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Countercyclical Capital Buffer

Background material for the decision

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COUNTERCYCLICAL CAPITAL BUFFER

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Background material for decision

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

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DECISION REGARDING THE COUNTERCYCLICAL CAPITAL BUFFER RATE

On 30 March 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 significant continuous negative impact of COVID-19 on Lithuania's economy and financial system[2] and after considering 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. Although to a lesser extent than forecasted, in 2020 the economy contracted by 0.8%. Restrictions which were once again introduced at the end of the year restricted the activities of most companies, and they experienced a decline in demand. Despite the fact that the corporate loan portfolio of the MFIs is still shrinking, state aid measures significantly contribute to maintaining the liquidity of companies; the possibility for loan moratorium was extended[3]. But it is likely that after these measures are no longer in place, the number of corporate bankruptcies will go up. In addition to this, the currently worsening financial situation of the companies active in the sectors that are among the most affected by the pandemic (accommodation, catering, administration services and transport) also has a negative impact on the household sector: the unemployment rate went up and income of some households dropped. The CCyB rate which remains unchanged at 0% will help credit institutions withstand a challenge of possible 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 is still on a downward path. The gap between the credit-to-GDP ratio and its long-term trend remained negative, fluctuating between -10.1 and -3.9 p.p. at the end of Q3 2020 (depending on the method of assessment) (in the previous quarter, it fluctuated between -11.3 and -4.8%, see Charts B and C in Annex 2). On the other hand, mainly due to a shrinking lending portfolio, the gap of the ratio of MFI loans to the private non-financial sector to GDP turned more negative at the end of 2020, reaching -5.2% (in the previous quarter –5.0%). With the increase of deposits, the loan-to-deposit ratio continued to decline, reaching 71% (in the previous quarter it amounted to 76%), i.e. the level similar to the one observed in 2002. The current account balance continued to grow in Q3 2020 and reached 7.5% of GDP (in the previous quarter –6.2%, see Chart G of Annex 2), while the financial cycle index continued to shrink (see Chart H of Annex 2).

The portfolio of loans to the private non-financial sector continued to shrink, while the provision of new loans became more active. At the end of 2020, the portfolio of MFI loans to the private non-financial sector continued to contract, decreasing by 2.2% year on year (in the previous quarter -1.3%). These developments were mainly driven by a significant 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 the last quarter of 2020 some new loans were more actively granted: the flows of loans to non-financial undertakings and loans to households for house purchase already reached and surpassed the level of the corresponding period last year. However, the volume of new loans for household consumption has declined from the beginning of the second quarantine.

MFI portfolio of loans to non-financial undertakings has continued to contract rapidly, but the flows of new loans increased at the end of the year. At the end of 2020, the MFI corporate loan portfolio declined by 12.7% year on year (in the previous quarter, the decline was 10.3% year on year). On the other hand, in the last quarter of 2020, the flow of new loans recovered: the net quarterly flow of new loans to non-financial undertakings increased by 88.9% year on year. In Q4 2020, the flow of new corporate loans amounting up to €1 million (including renegotiations) grew by 42% year on year, while that of loans

[1] Resolution No 03-46 of the Board of the Bank of Lithuania of 30 March 2021 on the application of the countercyclical capital buffer.

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

[3] Temporary moratorium on credit obligations has been extended until 31 March 2021.

exceeding €1 million went up by 67%. During the last month of 2020, the flow of renegotiated corporate loans, excluding loans restructured under the terms of the moratorium, also grew and reached €343.2 million (exceeding the average flow of renegotiated loans in 2019 by 2.6 times). When assessing the entire year 2020, it is apparent that the total flow of loans granted by credit institutions to undertakings was smaller than a year ago by €445 million, but this contraction was offset by the state aid measures used by undertakings, amounting to €2.2 billion[4]. Interest rates on pure new loans to non-financial corporations remained stable – in December 2020, their annual average amounted to 3.0%, remaining unchanged ona quarterly basis.

