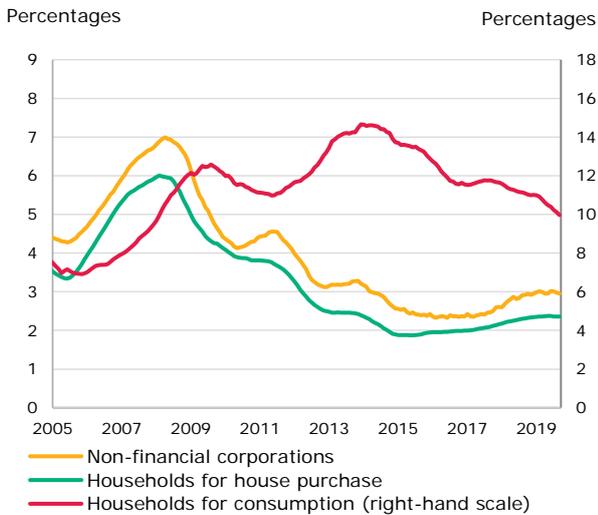
Thousands   Thousands

- Natural persons with loans
- Natural persons with no loans
- Legal persons with loans (right-hand scale)
- Legal persons with no loans (right-hand scale)

Source: Bank of Lithuania.

Chart 6. Consumer survey results
(July 2001–July 2020)

Percentages   Percentages

- Intend to upgrade a house
- Intend to buy a car
- Intend to buy/build a house
- Consumer confidence (right-hand scale)

Sources: Statistics Lithuania and Bank of Lithuania.

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

Percentages   Percentages

- Non-financial corporations
- Households for house purchase
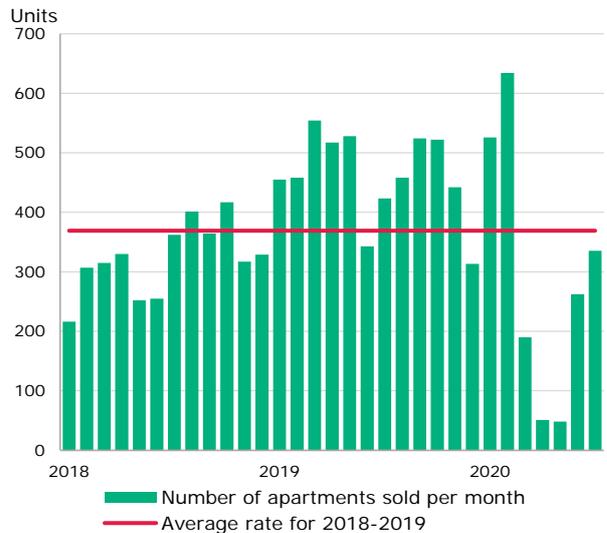- Households for consumption (right-hand scale)

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

Chart 8. Number of new apartments sold in Vilnius primary market
(January 2018–July 2020)

Units

- Number of apartments sold per month
- Average rate for 2018-2019

Source: Inreal.

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

Gap between actual and fair values, percentages

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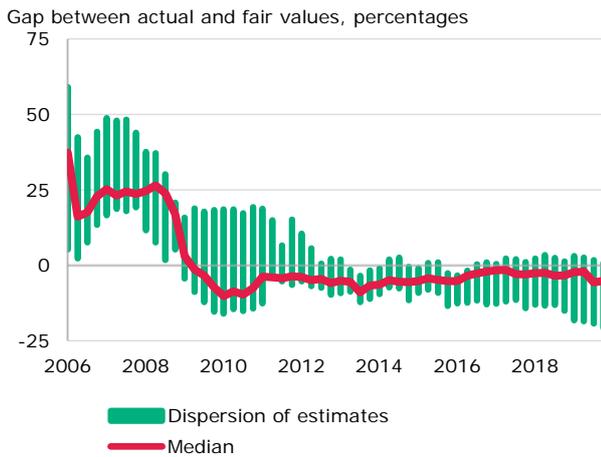
Source: Bank of Lithuania calculations.
Note: Estimates were made using the price-to-rent ratio, the price-to-income ratio, the econometric model and the HP filter.

