CNB press conference

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I.

Aggregate assessment of risks and overview of CNB’s main measures

Financial stability paradox in good times

- The measures adopted on the basis of the analyses in FSR 2017/2018 have their common ground in the logic of the **financial stability paradox**:
  - The greatest risks to financial stability arise in **good times**, when banks and their clients perceive risks to be lowest.
  - The financial system is **most vulnerable** when it looks most robust.
- Growing **risks in the banking sector are not visible at first glance**, as the non-performing loan ratio tends to be very low at times of strongest economic expansion.
  - This tends to be misinterpreted as evidence of low risks.
  - In such a situation, however, risks usually increase unobserved.

- **Backward-looking view (trend in risks over the last year):**
  - maintenance of sector's high resilience to potential adverse shocks

- **Forward-looking view (potential sources of future risks)**
  - moderate growth in risks associated with business cycle
  - stagnation of structural risks

- As regards risks to financial stability emerging in good times, the CNB as a macroprudential policy and microprudential supervisory authority must:
  - respond **in a preventive manner**.
  - adopt adequate measures **in time**

Decision on countercyclical capital buffer (CCyB) rate

CNB CZECH NATIONAL BANK

- The Bank Board has decided to **increase the countercyclical capital buffer rate** to **1.5%** with effect **from 1 July 2019** (from the current rate of 0.5%, from the 1.0% in effect as from 1 July 2018 and from the 1.25% in effect as from 1 January 2019).

  - In the event of continued rapid credit growth, increasing risks associated with property purchase financing and rising vulnerability of the banking sector, the CNB **stands ready to increase the CCyB rate further**.

  - Conversely, if the business and financial cycles **reverse** and financial market stress intensifies, the CNB is ready to **immediately lower the buffer or release it fully**.

  - The CNB will use indicators of financial market stress and of the general availability of (unsecured) financing (OIS and PRIBOR rates and OIS-PRIBOR spreads), which can indicate a significant change in market conditions, to assess the need to lower or release the countercyclical capital buffer.

Property market and mortgage lending (1)

- The CNB **does not currently consider it necessary to change the applicable LTV limits** (the upper LTV limit of 90% and the aggregate limit of 15% for loans with an LTV of 80%–90%).

- The CNB's current measures in the LTV area are having a positive effect.
  - **Growth in genuinely new mortgages has slowed** after the tightening of LTV limits.
  - Overall, banks have been **compliant with the recommended aggregate 15% LTV limit** since 2017 Q3.
  - In year-on-year comparison, banks have started to **take greater account of clients' risk characteristics** when setting interest rates.

- Given the current overvaluation of housing prices of roughly 15% as indicated by the CNB model, the current LTV caps represent **the limit** as regards sufficient coverage of potential risks by banks.

Property market and mortgage lending (2)

- A year ago, the CNB **warned** banks that it regarded new loans with **a DTI (debt-to-income) ratio of higher than 8** and **a DSTI (debt service-to-income) ratio of higher than 40% as highly risky**.

- The indicators of **borrowers' ability to service loans from their current income** are implying growth in potential systemic risks.
  - When limiting loans with an LTV of 80%–90%, banks did not significantly reduce loans with a DSTI of over 40% and a DTI of over 8.
  - Almost 10% of loans provided in 2017 had **both ratios above these levels**.

- **Borrowers** are becoming **more vulnerable** due to faster growth in housing prices relative to income.

- The probability that **riskier clients with a greater tendency to take risks** will increasingly apply for loans is simultaneously rising.

Property market and mortgage lending (3)

- The CNB is therefore **adding a new recommendation** that banks take account of loan applicants' income as of 1 October 2018 and comply with:
  - an upper **DTI limit of 9 times** the applicant's net annual income,
  - an upper **DSTI limit of 45%** of the applicant's net income.
  - The warning to banks regarding risky DTI and DSTI levels remains in effect.
- The CNB respects the fact that a small proportion of loans have specific characteristics and that **strict insistence** on the application of the caps **could lead to excessive regulatory hardship**.
  - It is therefore allowing lenders to cover specific cases under a **5%** exemption.
- The CNB and the Ministry of Finance are continuing to prepare **a new proposal to introduce a statutory power of the CNB** to set binding upper LTV, DTI and DSTI limits.