The growth of the MFI loans to households remained stable, mainly due to active provision of housing loans, which offset the contraction of consumer and other loans. At the end of 2020, the household loan portfolio recorded a year-on-year increase of 6.5% and remained unchanged over the quarter. The growth of the total loan portfolio remained supported by housing loans which continued to grow at a rapid rate of 9.4% as a result of the increased flow of new loans. In Q4 2020, the flow of pure new housing loans was almost one fifth (21%) higher year on year. On the other hand, the portfolio of consumer and other household loans continued to shrink and was 5.8% lower year on year, mostly due to the decline in consumer loans. In Q4 2020, the flow of pure new consumer loans contracted by 12.4% year on year, whereas the flow of loans for other purposes grew by 13.7%. Interest rates remained stable: in December 2020, the annual average interest rate on new housing loans amounted to 2.4%, remaining unchanged over the quarter, while the annual average interest rate on consumer loans was 8.4% (a quarter-on-quarter decrease of 0.2 p.p.), although in recent months a trend of decline in interest rates on these loans was observed. Despite the improvement in household expectations, after the second quarantine was announced, the expectations went down slightly and the indicator of consumer confidence once again became negative.

In Q4 2020, the expectations of banks regarding the potential changes in the value of commercial real estate slightly improved, yet the office vacancy rate continued to grow. Although the majority (66%) of commercial banks surveyed by the Bank of Lithuania have indicated that they expect a fall in commercial real estate prices during the upcoming year, the share of those not expecting any changes or even expecting a slight increase in prices grew. For comparison, none of the banks surveyed in the first three quarters of the year expected an increase in commercial real estate prices. After a dramatic decline during the first lock-down, prices of the real estate funds traded on the Baltic stock exchanges stabilised at the level observed in the beginning of 2020, which shows that the expectations of investors with regard to the future prospects of commercial real estate recovered. Nevertheless, as the supply of offices continued to rise, the office vacancy rate in Vilnius grew for the third consecutive quarter: the share of vacant offices in the Lithuanian capital reached 8% and was the highest in the last two years. There were no significant changes in the office rental rates during the period under review. Looking at the future, however, there remains a risk that commercial real estate demand falls and the office vacancy rate increases due to technological and social developments[5]. In such a case, rental prices may also fall and the liquidity risk for commercial real estate holders will increase.

The housing market remained active in November, even after the second lock-down period was announced. According to the Centre of Registers, housing sales increased by 6.7% in Q4 2020, compared to the same period of 2019, when real estate market activity was historically high. In Q4 2020, activity levels in the primary apartment market were record high: 40% more apartments were reserved, compared to the same period in 2019. Apartment liquidity ratio shows that, given the higher activity in the primary market, the total new apartment stock would be sold out in less than a year. However, the recent data show that in January 2021, as the restrictions of the second quarantine remained in place, the housing market development slowed down noticeably (the number of apartments that were sold was 13.6% lower than in January 2020).

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[4] The total envelope of all measures, subsidies for micro-enterprises, tax loans and tax arrears directly implemented by INVEGA by 31 December 2020.

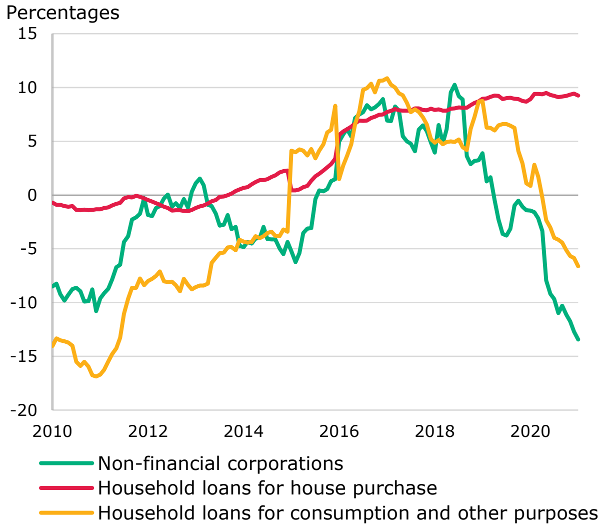
[5] With the growth of e-commerce and distance working.

