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.
Financial stability in Czech Republic in June 2018

- **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*
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.
• 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.
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.
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
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.
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.
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

### Genuinely new mortgage loans

(6-month totals in CZK billions)

Source: CNB

*Note: The data on new housing loans also include refixed and refinanced loans.*
• 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.

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**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)
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 %)

- **First phase of tightening of LTV limits**
- **Second phase of tightening of LTV limits**

### LTV distribution of new loans

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

- LTV > 100
- LTV > 90
- LTV > 95
- LTV 85–95
- LTV 80–90
- Individual limit
- Aggregate limit

Source: CNB
The shares of loans with risky LTI and LSTI levels were virtually unchanged in 2017 H2.
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 %)

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<th>LTV &gt; 80</th>
<th>2017 H1</th>
<th>2017 H2</th>
<th>Total</th>
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<tr>
<td>LTI &gt; 8, LSTI &gt; 40%</td>
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<tr>
<td>LTI &gt; 8, LSTI &lt; 40%</td>
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</tbody>
</table>

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**.

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

- > 6: 33.3%
- > 7: 22.2%
- > 8: 14.0%
- > 9: 8.3%
- > 10: 4.7%
- > 11: 2.5%
- > 12: 1.5%

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

- > 30: 32.2%
- > 35: 20.5%
- > 40: 12.2%
- > 45: 6.6%
- > 50: 3.9%
- > 55: 2.7%
- > 60: 2.0%

Source: CNB
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**.
More information on *Financial Stability Report 2017/2018* is available at

Information on financial stability and CNB macroprudential policy is available at