Chart 10. Number of unsold apartments in under-construction and completed multi-apartment buildings in Vilnius
(Q1 2012–Q2 2020)

Thousands of units

- Unsold apartments in multifamily buildings under construction
- Unsold apartments in completed multifamily buildings
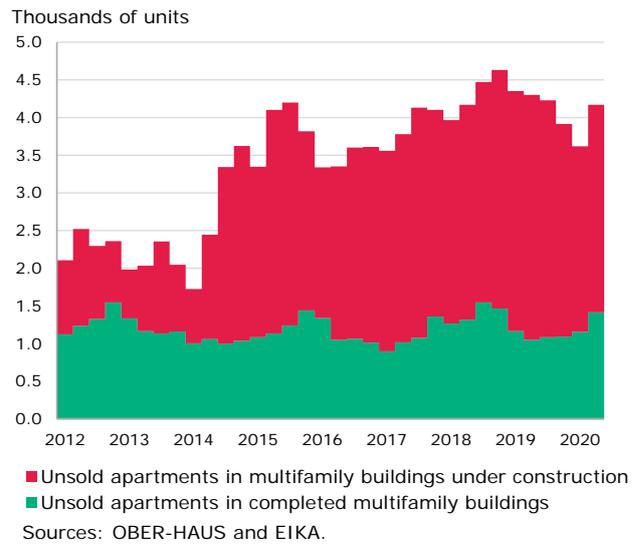
Sources: OBER-HAUS and EIKA.

Chart 11. Number of under-construction and completed houses in Lithuania
(Q1 2014–Q2 2020)

Thousand units

- 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
- Completed houses in Lithuania (4-quarter moving average)

Source: Statistics Lithuania.
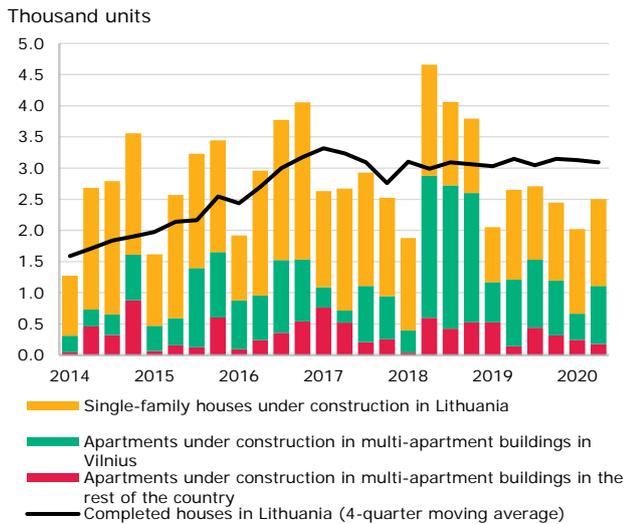
Chart 12. Share of housing transactions by mortgage
(Q1 2007–Q2 2020)

Percentages

- Share of housing transactions by mortgage (all purchases)
- Share of housing transactions by mortgage (single-family building purchases)
- Share of housing transactions by mortgage (apartment purchases)

Source: Centre of Registers.
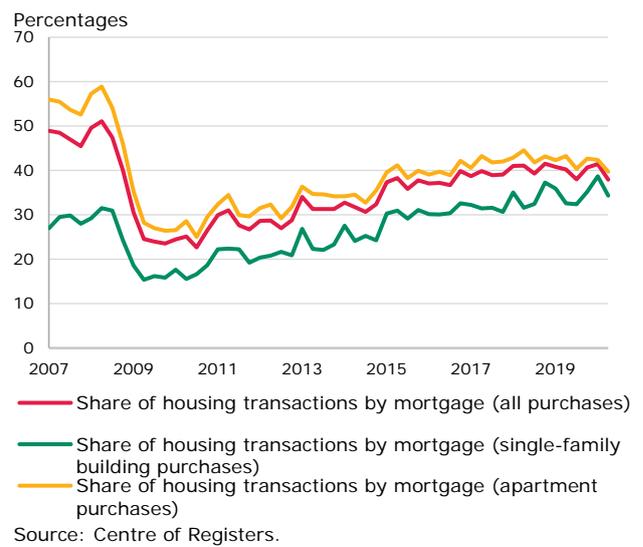
ANNEX 2. CREDIT AND HOUSING MARKET IMBALANCES

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

(Q3 2020)

