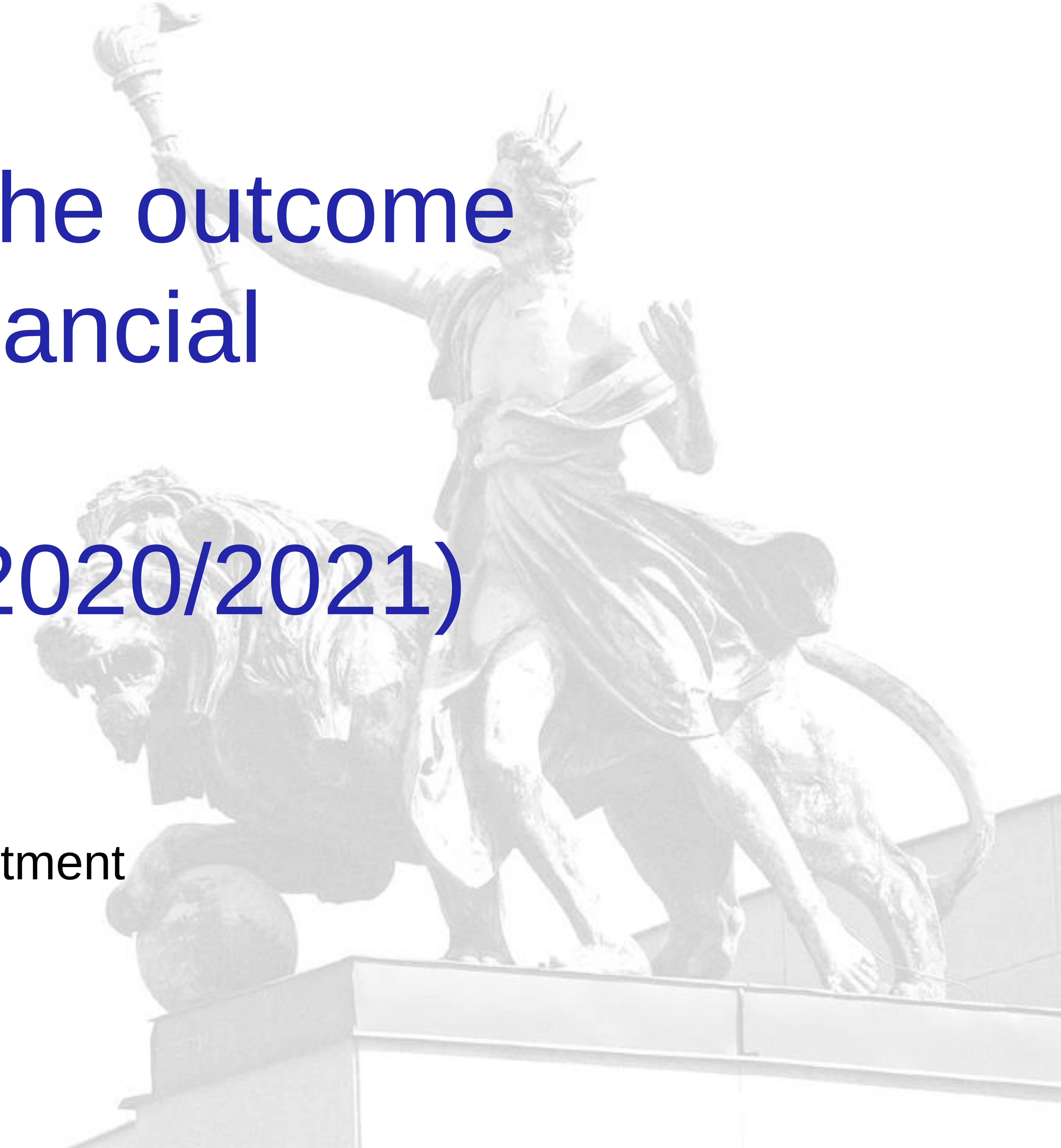
CNB CZECH NATIONAL BANK

CNB press conference on the outcome of the spring meeting on financial stability issues

(Financial Stability Report 2020/2021)



Jiří Rusnok, Governor
Jan Frait, Executive Director, Financial Stability Department

27 May 2021

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Financial stability in May 2021

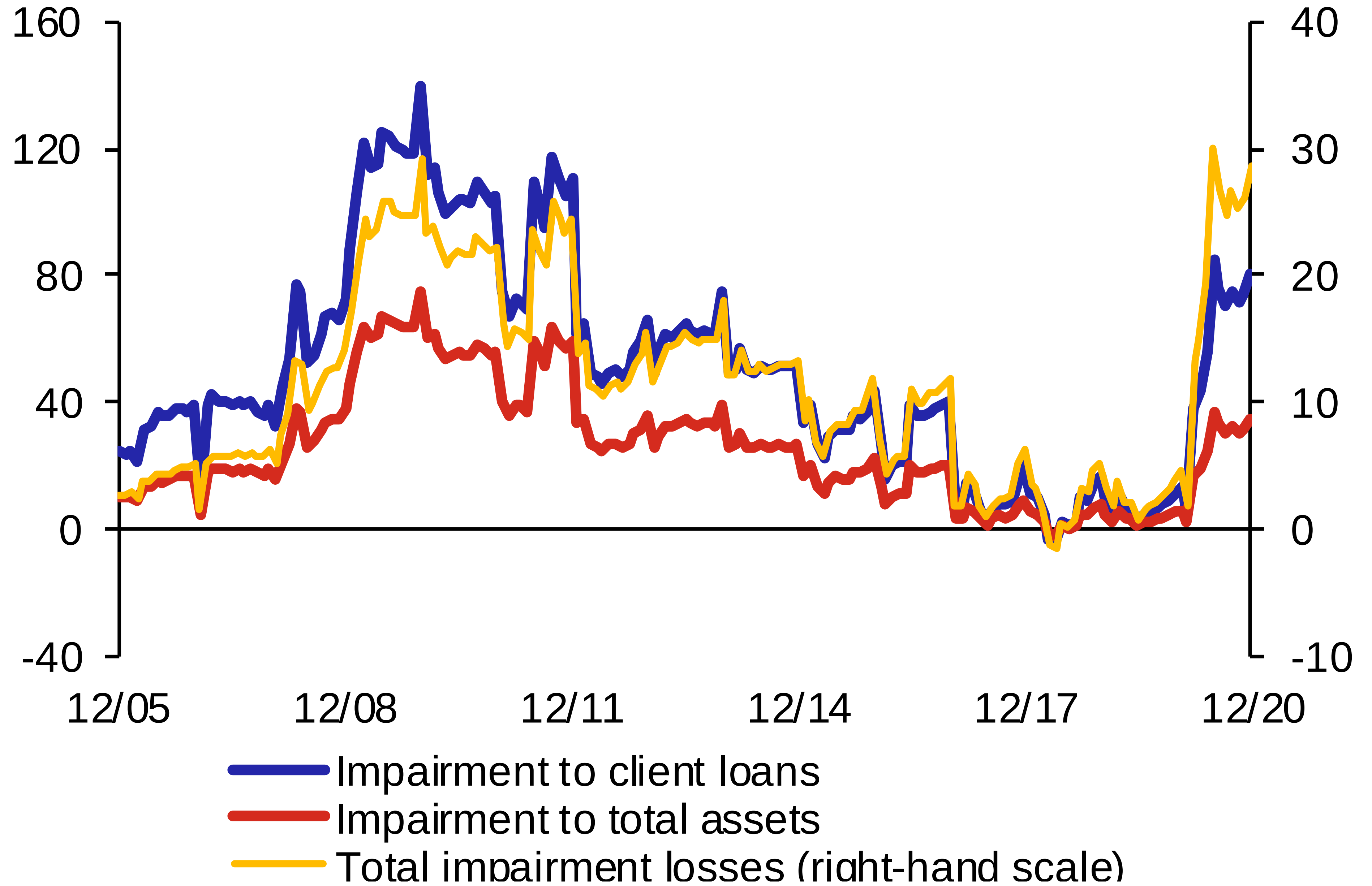
- The Czech financial sector strengthened its traditionally high resilience to adverse shocks last year and in the first few months of this year.
- The income of some households and especially non-financial corporations fell markedly. This had an adverse effect on their solvency and, in turn, on the results of financial institutions.
  - However, stabilisation and support programmes together with prudent risk management by financial institutions significantly limited the adverse impacts of the pandemic.
  - The end of the statutory moratorium led to only partial materialisation of credit risks and a decrease in their latency, while a client-friendly approach to those affected by the pandemic was maintained.
- The pass-through of credit risk to banks' balance sheets and profits was also mitigated by the flexibility of the regulatory and accounting frameworks.
  - However, part of the impacts will materialise with a lag this year and the next.
- Uncertainty regarding future developments still requires financial institutions to act very prudently in managing capital and in their dividend policies.