Relative housing market indicators show that currently housing prices in Lithuania are not overestimated, while their potential decline would be limited by sufficient liquidity buffers accumulated by real estate developers. The COVID-19 pandemic has so far only had a short-term impact on the Lithuanian housing market. After a stagnation observed in March-April 2020, the housing market activity in Lithuania rapidly bounced back and reached historically high levels by the end of the year. Despite this, as the restrictions of the second quarantine remain in place, a slowdown of the market activity has been observed again in January. The annual growth of housing prices remained broadly unchanged at the end of 2020, growing at around 6-8% depending on the chosen house price index. Should the second quarantine restrictions remain in place further, a significant reduction in housing market activity is likely as well as a slowdown in the growth of housing prices. However, their potential decline will be less pronounced due to the fact that housing price levels and their growth have been in line with demographic, macroeconomic and household income developments since the 2008–2009 financial crisis and are not the result of excessive lending. Moreover, current assets of real estate developers exceeded their current liabilities more than 1.5 times, while their equity was higher than the total amount of liabilities. The sustainable financial situation of real estate developers will make most of them capable to avoid forced property sales to meet short-term liabilities and will reduce the likelihood and potential scale of a sudden drop in housing prices. On the other hand, a further robust growth in the housing market may increase the risk of house price overestimation in the medium term, especially in case of unreasonable expectations regarding housing price growth and higher investor activity accordingly.

ANNEX 1. CREDIT AND HOUSING MARKET TRENDS

Chart 1. Annual growth of the portfolio of MFI loans to non-financial corporations and households

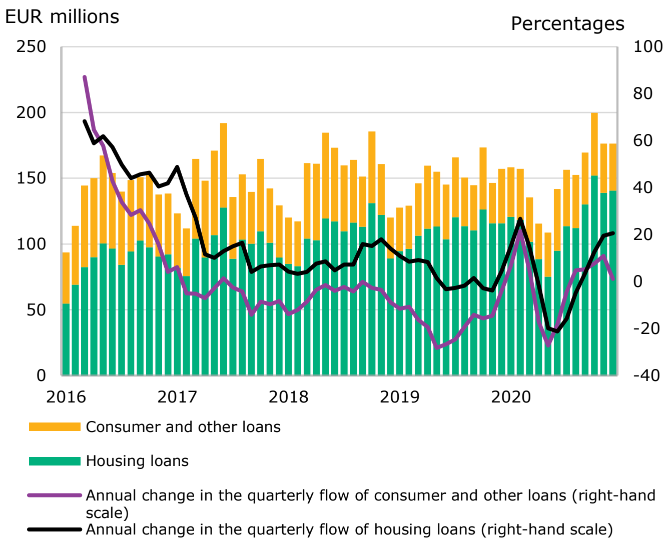
(January 2010–December 2020)



Source: Bank of Lithuania.

Chart 2. Flow of pure new MFI loans to households

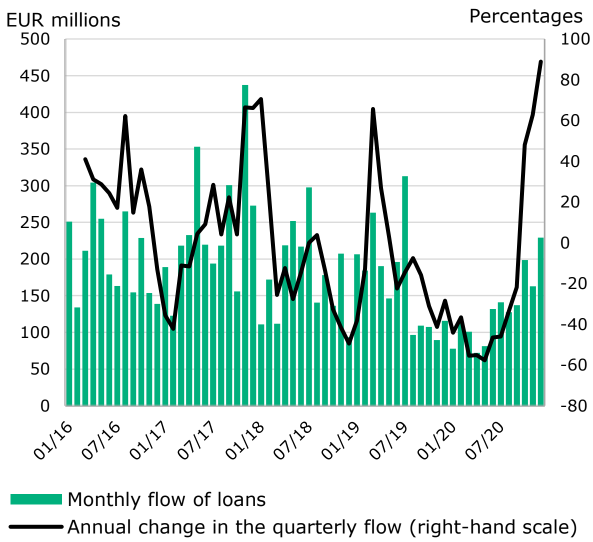
(January 2016–December 2020)



Source: Bank of Lithuania.

