Financial Stability Report
2016/2017

Press conference

on the publication of the 13th Financial Stability Report

Prague, 13 June 2017

I.

Overall assessment of risks and overview of the CNB's main measures

- This summer marks the tenth anniversary of the start of the global financial crisis.
  - It started in August and September 2007 with problems in banks in the USA and the UK relating to subprime mortgage loans.
  - After the collapse of Lehman Brothers in 2008, it continued in 2009 with banking sector crises in Ireland and Spain caused largely by loan financing of property purchases.
- Key lessons learned from the crisis:
  - The seeds of financial crises are sown in good times when financial institutions and their clients lose the ability to perceive and rate risk.
  - Central banks and supervisory authorities must use preventive measures to prevent problems in the financial sector.
  - Subsequent solutions to specific financial crises tend to be painful and costly.

- Backward-looking view (evolution of risks over the last year):
  - The Czech financial sector has maintained a high level of resilience to possible adverse shocks.
  - Stress tests prove the ability of financial institutions to withstand very unfavourable economic developments.
- Forward-looking view (potential sources of future risks):
  - Systemic risks remain only potential in all areas.
  - The risks associated with the cyclical behaviour of financial institutions, firms and households have increased further.
  - The main risk is the continuation of a spiral between property prices and property purchase loans.
- The CNB as a macroprudential policy and microprudential supervisory authority must respond to emerging risks in a forward-looking manner and adopt appropriate measures in time.

Decision on setting of countercyclical capital buffer

- The Bank Board decided to increase the countercyclical capital buffer rate from 0.5% to 1.0% with effect from 1 July 2018.
  - The domestic economy has shifted further into a growth phase of the financial cycle, characterised by rapid growth in loans.
  - The increase in the countercyclical capital buffer rates is in line with a set of quantitative indicators and an assessment of systemic risk indicators.
  - It is necessary to use good times for provisioning, as provisions enable the banking sector to operate smoothly in worse times.
- The CNB does not expect the decision to lead to credit constraints.
  - Assuming reasonable dividend policies, banks have sufficient space for an increase in the countercyclical capital buffer and growth in their loan portfolios.

Property market and mortgage lending

- Property financing loans are the principal source of risks to the stability of the domestic banking sector.
- The CNB does not currently consider it necessary to lower the applicable LTV limits (an upper limit of 90% and an aggregate limit of 15% for loans with an LTV of 80%–90%).
- The CNB is not setting upper DTI (debt-to-income) or DSTI (debt service-to-income) limits for the time being.
- The CNB is responsible for the stability of the financial sector as a whole, while banks are responsible for the management of risks associated with mortgage lending, including risks associated with distribution channels.
  - Banks should highly prudently assess clients' ability to service loans from their own resources in a less favourable economic situation.
  - They should not create incentive schemes for intermediaries (with no direct responsibility) leading to increased risk-taking.

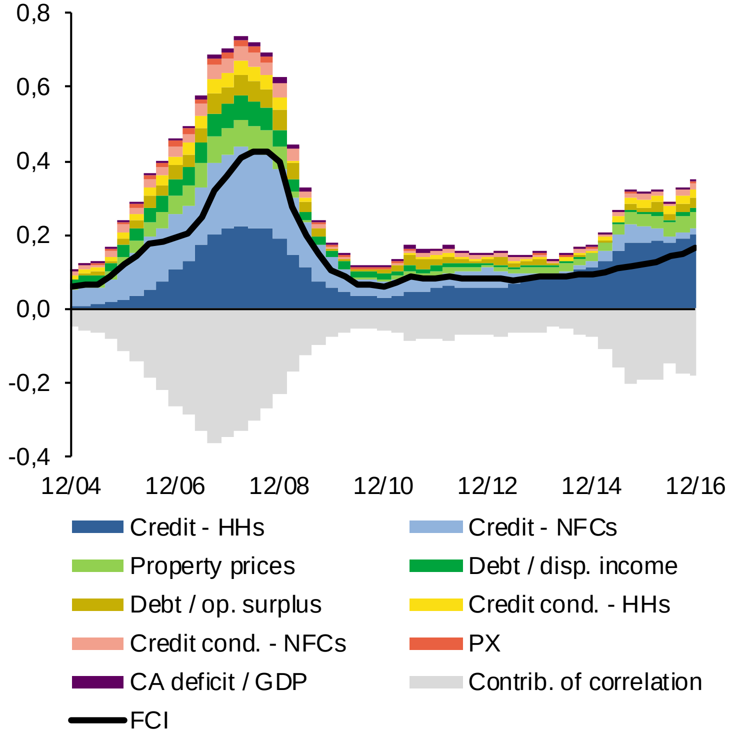
ČNB ČESKÁ NÁRODNÍ BANKA

II.