Credit risk in banking sector (1)

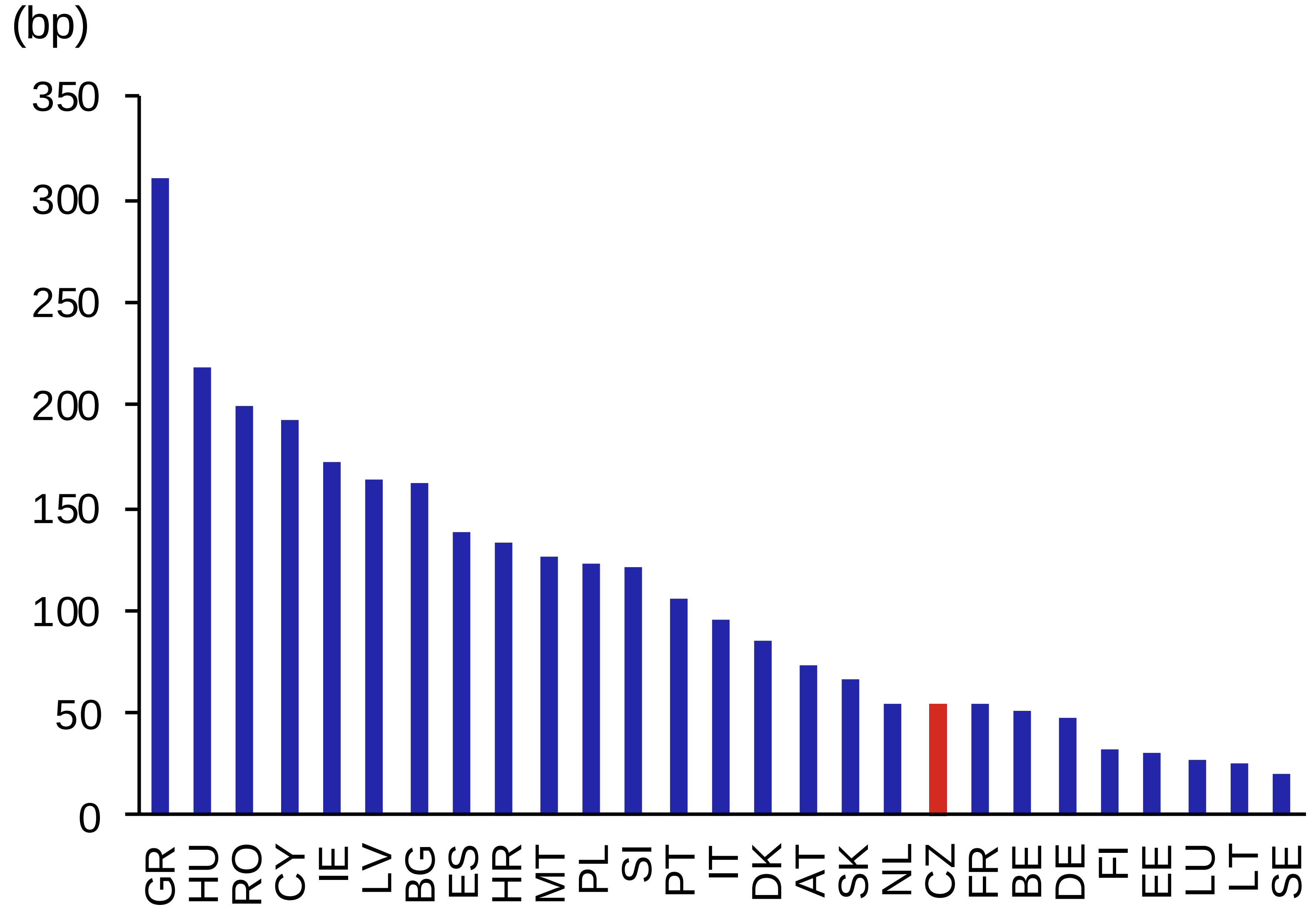
- Impairment losses on loans and total assets remained low in relative terms compared with the global financial crisis (CZK 30 billion on an annual basis in absolute terms).
- Credit risk costs in the Czech Republic are among the lowest in the EU.

Annualized impairment losses

(impairment/total assets in bp; total impairment losses in CZK billions)



Comparison of risk costs in the EU as of December 2020



Source: EBA

Note: Risk costs are expressed asn impairment charges relative to total client loans. Number for CZ in the CNB methodology is somehow higher.

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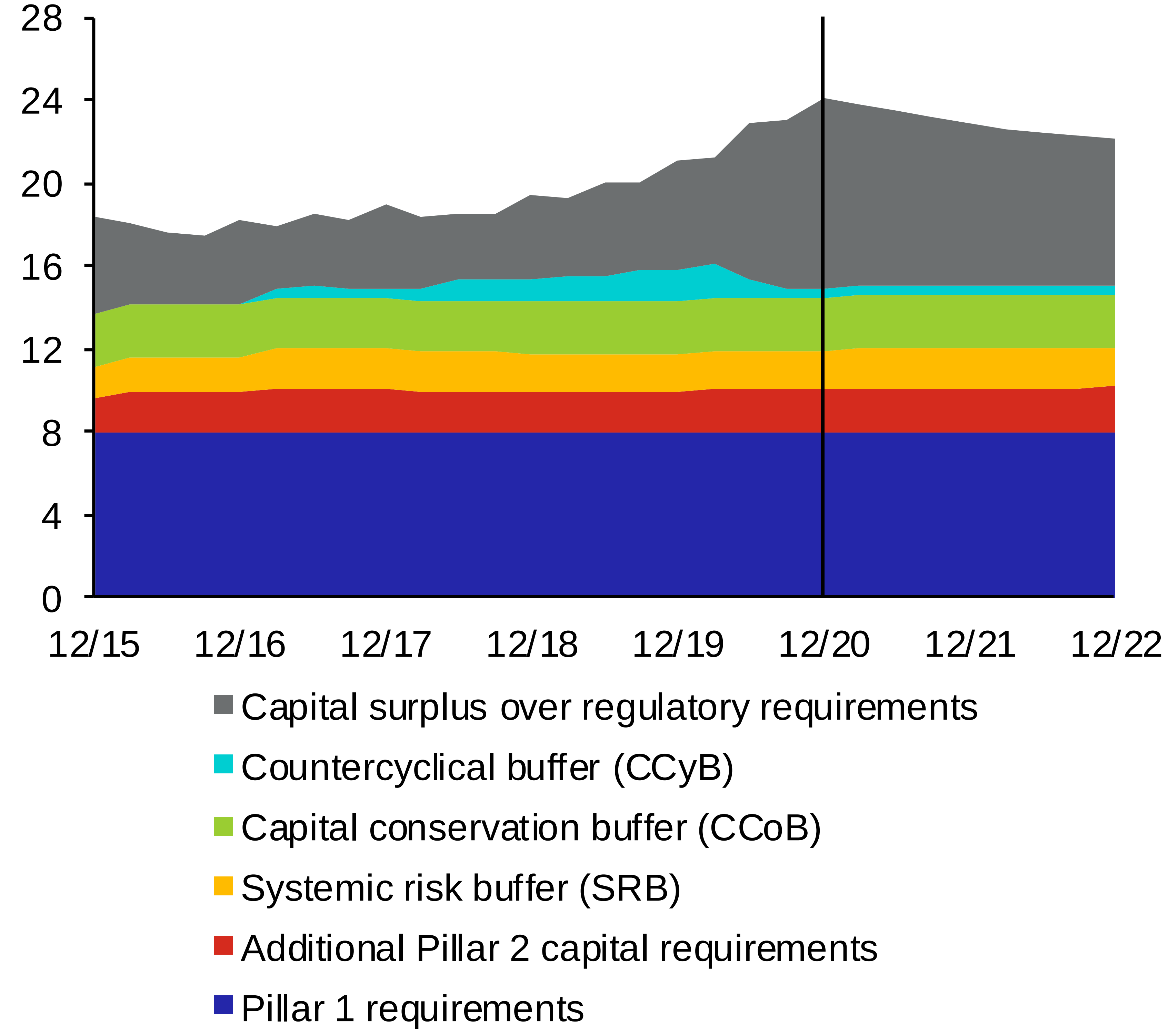
Credit risk in banking sector (2)

- Risks partially materialised after the statutory moratorium ended in October 2020 – the share of impaired exposures (Stage 3, “bad loans”) rose by 0.4 pp to 2.6% as at the end of 2020.
- The ratios of non-performing loans with deferred instalments (under the statutory moratorium or bank moratoria) remain lower than had been expected before the end of the statutory moratorium.
    - The volume of approved (statutory or individual) moratorium applications stood at around CZK 470 billion at the end of September 2020 (about 15% of banks’ credit exposures to the private non-financial sector).
    - Interest in deferrals granted by banks after 1 October 2020 has been relatively low so far. Such loans amounted to around CZK 43 billion at the end of March 2021.
    - More than half of loans with any deferral of instalments after the onset of the pandemic remained in Stage 1 at the end of March 2021, i.e. they did not record a rise in credit risk.