II.

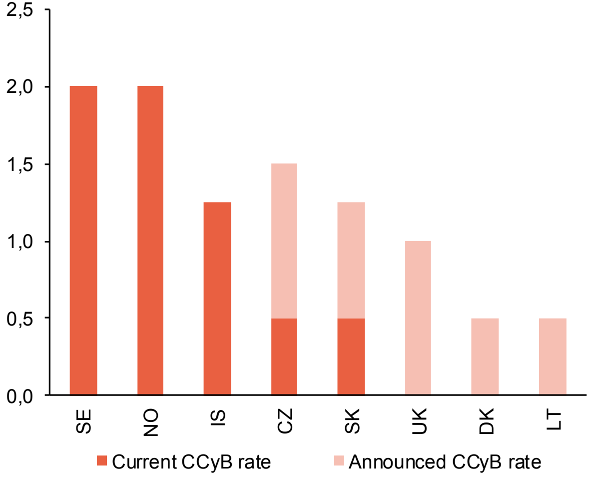
Assessment of selected risks and main changes in CNB macroprudential policy

Setting of countercyclical capital buffer rate

- Eight European countries have set a **non-zero CCyB rate**; in five a non-zero CCyB rate is in effect and five have announced a rise (including CZ).

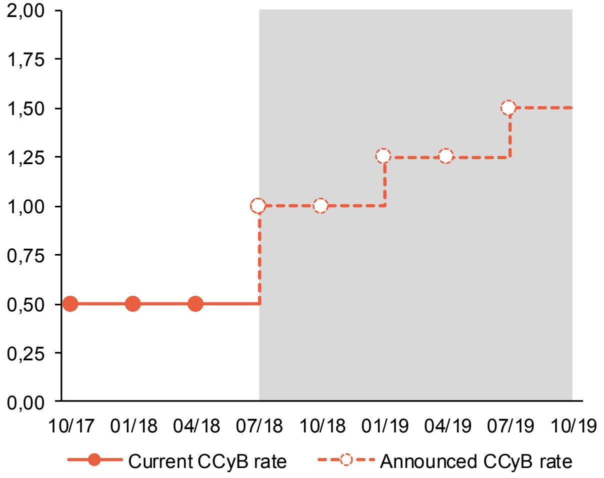
- **The rise in the CCyB rate** to 1.5% with effect from 1 July 2019 is based on an assessment of the position of the economy in the financial cycle and of banking sector vulnerability indicators.

CCyB rates in selected European countries
(% of total risk exposure)



Source: ESRB

Current and announced CCyB rate in the Czech Republic
(% of total risk exposure)



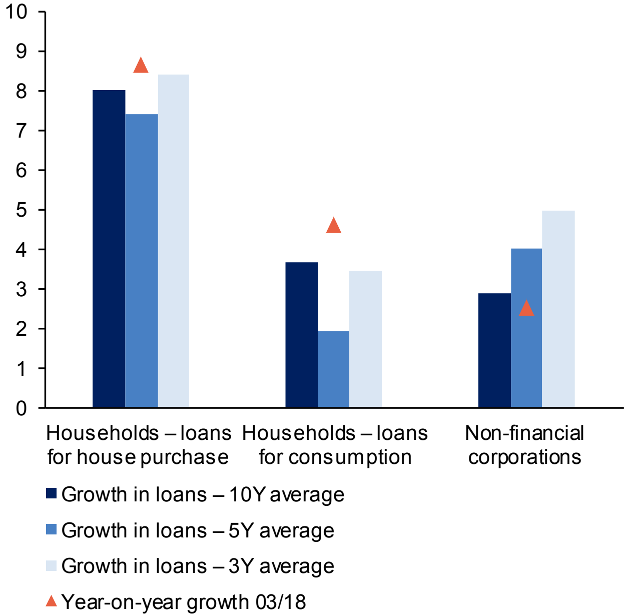
Source: CNB

- **The upward shift of the Czech economy in the growth phase of the financial cycle is continuing, albeit more slowly.**

  - Fast growth from an increasingly high base is continuing in a number of credit segments.
  - For illustration: 9% annual growth in housing loans would have meant CZK 14 billion more in 2004, CZK 33 billion more in 2007 and still "only" CZK 65 billion more in 2011.
  - This year, however, it would mean growth in loans of over CZK 100 billion.