- Large imbalances accrued
- Emerging imbalances
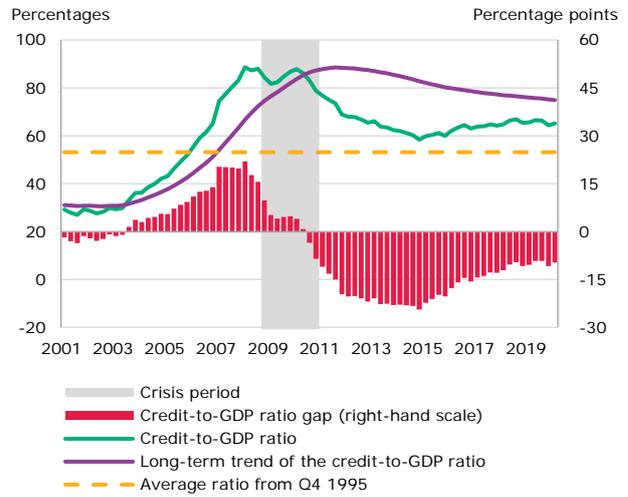- Sustainable environment
- Assessment in Q2 2019
- Assessment in Q2 2020
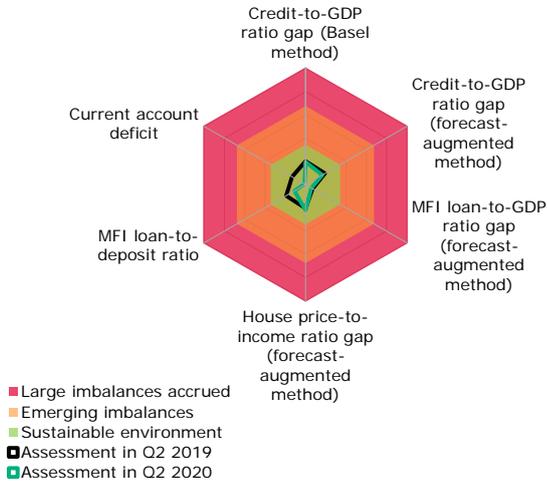
Sources: Statistics Lithuania and Bank of Lithuania calculations.
Note: Axes are scaled according to the range of a particular indicator: from its minimal value up to the maximal value.

Chart B. Core indicator I: Credit to the private non-financial sector-to-GDP ratio gap (calculated using the standardised Basel method)
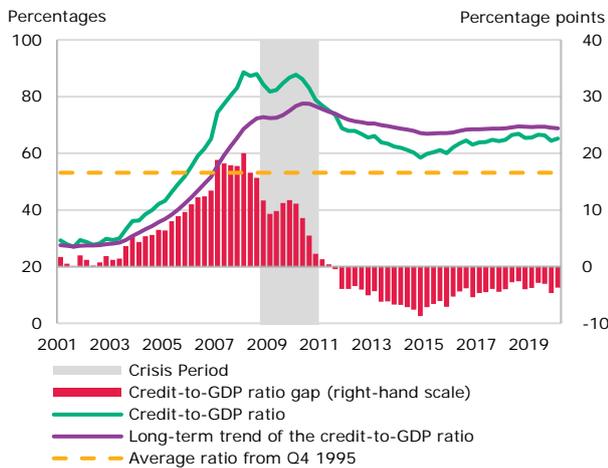
(Q1 2001–Q1 2020)

- Crisis period
- Credit-to-GDP ratio gap (right-hand scale)
- Credit-to-GDP ratio
- Long-term trend of the credit-to-GDP ratio
- Average ratio from Q4 1995

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)
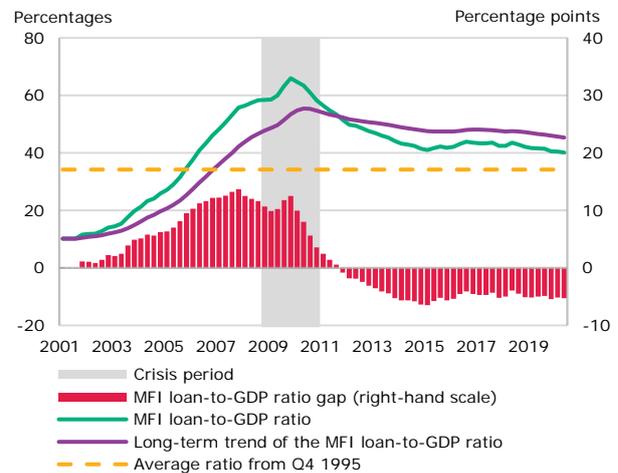(Q1 2001–Q1 2020)

- Crisis Period
- Credit-to-GDP ratio gap (right-hand scale)
- Credit-to-GDP ratio
- Long-term trend of the credit-to-GDP ratio
- Average ratio from Q4 1995

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–Q2 2020)

- Crisis period
- MFI loan-to-GDP ratio gap (right-hand scale)
- MFI loan-to-GDP ratio
- Long-term trend of the MFI loan-to-GDP ratio
- Average ratio from Q4 1995