Assessment of selected risks and changes in the CNB's macroprudential policy

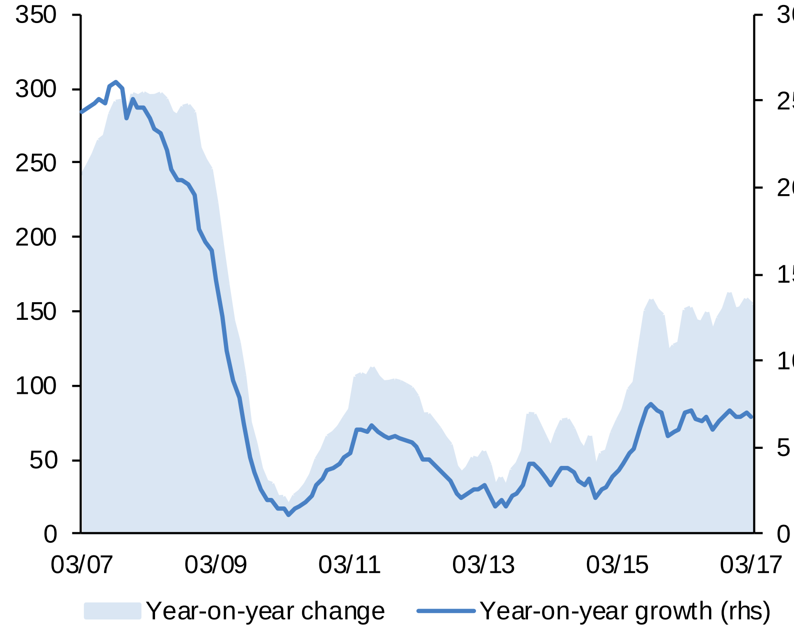
- According to the FCI, the Czech economy has shifted further into a growth phase of the financial cycle.
- Absolute year-on-year growth in bank loans is at its highest level since 2009 Q2.

The financial cycle indicator (FCI) and its components
(0 minimum, 1 maximum)



Source: CNB, CZSO

Absolute year-on-year change and growth in bank loans to the private non-financial sector
(CZK billions; right-hand scale: %)



Source: CNB

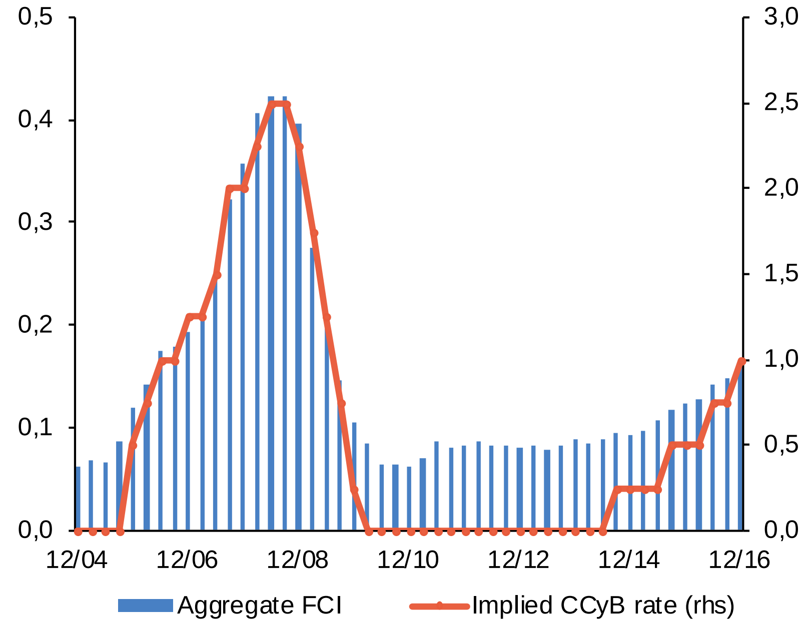
- The CNB's quantitative approaches indicate a need to set the CCyB rate in the range of 0.75% to 1.00%.
- The CNB Bank Board's decision to increase the CCyB rate to 1% reflects the above results and estimates of the potential losses the banking system as a whole may face in the future.