Decision on countercyclical capital buffer rate (1)

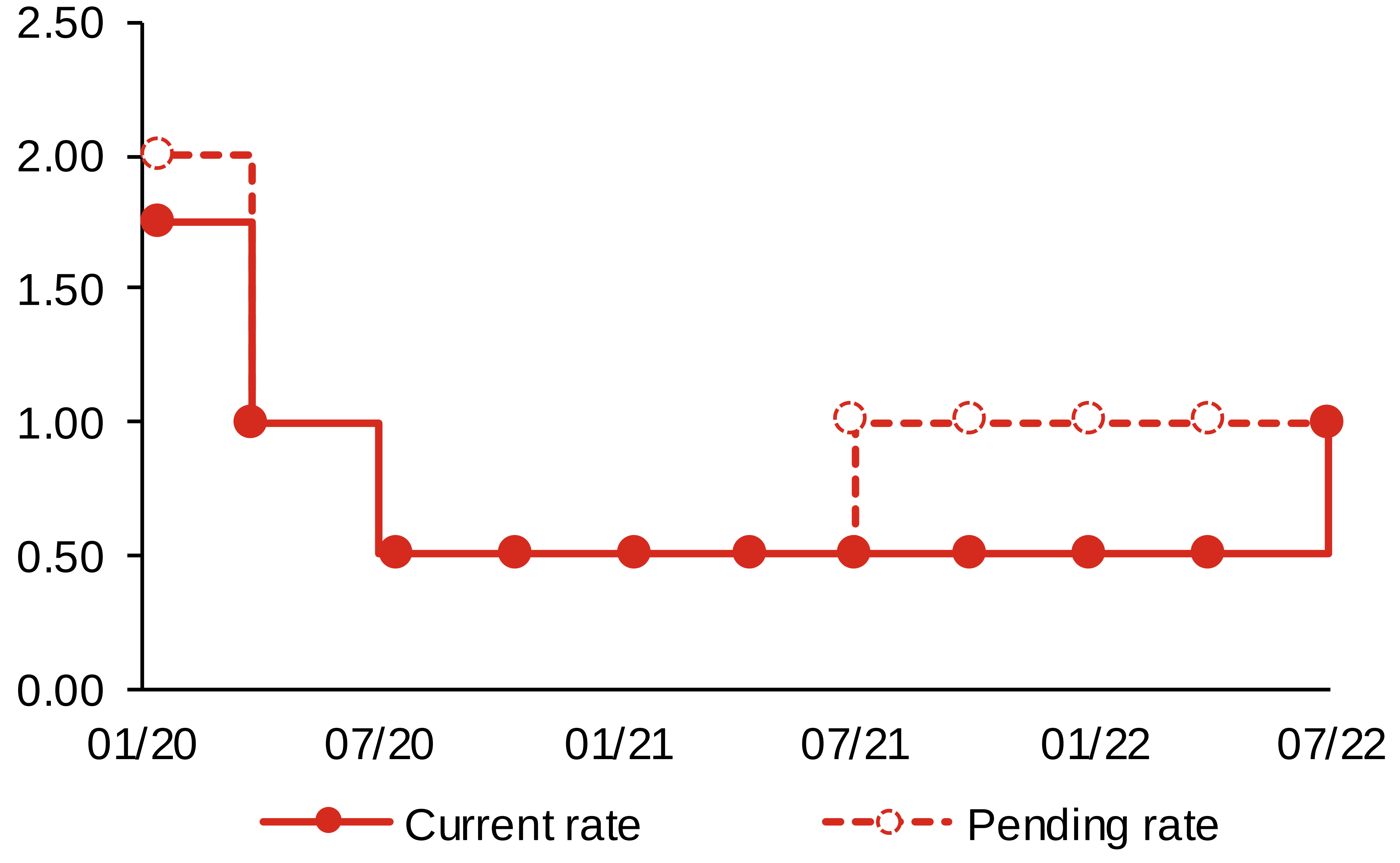
Structure of capital requirements in the domestic banking sector
(pp)



- The capital position of the domestic banking sector is currently very robust.
- The aggregate capital ratio of the banking sector was 24.3% at the end of last year.
  - The surplus of capital over the regulatory requirements accounted for more than one-third of the sector's capitalisation.
  - Premature use of a large proportion of the capital surplus could be a source of systemic risk.
- Banks in the Czech Republic currently meet the overall capital requirement – consisting of the minimum regulatory level in Pillar 1, the requirements based on the supervisory review of risks in Pillar 2, and macroprudential capital buffers – by a sufficient margin.
- Theoretically, the banking sector's current capitalisation would allow it to lend an additional more than CZK 3.5 trillion.

Decision on countercyclical capital buffer rate (2)

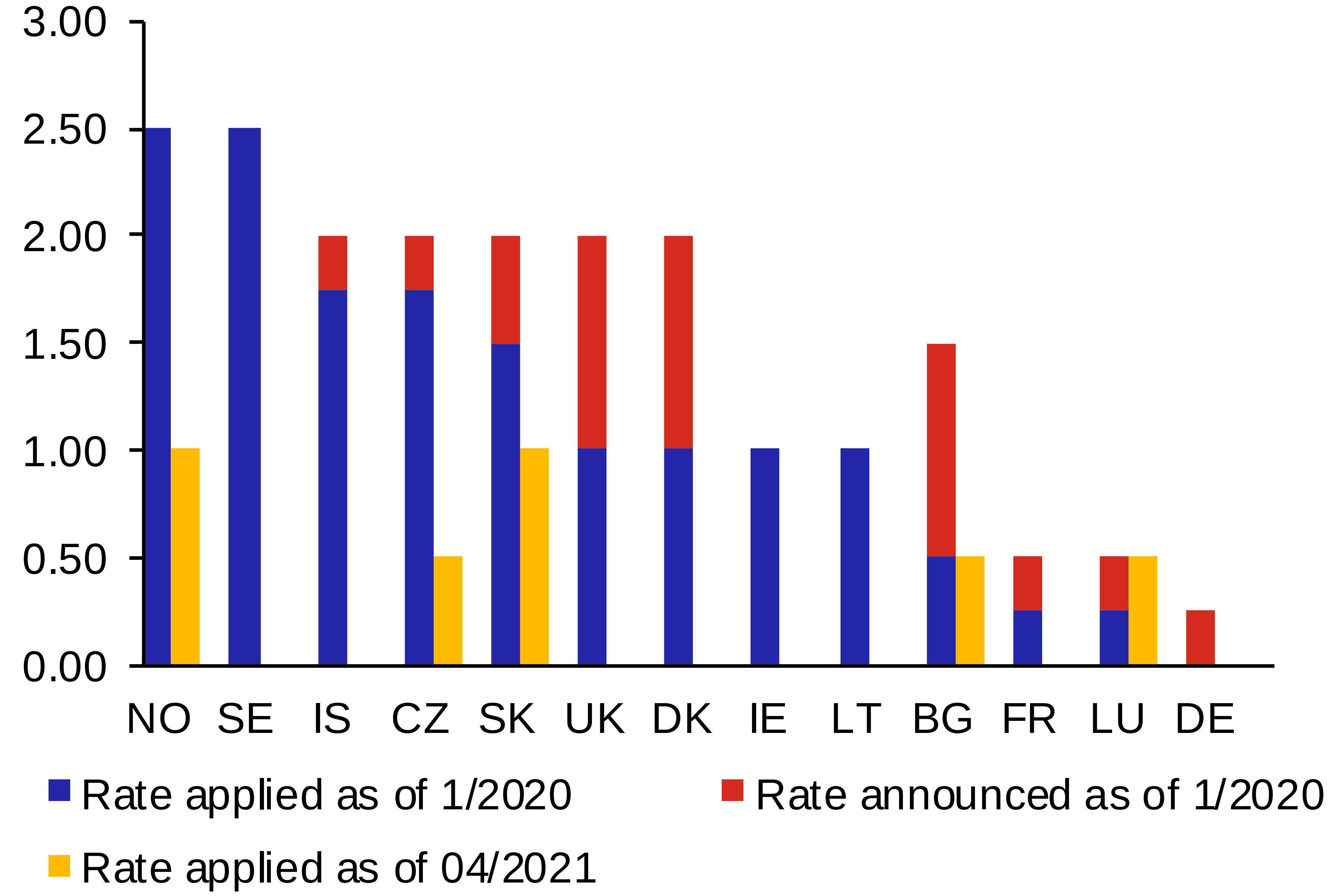
Current and pending CCyB rate in the Czech Republic
(% of total risk exposure)



- **With effect from 1 July 2022, the Bank Board decided to increase the countercyclical capital buffer (CCyB) rate to 1%**, the rate covering the usual level of risks.
- In taking this decision, the Bank Board took into account the standard rate concept, which the CNB is ready to apply every time the acute phase of an economic downturn fades away.
- In setting the CCyB rate, the CNB is ready to react flexibly to changes in the economic and financial conditions.
- The coming into effect of the CCyB rate after one year gives the CNB room to react quickly in the event of unexpected adverse shocks.

Decision on countercyclical capital buffer rate (3)

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



- Most countries fully released their CCyBs last year, albeit from lower rates than in the Czech Republic or with generally lower capital surpluses in their banking sectors.
- Besides the Czech Republic a rate of 1% is now applied in Slovakia and Norway.
- Many national macroprudential authorities now prefer to apply a rate of 1% under normal conditions, "following the example" of the CNB.