Average and current growth in bank loans to the private non-financial sector

(%)



Source: CNB

Sources of banking sector vulnerability

- **Financial conditions** remain very relaxed as regards most indicator levels, and prices of housing and some other assets remain **overvalued** relative to fundamentals.

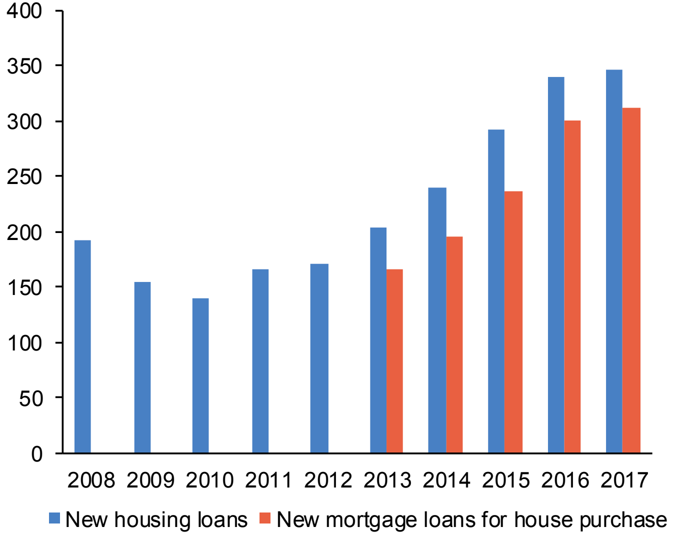
- The continuing good times are leading to a **drop in the level of risks perceived** by banks and their clients.
  - The favourable economic developments coupled with low loan interest rates are encouraging the emergence of optimistic expectations and **increasing households' willingness to finance their expenditure through debt**.

- Banks are showing high profitability in the current favourable environment, due mainly to **exceptionally low asset impairment losses**, which is unsustainable in the long term.

- **Conditions for the development of a spiral** between property prices and property purchase loans persist.

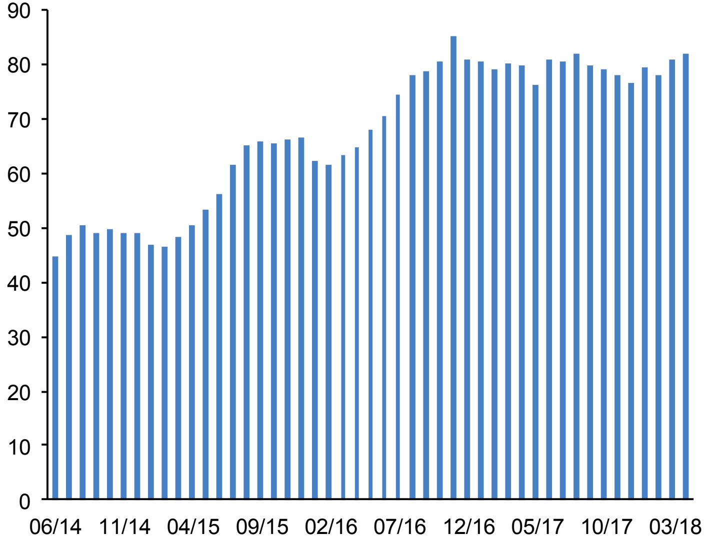
- Banks provided a **record amount** of new housing loans in 2017.
- The amounts of **genuinely new mortgage loans** are high and have been rising again in recent months.

New housing loans and new mortgage loans
(yearly totals in CZK billions)



Source: CNB
Note: The data on new housing loans also include refixed and refinanced loans.