Chart 3. Flow of pure new MFI loans to non-financial corporations

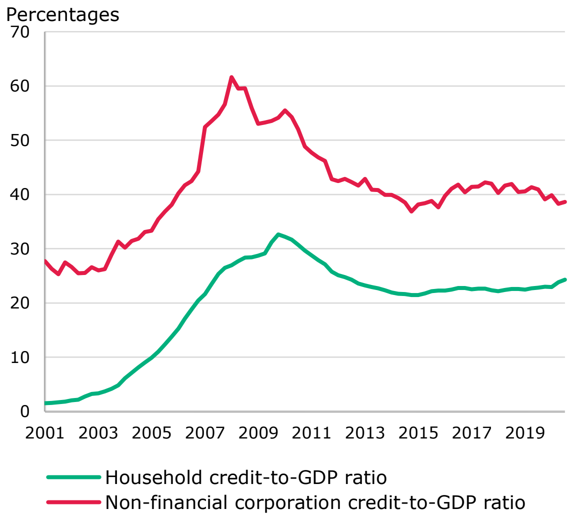
(January 2016–December 2020)



Source: Bank of Lithuania.

Chart 4. Credit-to-GDP ratio of non-financial corporations and households

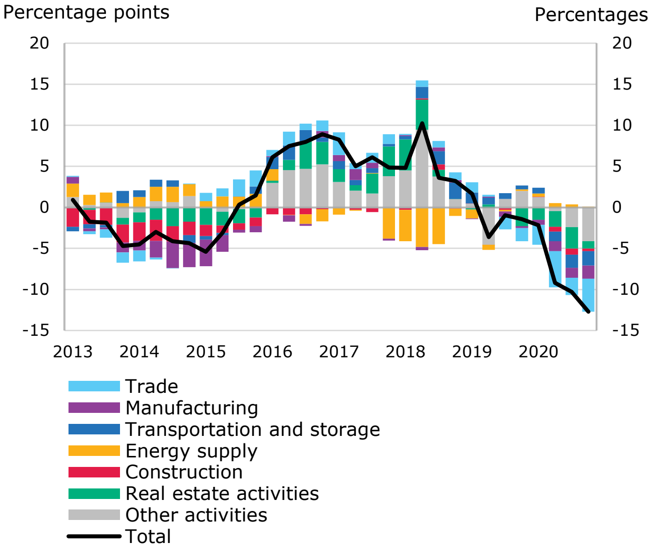
(Q1 2001–Q3 2020)



Source: Bank of Lithuania.

Chart 5. Annual change in the portfolio of MFI loans to non-financial corporations by economic activity

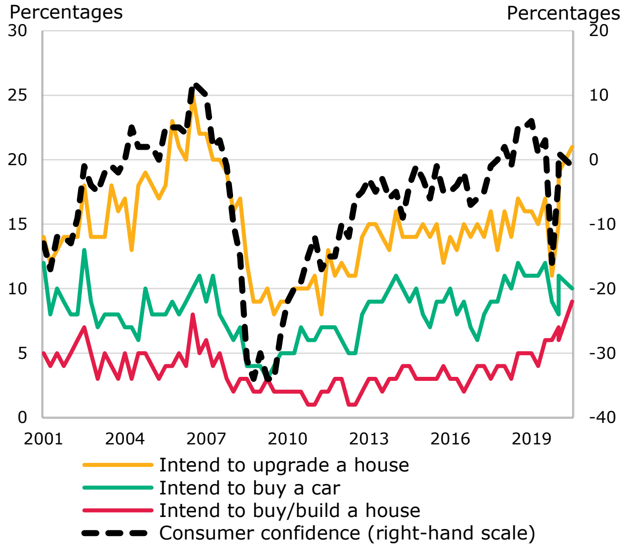
(Q1 2013–Q4 2020)



Source: Bank of Lithuania calculations.