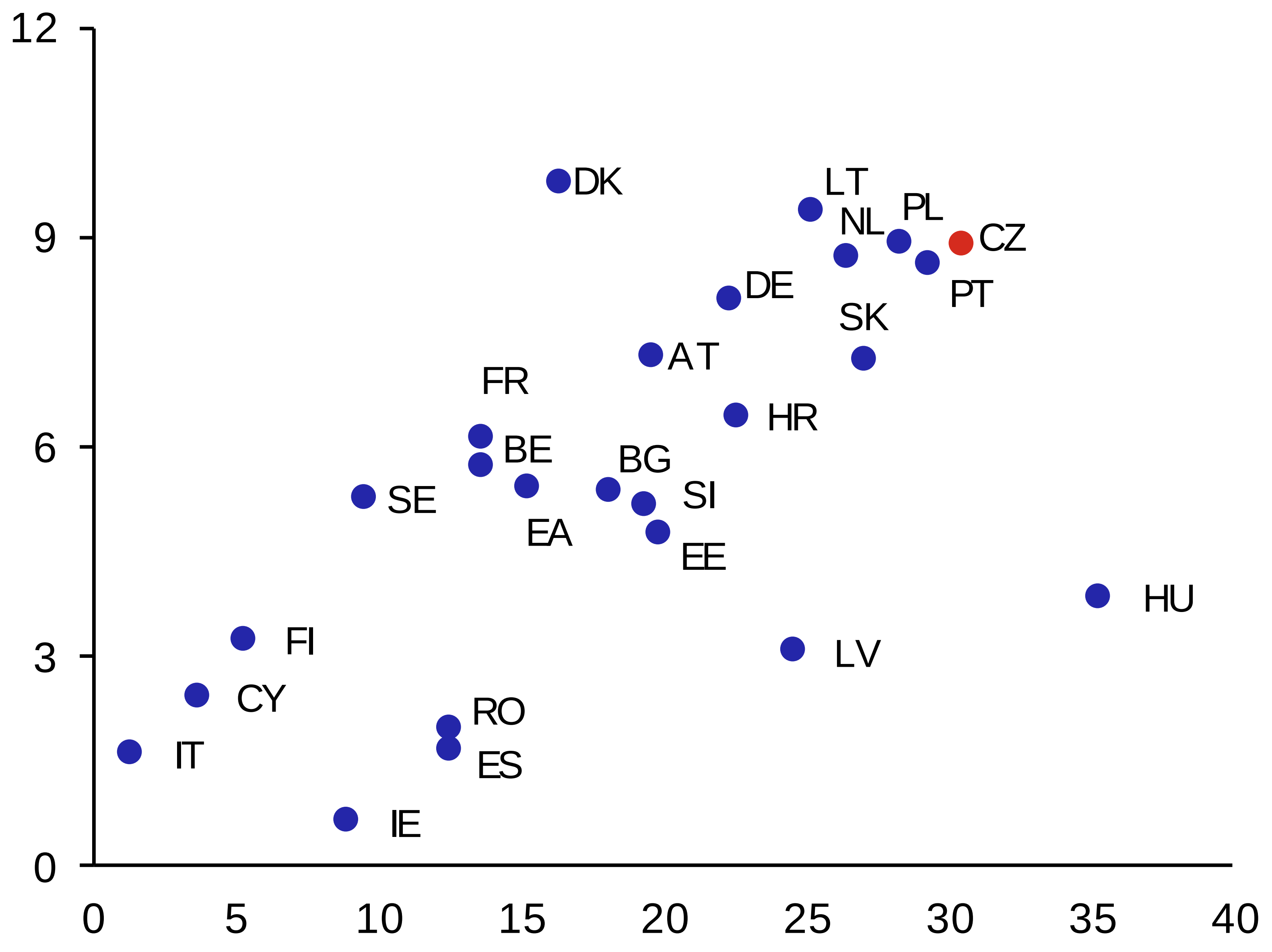
Changes to liquidity-providing repo operations

- In March 2020, the CNB Bank Board adjusted the rules of the monetary repo operations for providing liquidity to financial institutions.
  - They were announced twice a week for two-week maturity and once a week for three-month maturity, with bids fully satisfied at a fixed rate equal to the two-week repo rate.
  - In addition, a two-week repo operation for providing liquidity to certain non-bank financial institutions at a fixed rate equal to the two-week repo rate plus 20 bp was introduced for precautionary reasons.
- In view of the overall decrease in stress on the domestic financial market and the return of market conditions to the pre-pandemic situation, the CNB Bank Board decided:
  - on 6 May 2021 to abolish the three-month liquidity-providing repo operation for credit institutions;
  - on 27 May 2021 and with effect from 28 May 2021 to reduce the frequency of the two-week liquidity-providing repo operations for credit institutions to once a week and to reintroduce the previously applied interest mark-up of 0.1 pp;
  - to keep the terms of the liquidity-providing facility for non-bank financial institutions unchanged but to reduce its frequency to once a week as well.

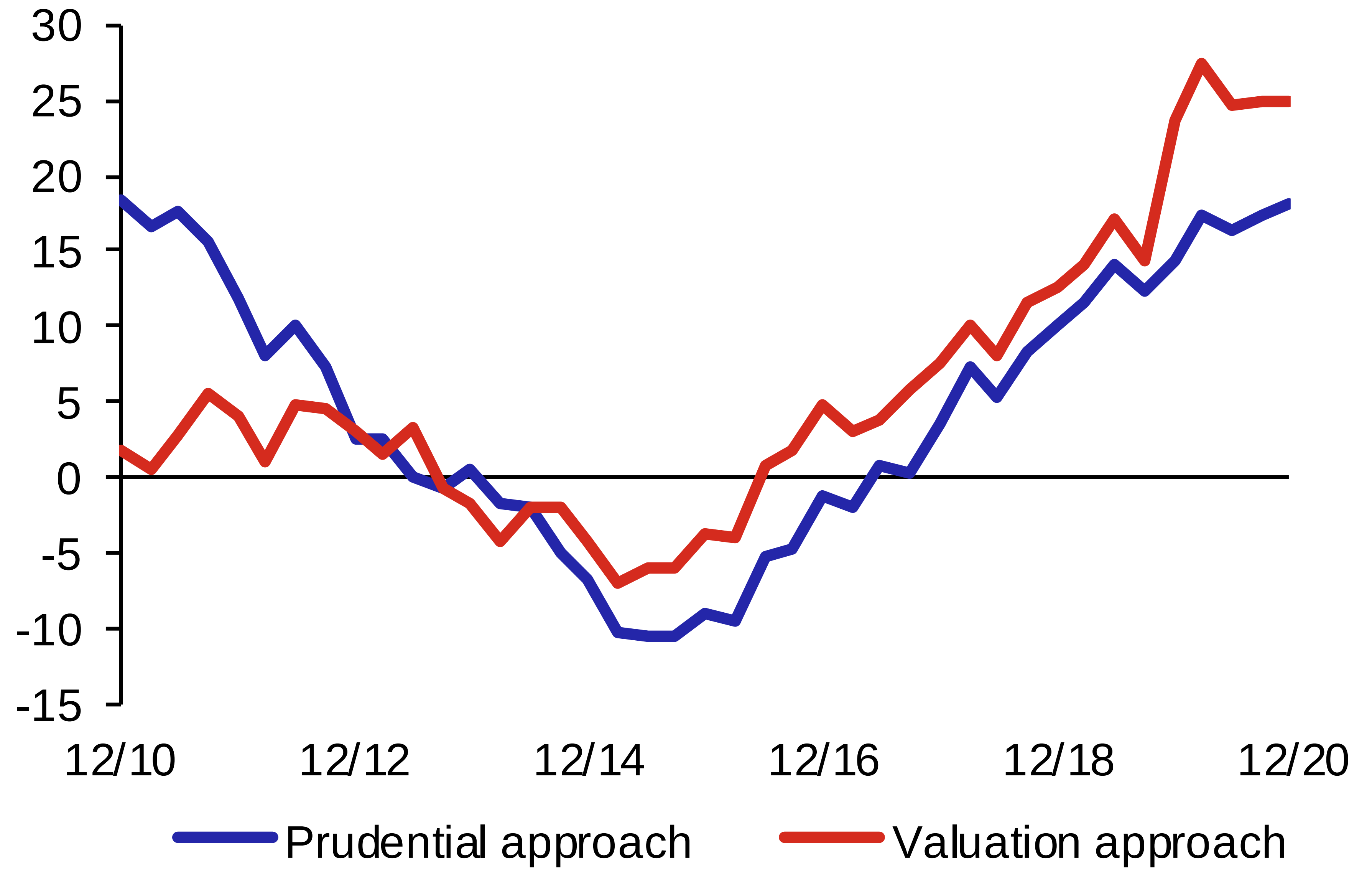
Property market and mortgage lending (1)

- House prices increased in all European countries last year; the rise in the Czech Republic was one of the highest at both the one-year and three-year horizons.
- The CNB estimates that, for households with median incomes, apartments in the Czech Republic are overvalued by 18% on average and by as much as 25% or more in localities with a high share of investment apartments.