Genuinely new mortgage loans
(6-month totals in CZK billions)



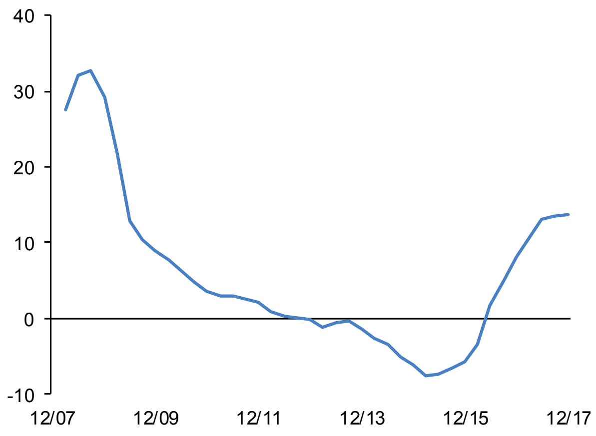
Source: CNB

Property price overvaluation

- The CNB’s methods indicate that **housing prices** were overvalued at the end of 2017.
- The CNB’s models also suggest that **commercial property** is overvalued.

Estimated overvaluation of apartment prices

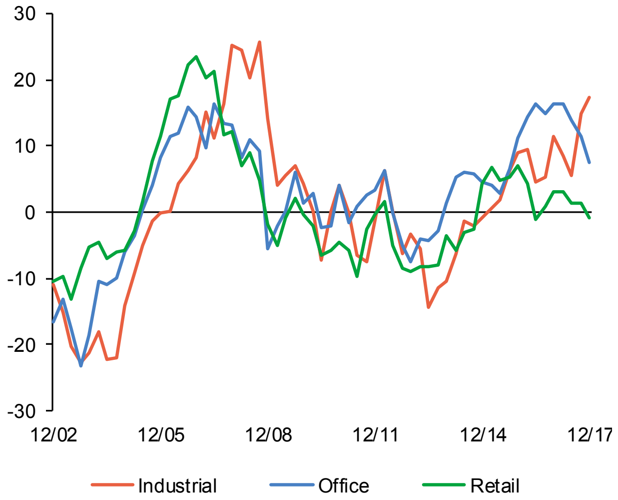
(%)



Source: CNB

Estimated overvaluation of commercial property prices

(%)



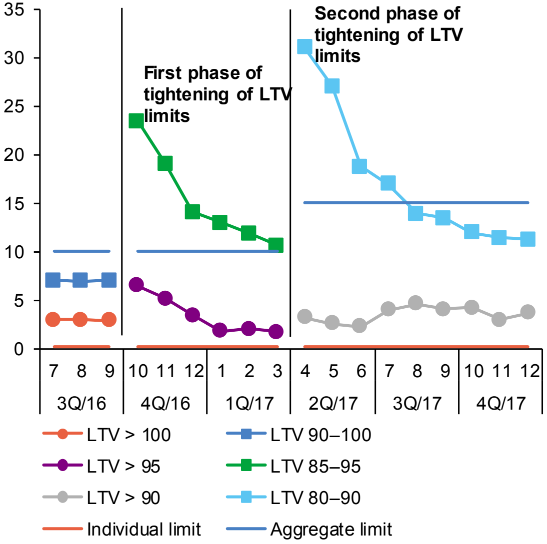
Source: Jones Lang LaSalle, Datastream, Eurostat, Bureau of Economic Research (US), CNB

Note: Overvaluation as estimated by panel regression on a sample of Central and Eastern European countries (CZ, SK, PL, HU and RO)

Compliance with recommended LTV limits

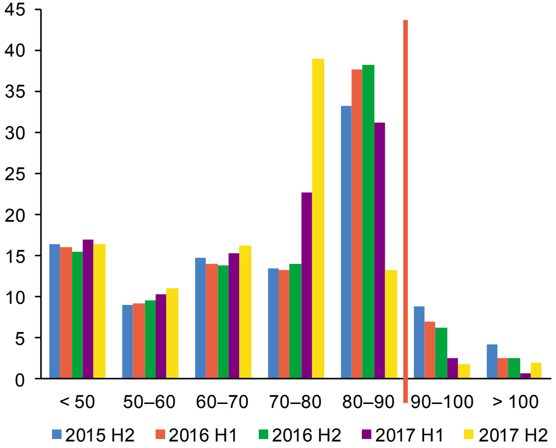
- Banks have been compliant with the **recommended aggregate LTV limit since 2017 Q3**.
  - However, they are still providing **a few percent of loans with LTVs of over 90%**.
  - In a number of cases, they are reducing the LTV just below the individual or aggregate limit by means of **optimistic property pricing**.