Implied CCyB rate based on various approaches
(in % RWA)

Approach	Implied CCyB rate
Conversion based on FCI values	1.00 %
Conditional distribution of future credit losses	0.75 %
Duration of expansionary phase of cycle	1.00 %

Source: CNB

The FCI and the implied CCyB rate
(0 minimum, 1 maximum; rhs: % of total risk exposure)



Source: CNB

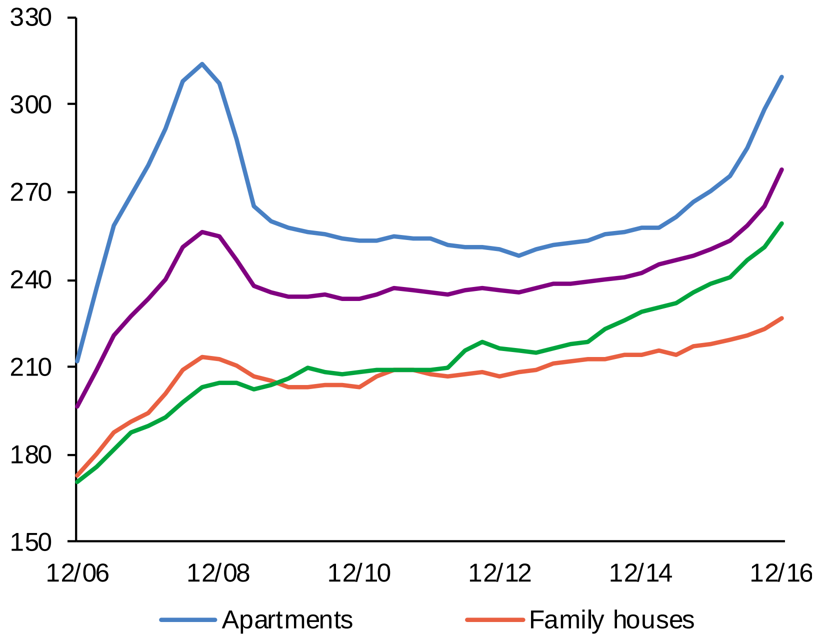
Outlook for countercyclical capital buffer rate

- However, if credit growth remains high, lending standards ease and systemic risks relating to the financing of property purchases grow, the CNB will stand ready to increase the CCyB rate further.
  - Conversely, if the financial cycle enters a downturn and the risk of excessive credit growth decreases, the CNB will stand ready to lower the CCyB rate immediately.
- CCyB decision-making is based on a set of quantitative approaches presented in a thematic article in FSR 2016/2017.
  - However, the final decision is always based on a comprehensive assessment of systemic risks, not on mechanical application of the result of these approaches.

Residential property price growth

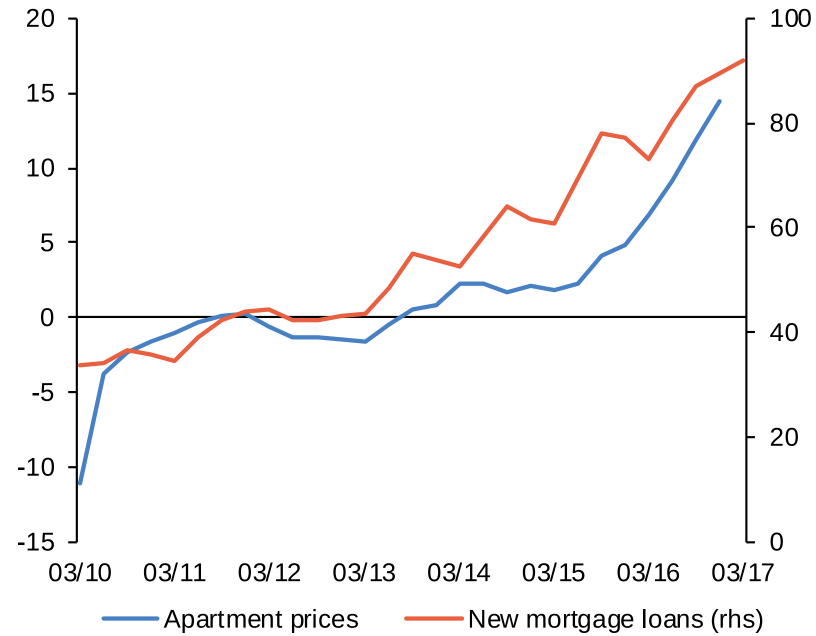
- Transaction prices reached the level of their previous 2008 peak at the end of 2016.
- Growth in residential property prices and house purchase loans in the Czech Republic is among the highest in the EU.