Property price growth in selected EU countries in 2020
(%; x-axis: three-year growth; y-axis: one-year growth)

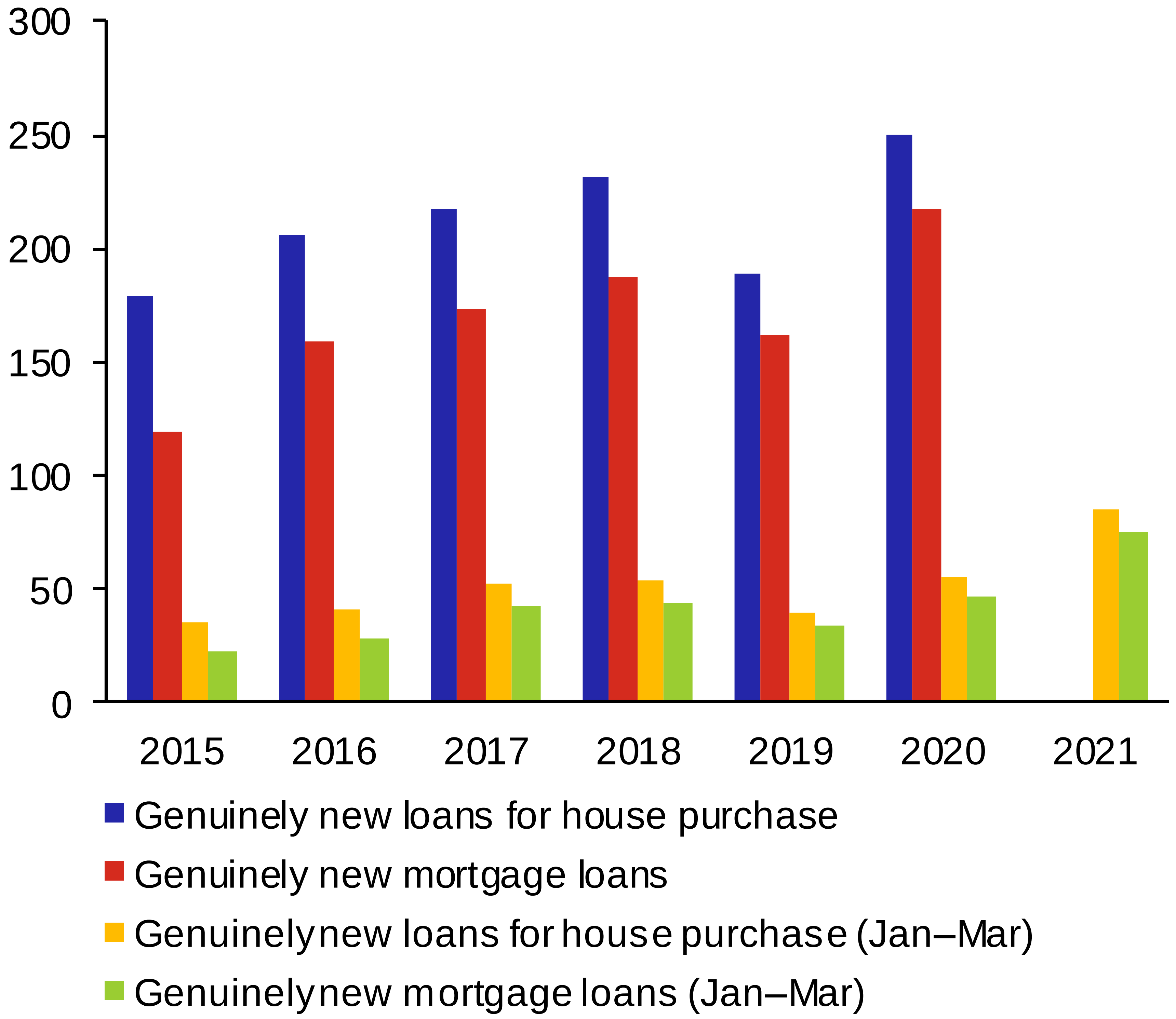


Estimated overvaluation of apartment prices
(%)



Property market and mortgage lending (2)

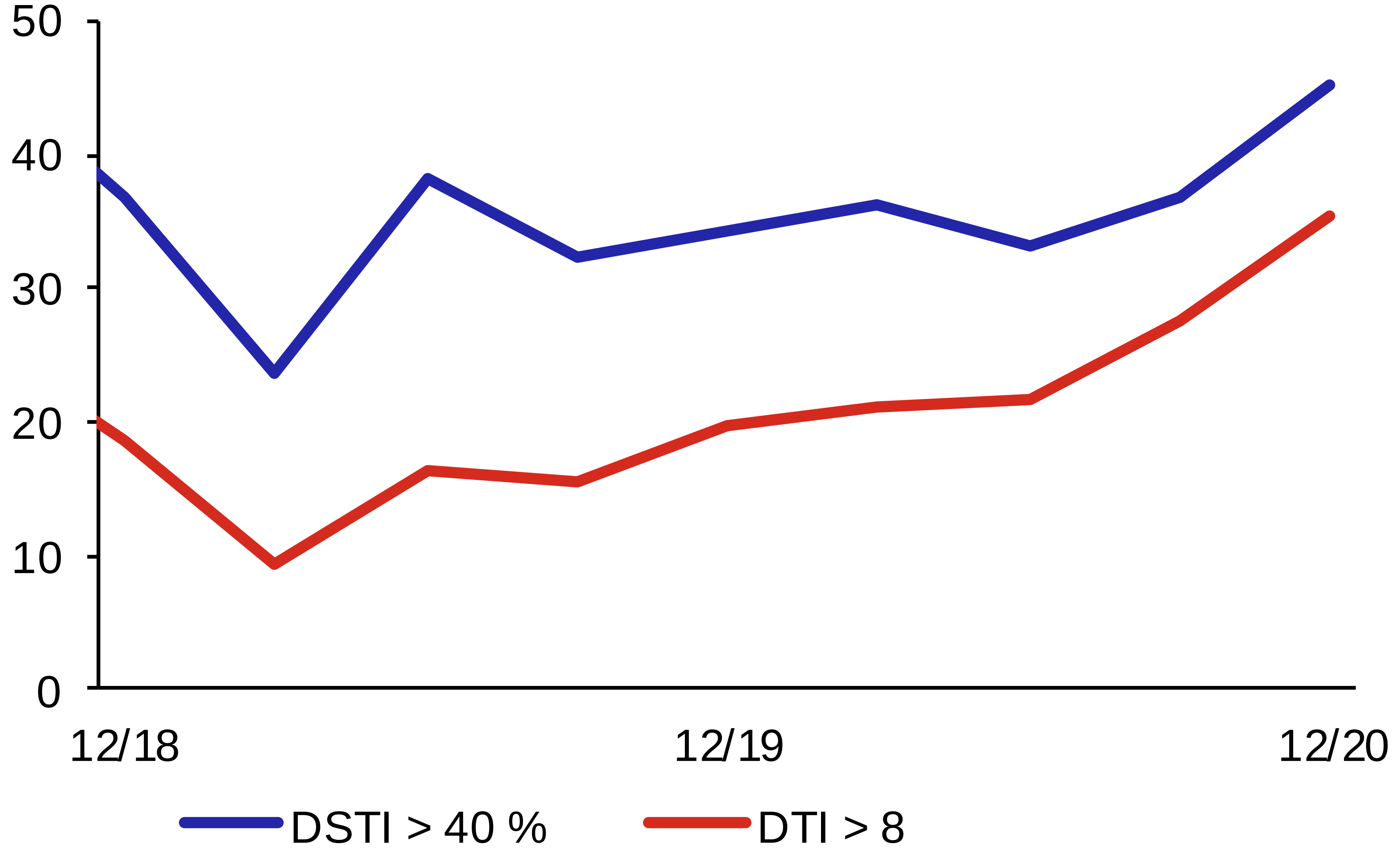
Housing loans and mortgage loans
(CZK billions)



- The drop in economic activity and the worse labour market situation did not cool the mortgage and property markets.
  - On the contrary, the volume of genuinely new housing loans and mortgage loans was at a record high in the second half of 2020 and the first few months of 2021.
- Besides genuinely new mortgage loans, the volume of refinanced loans also increased.

Property market and mortgage lending (3)

Mortgage loans with high DSTI or DTI
(% of reference volume)



- Lenders complied with the recommended LTV limit, aided by rapid growth in prices of property accepted as collateral.
- As for the DTI and DSTI ratios, lenders did not abide too much by the levels representing increased risk according to the CNB.
  - In the second half of last year, the share of risky mortgages rose towards the levels reached in the second half of 2018, when the CNB first introduced DTI and DSTI limits.

Property market and mortgage lending (4)

- In view of the still limited extent of systemic risk, the CNB Bank Board has decided in the current situation to keep the LTV limit unchanged at 90%, with the option of applying a 5% volume exemption.
- The CNB Bank Board does not currently deem it necessary to set DTI and DSTI limits or to tighten the other parameters of the existing Recommendation. However, it points out to lenders that it considers credit standards to be as relaxed as acceptable.
- The CNB regards the high and increasing share of loans with a DTI (debt-to-income) ratio of over 8 and a DSTI (debt service-to-income) ratio of over 40% as highly risky and a potential source of systemic risk.
  - Lenders should therefore take measures to ensure that such loans are indeed provided only to applicants who are highly likely to repay without problems.
- For the time being, the CNB will respond to the higher risk profile of some lenders using supervisory instruments, for example an additional Pillar 2 capital requirement for risk management systems.