Chart 6. Consumer survey results

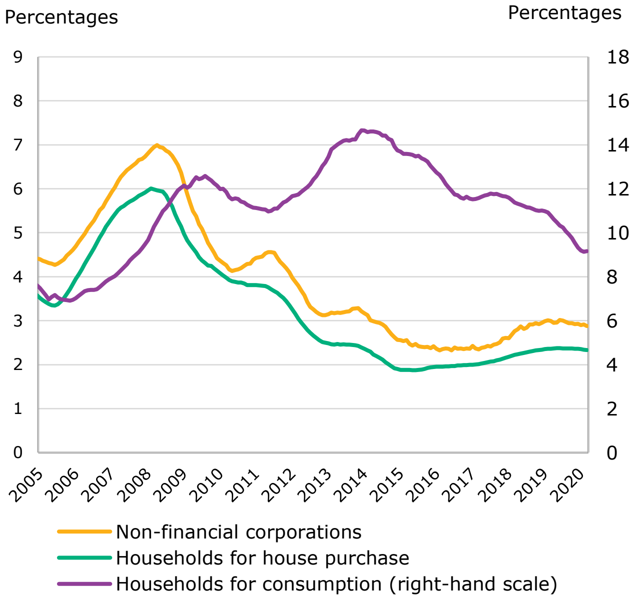
(July 2001–January 2021)



Sources: Statistics Lithuania and Bank of Lithuania calculations.

Chart 7. Average weighted interest rates on new loans to non-financial corporations and households

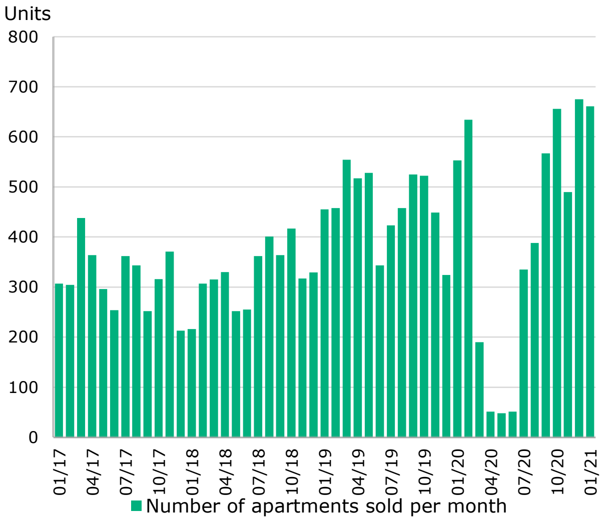
(October 2005–December 2020)



Source: Bank of Lithuania.

Chart 8. Number of new apartments sold in Vilnius primary market

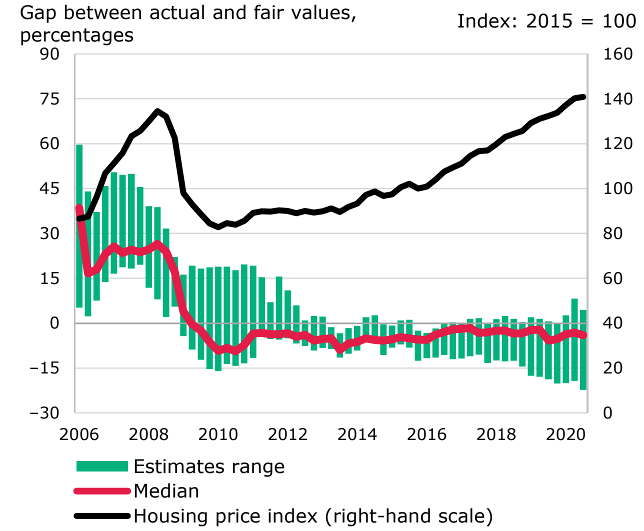
(January 2017–January 2021)



Source: Inreal.

Chart 9. Gap between actual house prices and their fundamental values

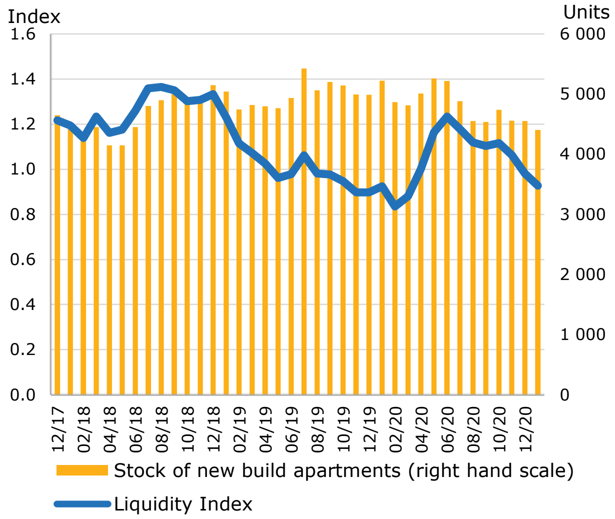
(Q1 2006–Q3 2020)