Fulfilment of the recommended LTV limits
(LTV in %; y-axis: share of loans in %)



Source: CNB

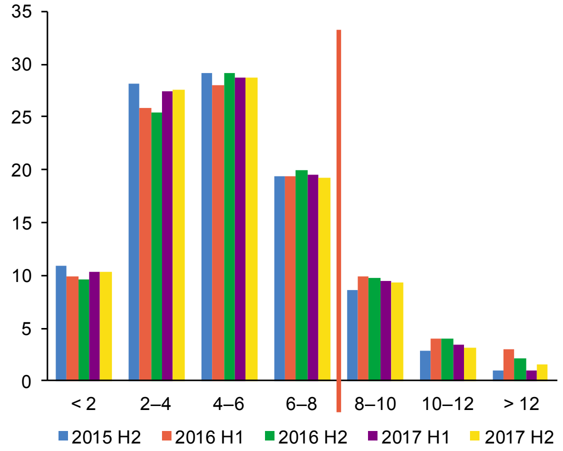
LTV distribution of new loans
(x-axis: LTV in %; y-axis: share of loans in %)



Source: CNB

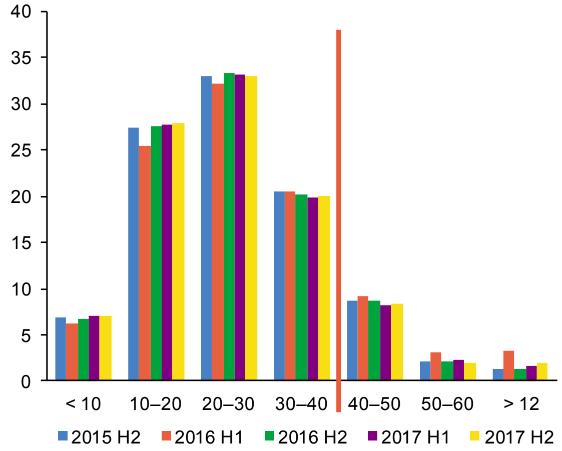
- The shares of **loans with risky LTI and LSTI levels** were virtually unchanged in 2017 H2.

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



Source: CNB

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

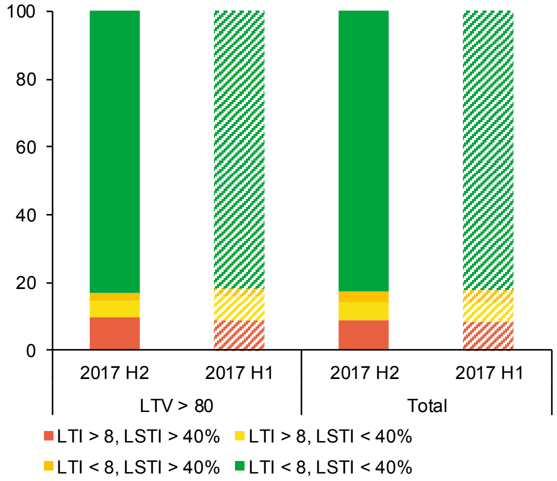


Source: CNB

Risks associated with debt and debt service

- Banks are continuing to provide loans with **simultaneously risky** LTV, LTI and LSTI ratios.

Breakdown of the riskiness of loans by LTV category in the Recommendation
(x-axis: LTV in %; y-axis: share of loans in %)



Source: CNB

Importance of DTI and DSTI limits

- DTI and DSTI target risks to which lenders as a whole are exposed **indirectly** through borrowers' balance sheets and their potential reaction to a deterioration in economic conditions.