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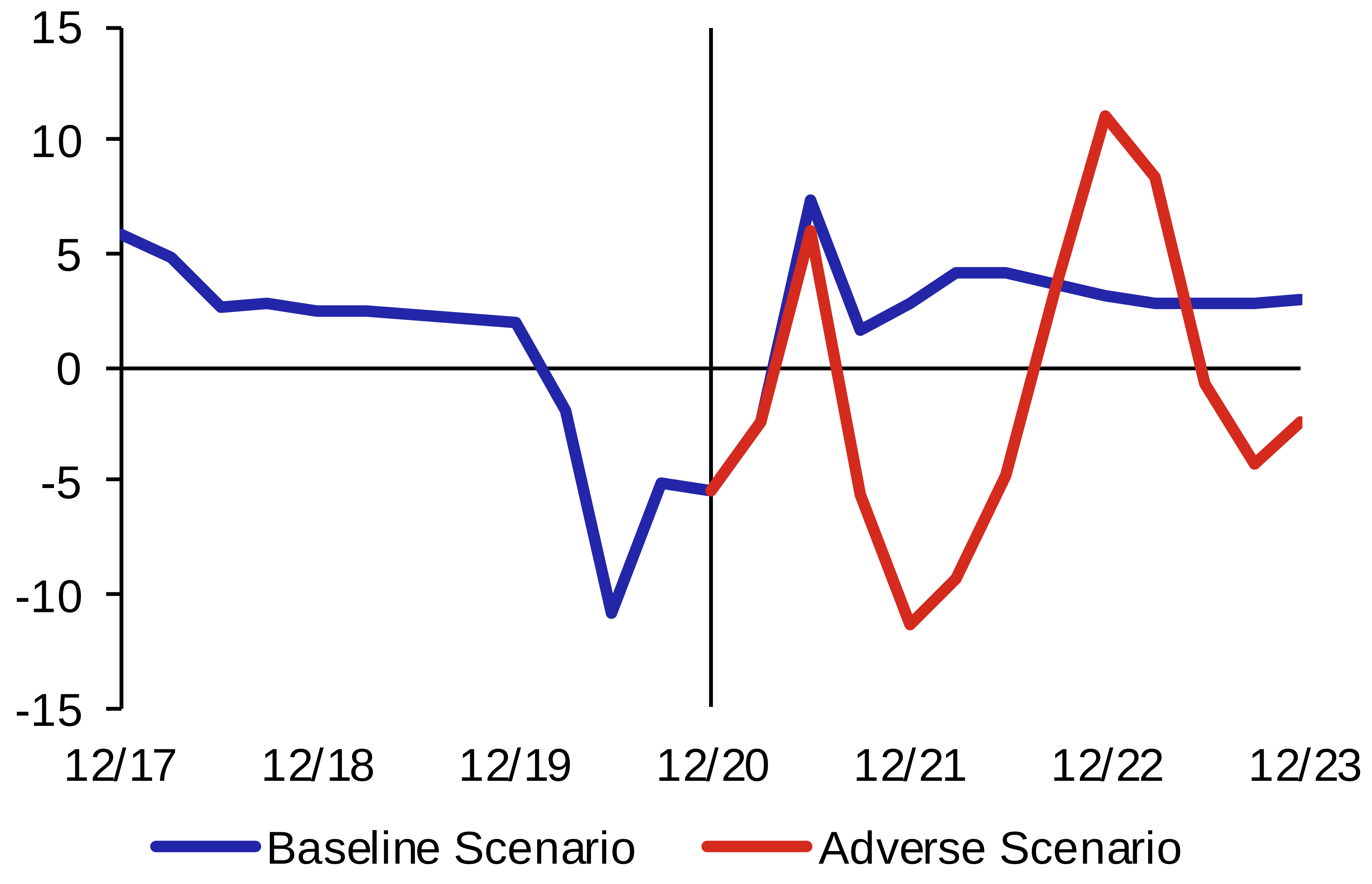
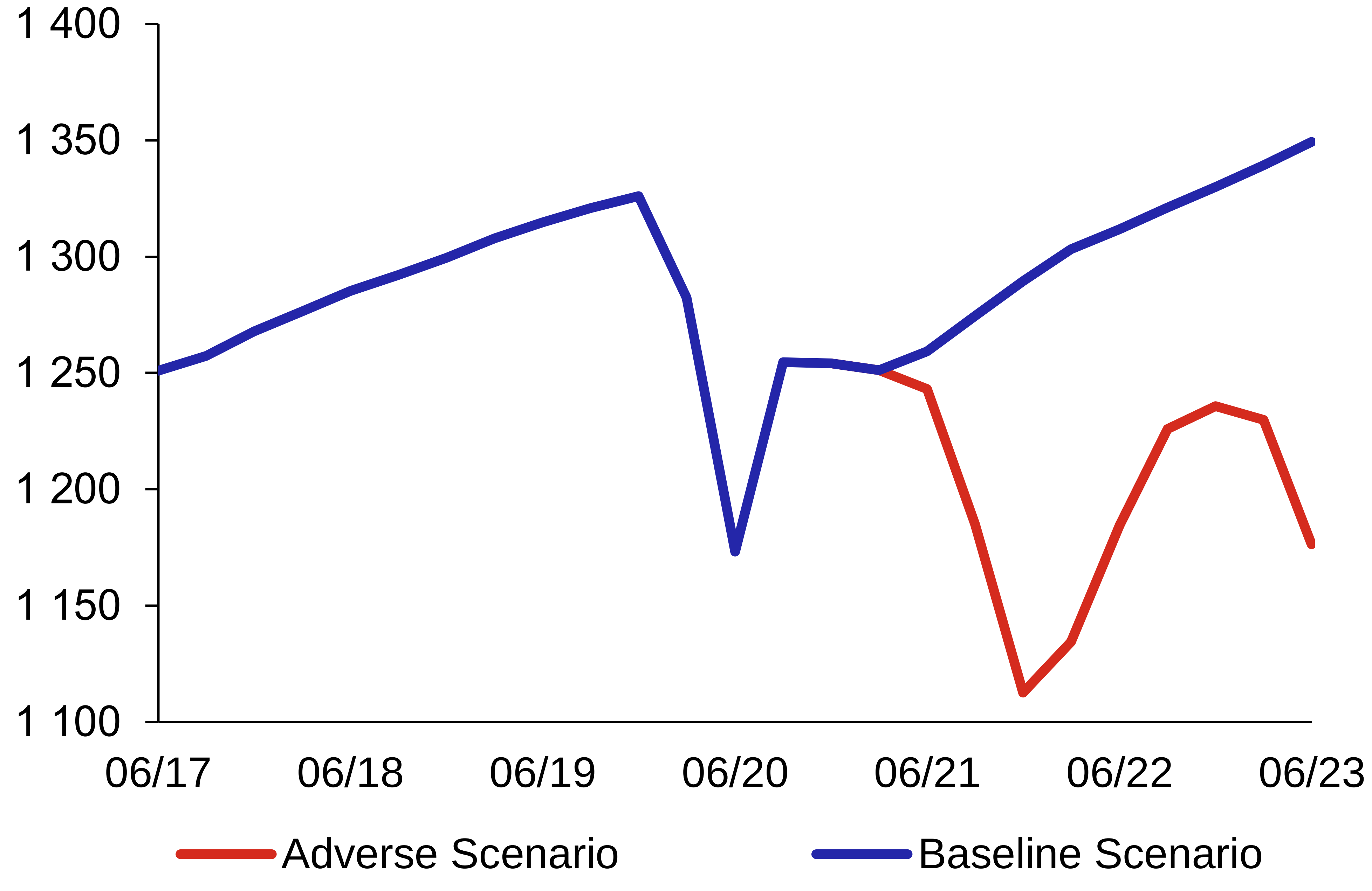
GDP in stress test

- The **Baseline Scenario** of the test is based on the CNB's January macroeconomic forecast and the **Adverse Scenario** represents hypothetical adverse economic developments used to test the resilience of the domestic banking sector.

Alternative scenarios: real GDP
(year-on-year in %)