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. Stock of available new build apartments and Stock Liquidity Index in Vilnius

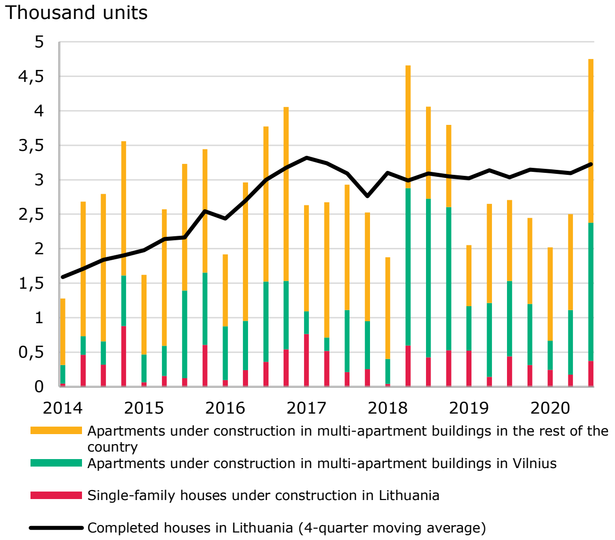
(December 2017–January 2021)



Source: Inreal and Bank of Lithuania calculations.
Note: 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

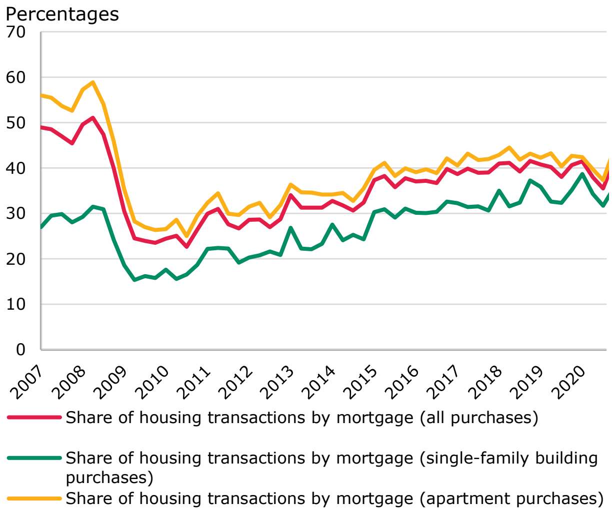
(Q1 2014–Q3 2020)



Source: Statistics Lithuania.

Chart 12. Share of housing transactions by mortgage

(Q1 2007–Q4 2020)

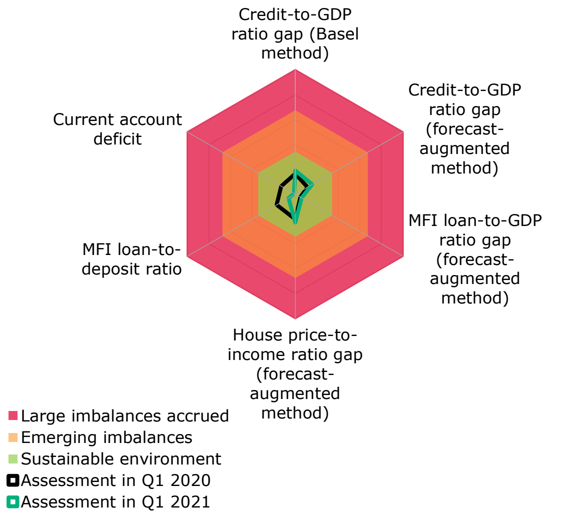


Source: Centre of Registers.