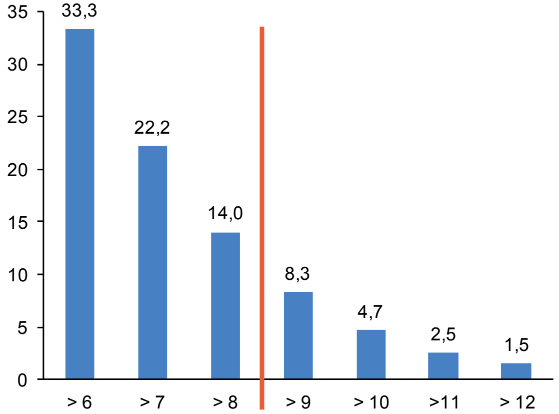
- DTI is designed primarily to mitigate risks associated with **excessive growth in the debt of the household sector**, while DSTI is targeted at risks connected with **excessive debt service of households**.

- Lenders' compliance with the DTI and DSTI limits **will increase the effectiveness of the LTV limits**.
  - May lead to reduction in risks associated with loans with high LTVs.
  - Reduce risk of circumvention of LTV limits through parallel provision of other consumer credit.

Potential impact of upper DTI and DSTI limits

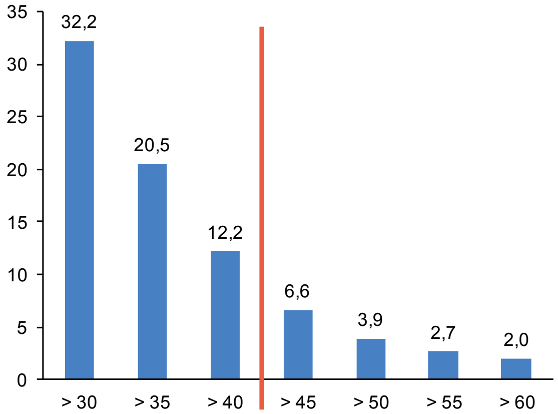
- Even if DTIs and DSTIs exceed the reported LTIs and LSTIs, the limits for both ratios in combination with the 5% exemption should **cover most** previously provided loans.
- In countries which apply DTI and/or DSTI limits, the relevant thresholds are set **at similar or even stricter levels**.

LTI distribution of new loans
(x-axis: LTI in years; y-axis: share of loans in %; 2017 H2)



Source: CNB

LSTI distribution of new loans
(x-axis: LSTI in %; y-axis: share of loans in %; 2017 H2)



Source: CNB

Illustrative example of indicator calculation

Applicant for loan for apartment in Brno:

- Apartment with floor area of 75 square metres @ CZK 44,300/sqm
- Apartment price CZK 3,323,300 (same, say, as expert estimate)
- Attainable loan with 80% LTV: **CZK 2,660,000**; need for own funds: CZK 664,700 + CZK 133,000 for transfer tax
- Attainable loan with 90% LTV: **CZK 2,991,000**; need for own funds: CZK 332,300 + CZK 133,000 for transfer tax

Applicant A Gross monthly income of **CZK 26,900**, i.e. around CZK 20,200 net

- 80% LTV: would have **DTI of 11 and DSTI of 56%** with 30-year loan maturity and 3% interest rate, i.e. would fail to meet conditions due to both DTI and DSTI.

Applicant B Gross monthly income of **CZK 41,500**, i.e. around CZK 31,100 net

- 80% LTV: would have **DTI of 7.2 and DSTI of 37%** with 30-year loan maturity and 3% interest rate, i.e. **would meet both DTI and DSTI**.
- 90% LTV: would have **DTI of 8 and DSTI of 41%** with 30-year loan maturity and 3% interest rate, i.e. **would meet both DTI and DSTI**.

Thank you for your attention

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on *Financial Stability Report 2017/2018*
is available at
http://www.cnb.cz/en/financial_stability/fs_reports/index.html

Information on financial stability
and CNB macroprudential policy
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