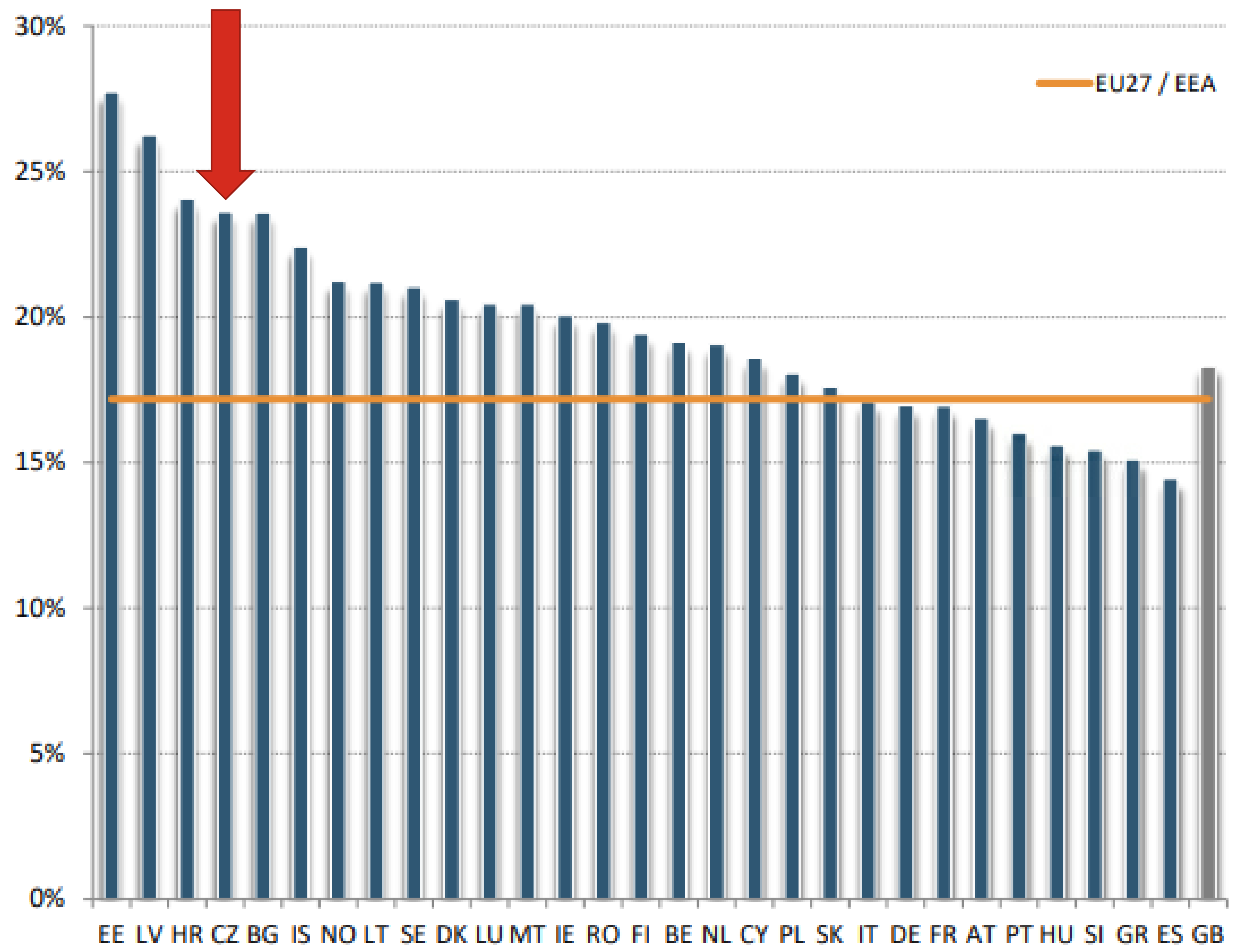


Alternative scenarios: real GDP
(CZK billions, quarterly data)



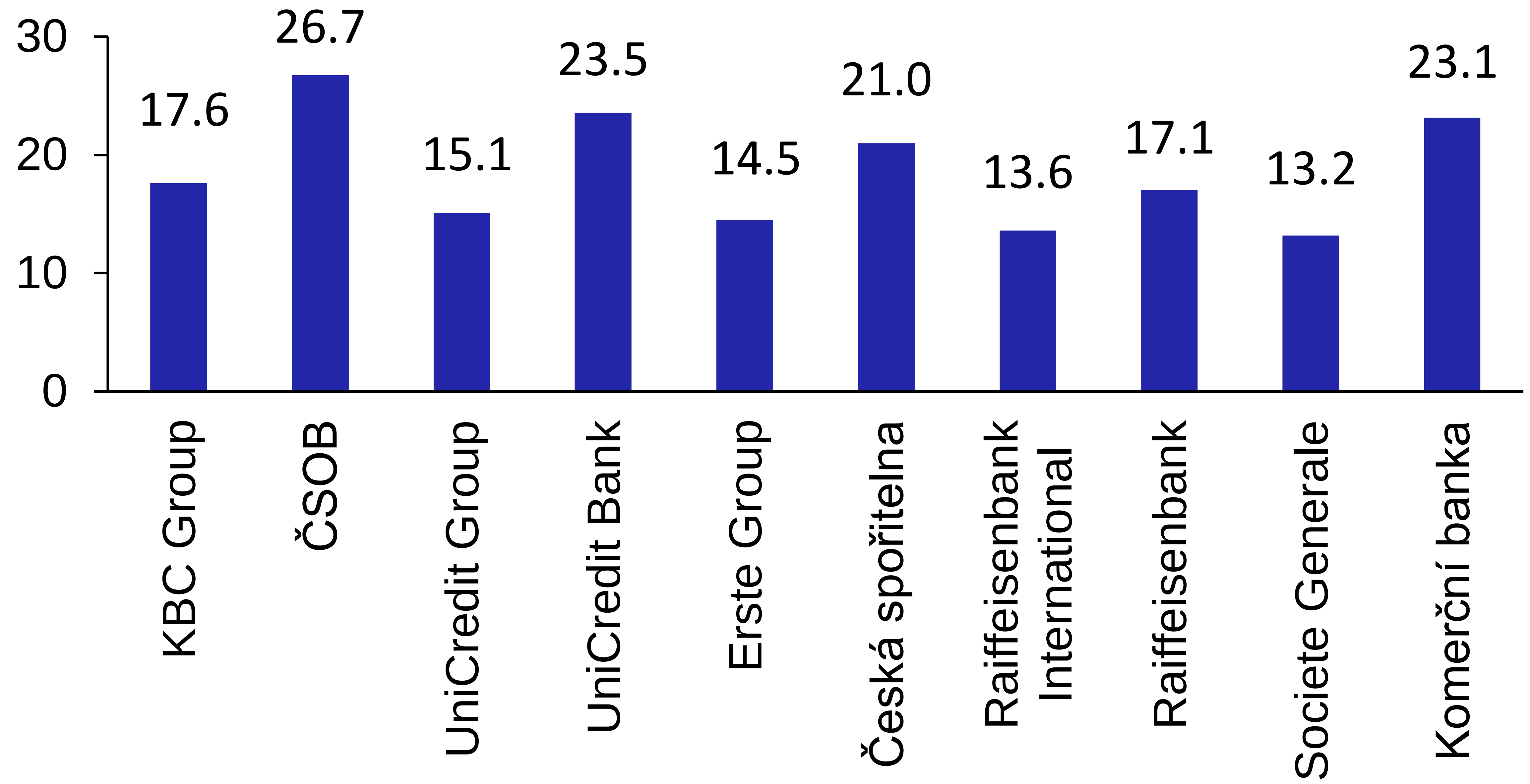
Initial capitalisation of banking sector

Tier 1 capital ratios
(December 2020)



Source: EBA

CET1 capital ratios of domestic O-SIIs and their foreign parents as of 2020 Q4
(pp)



Initial level of credit risk

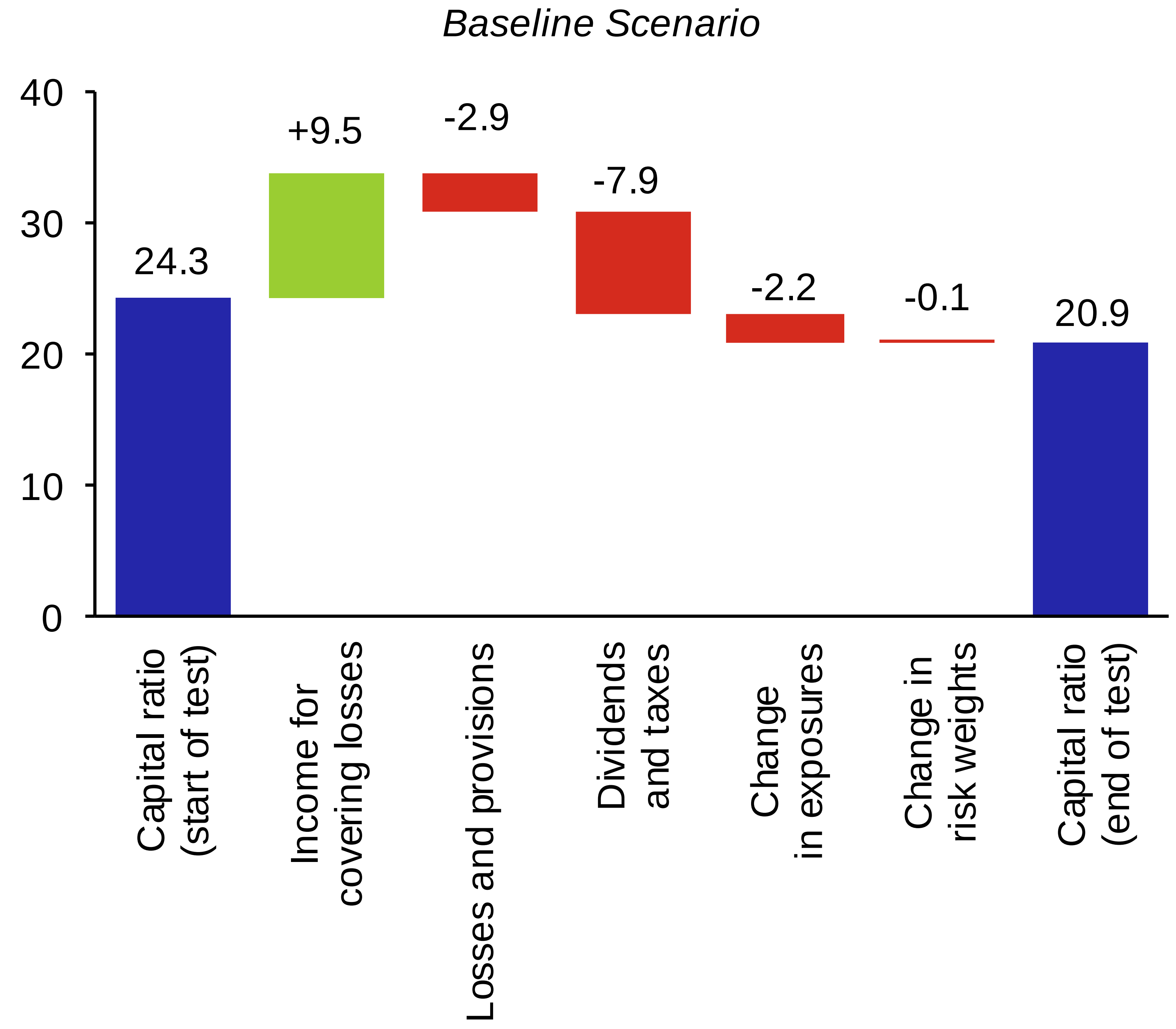
Loan structure by portfolio
(%)