Residential property prices – transaction prices
(1999 Q1 = 100)



Source: CZSO, HB index, CNB calculation
Note: The data for 2016 are calculated from alternative sources of data on transaction prices (apartment transaction prices from a CZSO survey, the HB index and the CZSO House Price Index).

Apartment prices and new mortgage loans
(year-on-year growth in %; right-hand scale: quarterly totals in CZK billions)

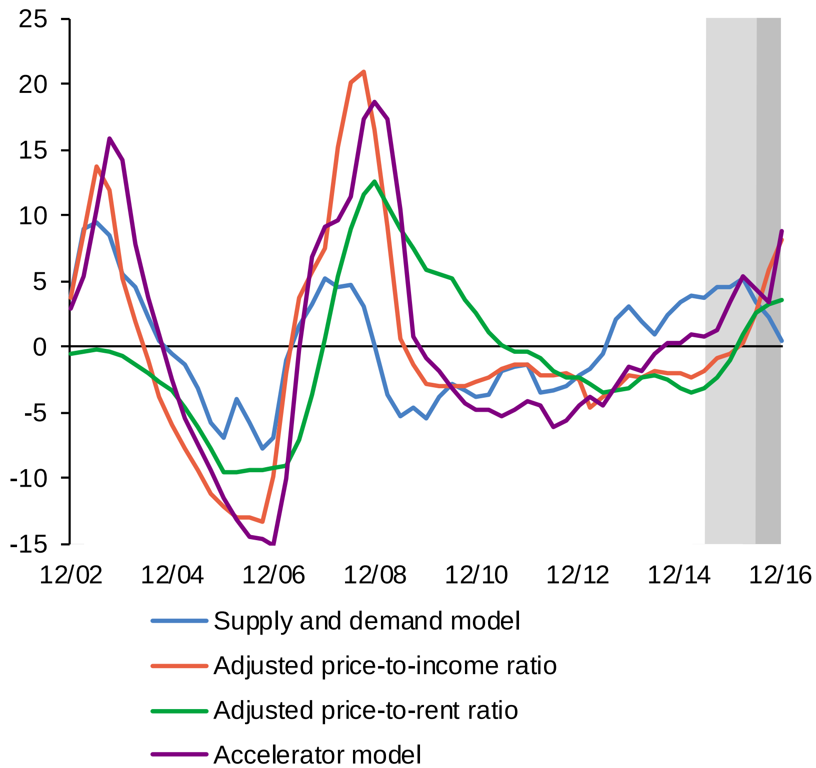


Source:CZSO, CNB, CNB calculation
Note: New mortgage loans comprise new loan agreements and increases in existing loans when refinancing.

Rise in overvaluation of residential property

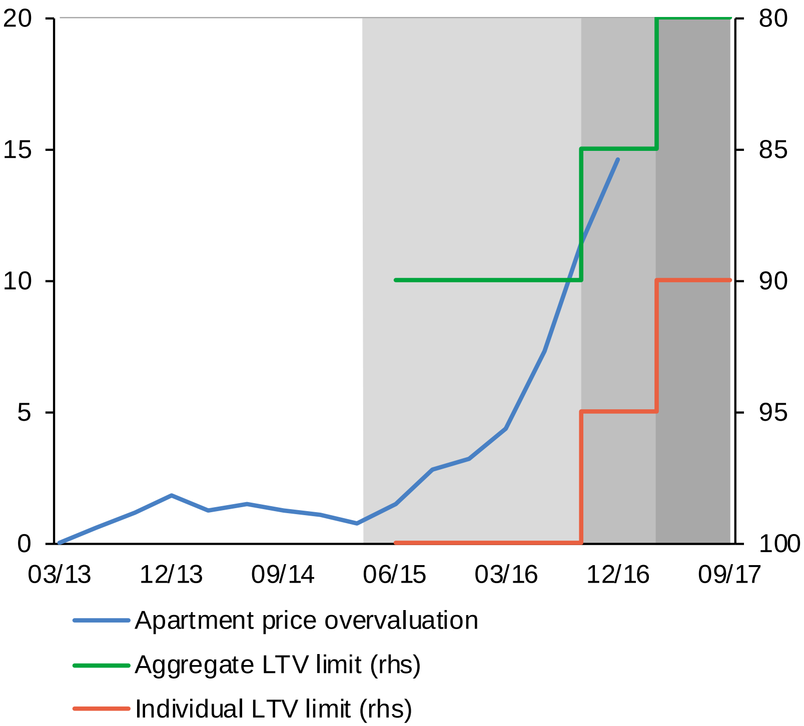
- Based on the methods used by the CNB, apartment prices are moderately overvalued at the end of 2016.
  - Rising overvaluation is signalled by an indicator comparing growth in apartment prices with wage growth since the last price trough.