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.
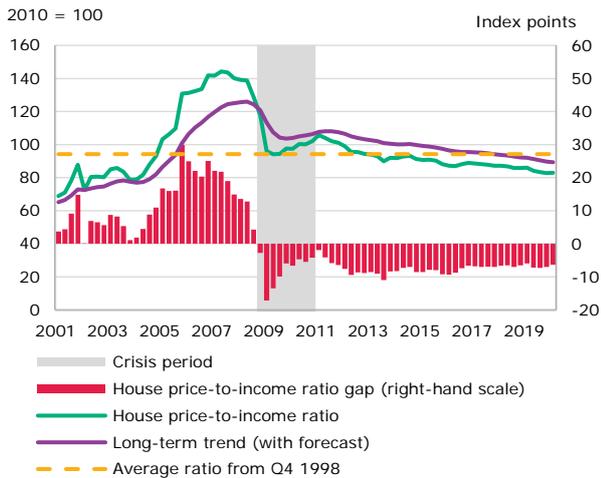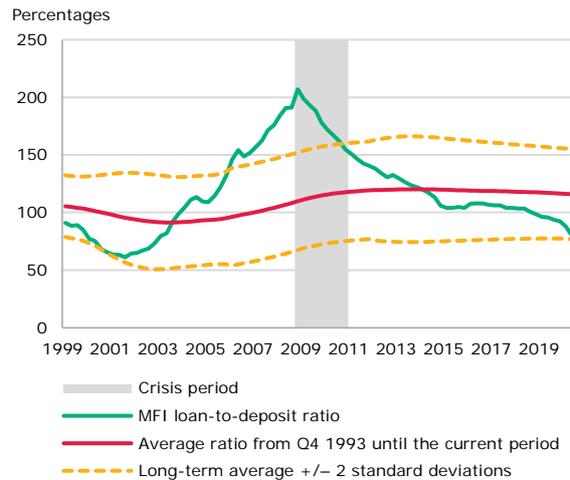
Chart E. Additional indicator II: House price-to-income ratio gap
(calculated using the forecast-augmented method)
(Q1 2001–Q1 2020)

2010 = 100 (left axis), Index points (right axis)

Legend:
- 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–Q2 2020)

Percentages

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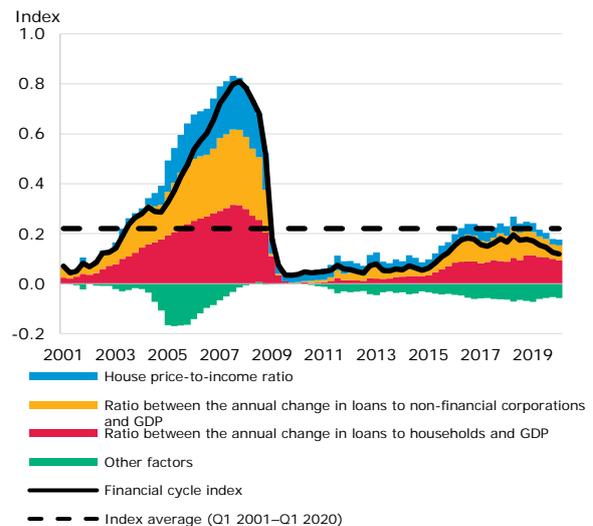- Long-term average +/– 2 standard deviations

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–Q1 2020)

Percentages of GDP, 4-quarter moving sums

Legend:
- Current account balance
- Average from Q4 1995 until the current period
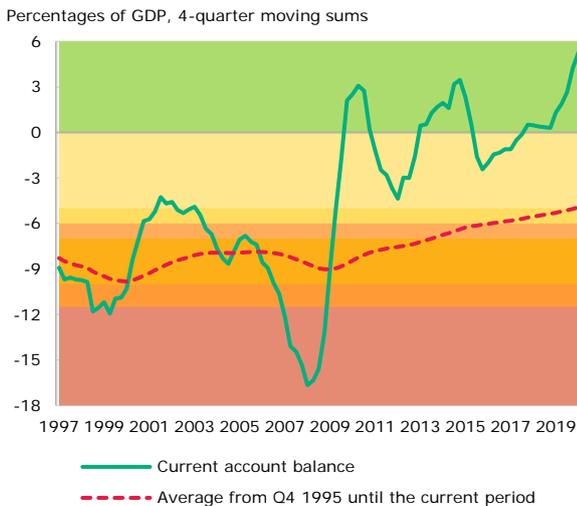
Sources: Statistics Lithuania and Bank of Lithuania calculations.
Note: Different colours indicate different levels of risk which have been set based on Reinhart S. M. and V. R. Reinhart (2008): "Capital flow bonanzas: An encompassing of the past and present", NBER working paper, 14321.

Chart H. Contributions to Lithuania's financial cycle index

(Q1 2001–Q1 2020)

Index

Legend:
- 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
- Other factors
- Financial cycle index
- Index average (Q1 2001–Q1 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).