ANNEX 2. CREDIT AND HOUSING MARKET IMBALANCES

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

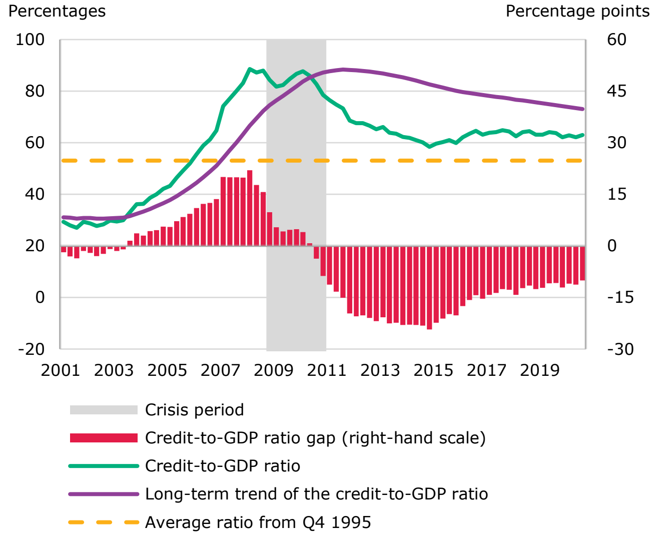
(Q1 2021)



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 (calculated using the standardised Basel method)

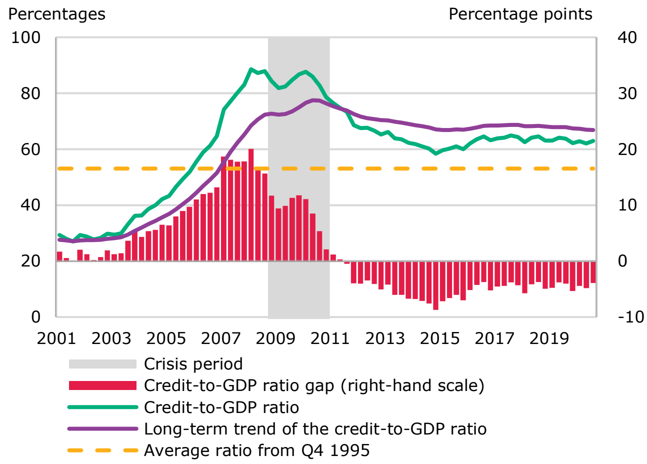
(Q1 2001–Q3 2020)



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)

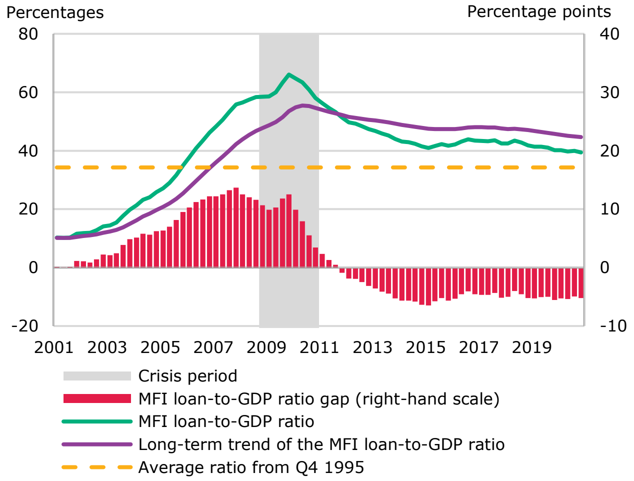
(Q1 2001–Q3 2020)



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

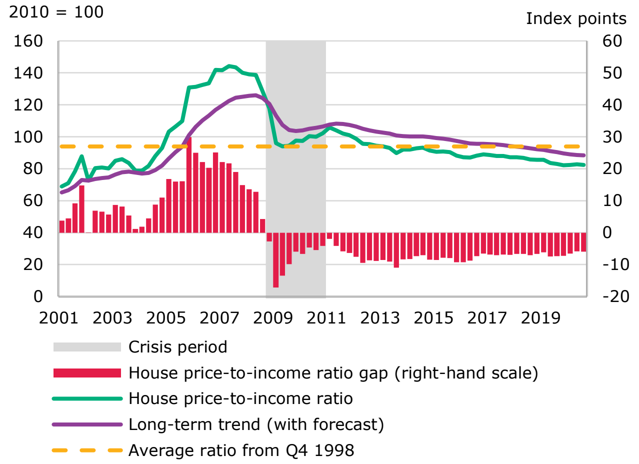
(Q1 2001–Q4 2020)