Apartment price gaps according to various methods
(%)



Source: CZSO; IRI; MRD; EC; CNB calculation

Alternative estimate of apartment price overvaluation and LTV limits
(overvaluation in %; right-hand scale: LTV in %)



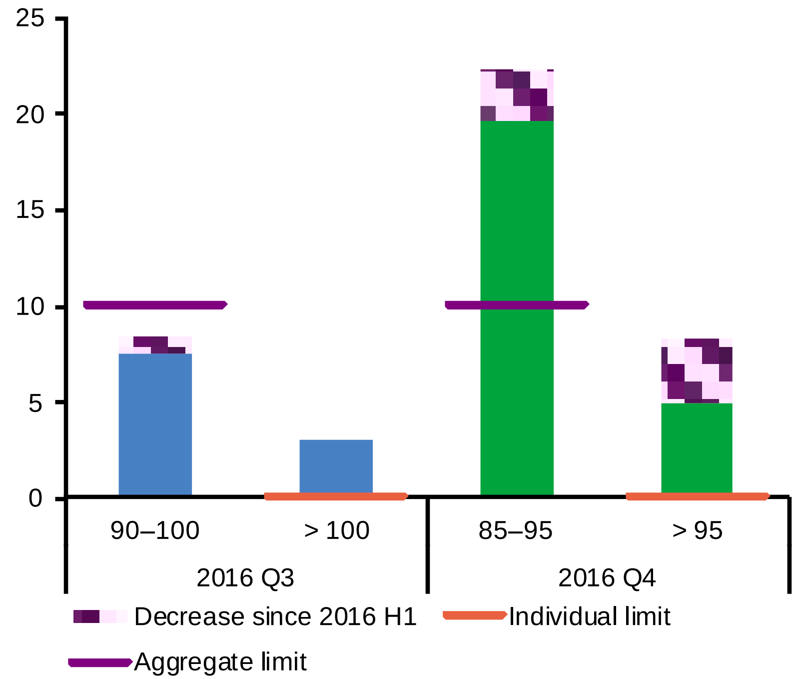
Source: CZSO; CNB; CNB calcualtion

Assessment of compliance with CNB Recommendation: LTV limits (1)

- With few exceptions, the LTV limits in place in 2016 Q1–Q3 (an upper LTV limit of 100% and no more than 10% of loans with LTVs of 90%–100%) were complied with.
- The reduced LTV limits in force since 2016 Q4 (an upper LTV limit of 95% and no more than 10% of loans with LTVs of 85%–95%) were complied with to a much lesser extent.

Fulfilment of the recommended LTV limits

(x-axis: LTV in %; y-axis: share of loans in %)

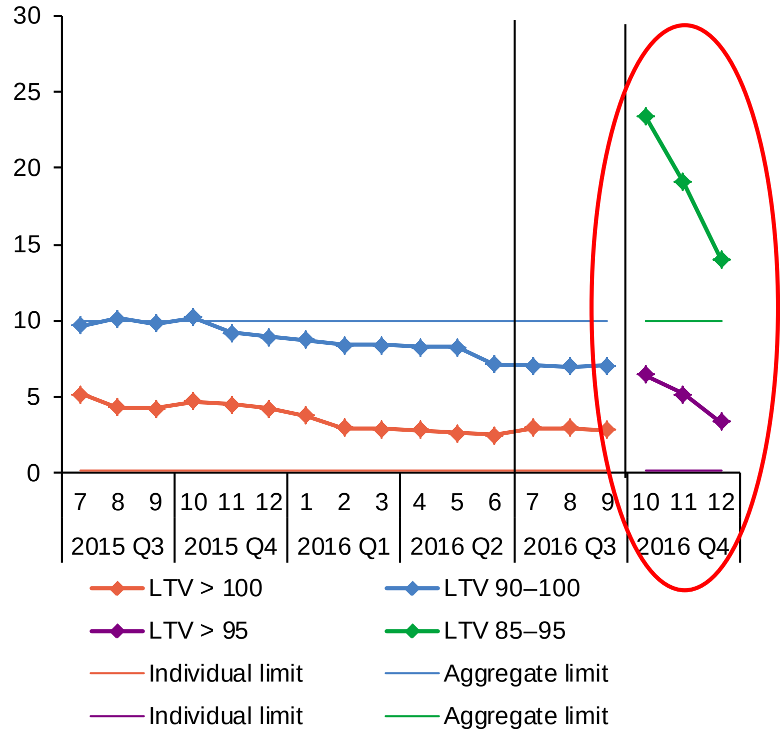


Source: CNB

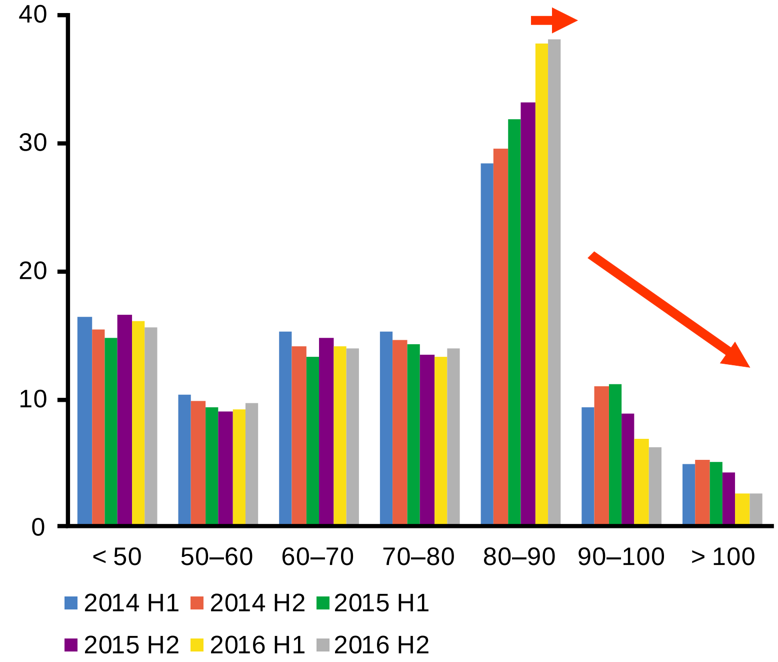
Assessment of compliance with Recommendation: LTV limits (2)

- A sharp reduction in the amount of loans in excess of the limit was recorded in December, i.e. two months after the tighter limit entered into force.
- The gradual lowering of the LTV limit led to a slowdown in growth in the share of loans with LTVs of 80%–90% and a fall in the share of loans with LTVs of over 90%.

Share of loans with LTVs above the recommended limits
(LTV in %; y-axis: share of loans in %)



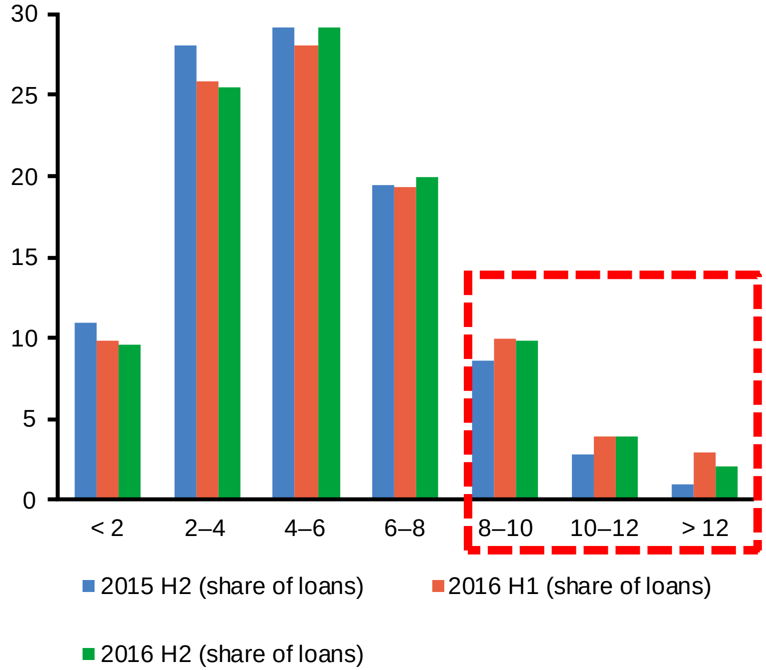
LTV distribution of new loans
(x-axis: LTV in %; y-axis: share of loans in %)