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

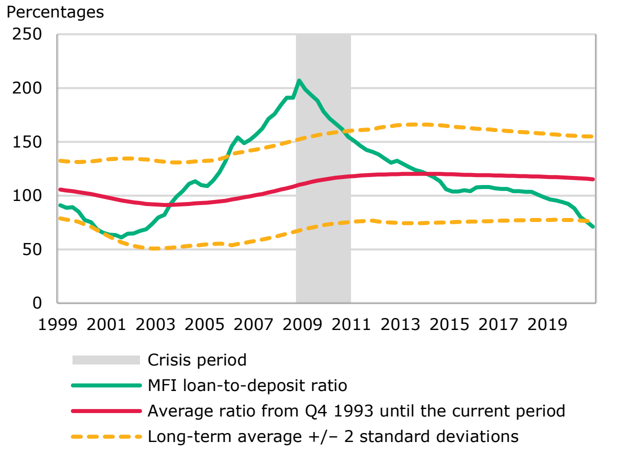
(Q1 2001–Q3 2020)



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 F. Additional indicator III: Ratio between MFI loans to the private sector and private sector deposits (adjusted for seasonal effects)

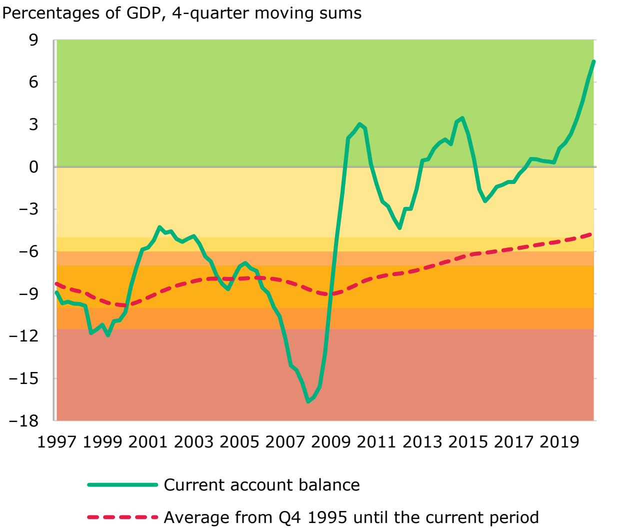
(Q1 1999–Q4 2020)



Source: Bank of Lithuania calculations.
Notes: 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

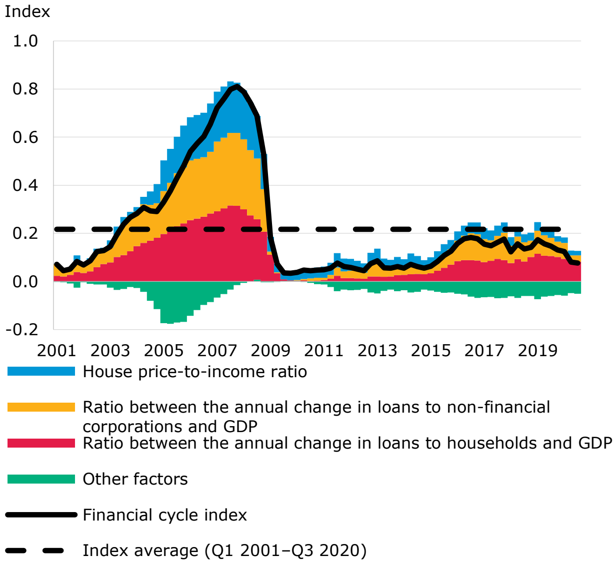
(Q1 1997–Q3 2020)



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 H. Contributions to Lithuania's financial cycle index

(Q1 2001–Q3 2020)



Sources: Statistics Lithuania and Bank of Lithuania calculations.
Note: The index has been calculated according to Holló et al. (2012) and Prašil et al. (2015).