Source: CNB

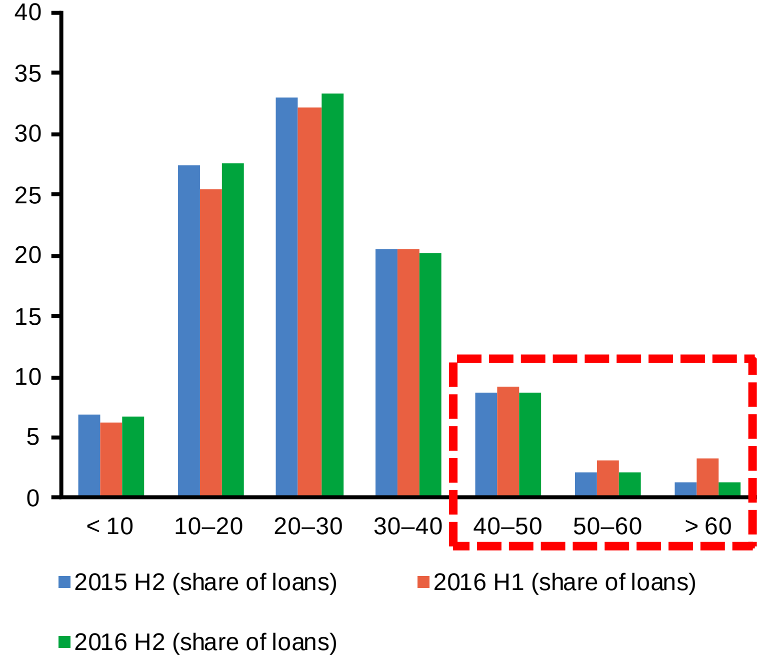
- Some new loans are being provided with LTI (loan-to-income) and DSTI (debt service-to-income) ratios at levels which imply high risk according to the CNB's analyses.

LTI distribution of new loans
(x-axis: LTI; left-hand scale: share of loans in %; right-hand scale: interest rate in %)



Source: CNB

DSTI distribution of new loans, average interest rate
(x-axis: DSTI in %; left-hand scale: share of loans in %; right-hand scale: interest rate in %)



Source: CNB

- Providers should monitor the DTI and DSTI ratios, set internal limits for them and prudently assess loan applications.
  - Providers should be particularly prudent when assessing loan applications submitted by consumers with a DTI ratio of over 8 and a DSTI ratio of over 40%.
  - This applies especially to loans with high LTVs that are subject to the aggregate limit of 15%.
- The CNB is extending the scope of application of the Recommendation to other loans provided to clients who already have a mortgage loan.
- With a view to standardising the terms and conditions for all providers, and given the possibility of future transmission of risks to non-bank financial institutions, the CNB is simultaneously extending the scope of application of the Recommendation to all credit providers.

Foundations of sound mortgage market

- Banks must respect the rule that applicants for house purchase loans should at least partly use their own savings.
  - Circumventing the recommended LTV limits by combining various types of loans may constitute non-prudential behaviour in breach of the CNB's legal provisions, regulations and recommendations.
- Borrowers must have the necessary financial reserve to be able to repay their loans if adverse changes occur in their income situation or the level of interest rates.
- The CNB will continue to increase the intensity of microprudential supervision in the area of banks' approach to lending.
  - The CNB will deal with any shortcomings by imposing remedial measures and, where necessary, an additional capital requirement for the risk management system.

Thank you for your attention

More information about the new Financial Stability Report 2016/2017 is available at http://www.cnb.cz/en/financial_stability/fs_reports/index.html