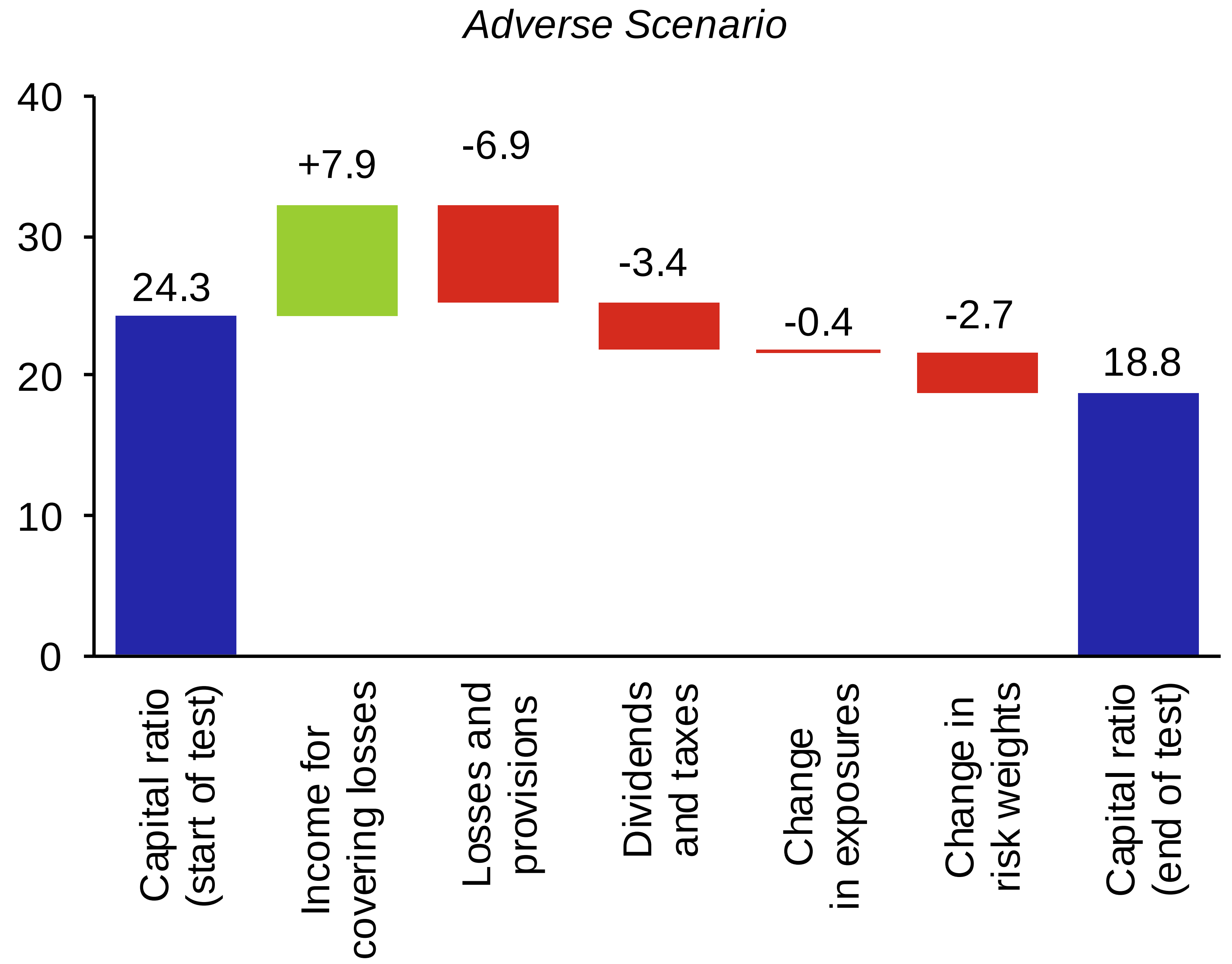
- The share of Stage 3 loans ("bad loans") rose only slightly during the year.
  - 2.6% overall, 4.2% for non-financial corporations and 1.8% for households at the end of 2020.
- The share of Stage 2 loans ("loans at risk of default") rose only slightly during the year.
  - 9.9% overall, 15.5% for non-financial corporations and 7.2% for households at the end of 2020.
- The increase in the share of Stage 2 and 3 loans means that the level of credit risk latency in the banking sector has declined.

Main sources of stress

- In **both scenarios**, a decrease in the capital ratio is fostered by credit losses, dividend payments and tax payments.
- In the **Adverse Scenario**, these factors are accompanied by a rise in risk weights.

Decomposition of the change in the capital ratio of the banking sector in the *Baseline* and *Adverse Scenario*
(%)





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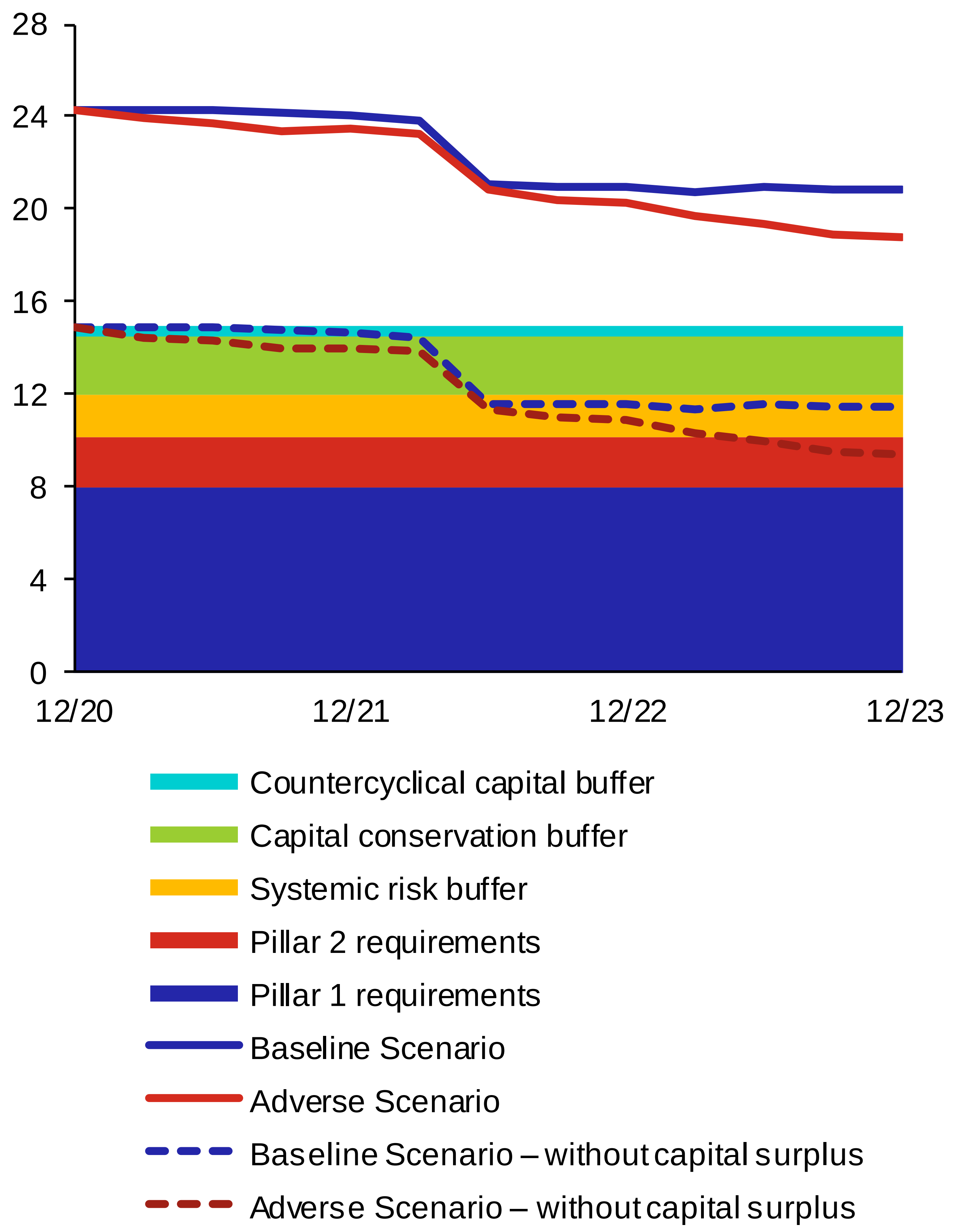
Bank macro-stress test results

Impact of the scenarios on the capital ratio and interactions with the capital requirements of the banking sector
(pp)

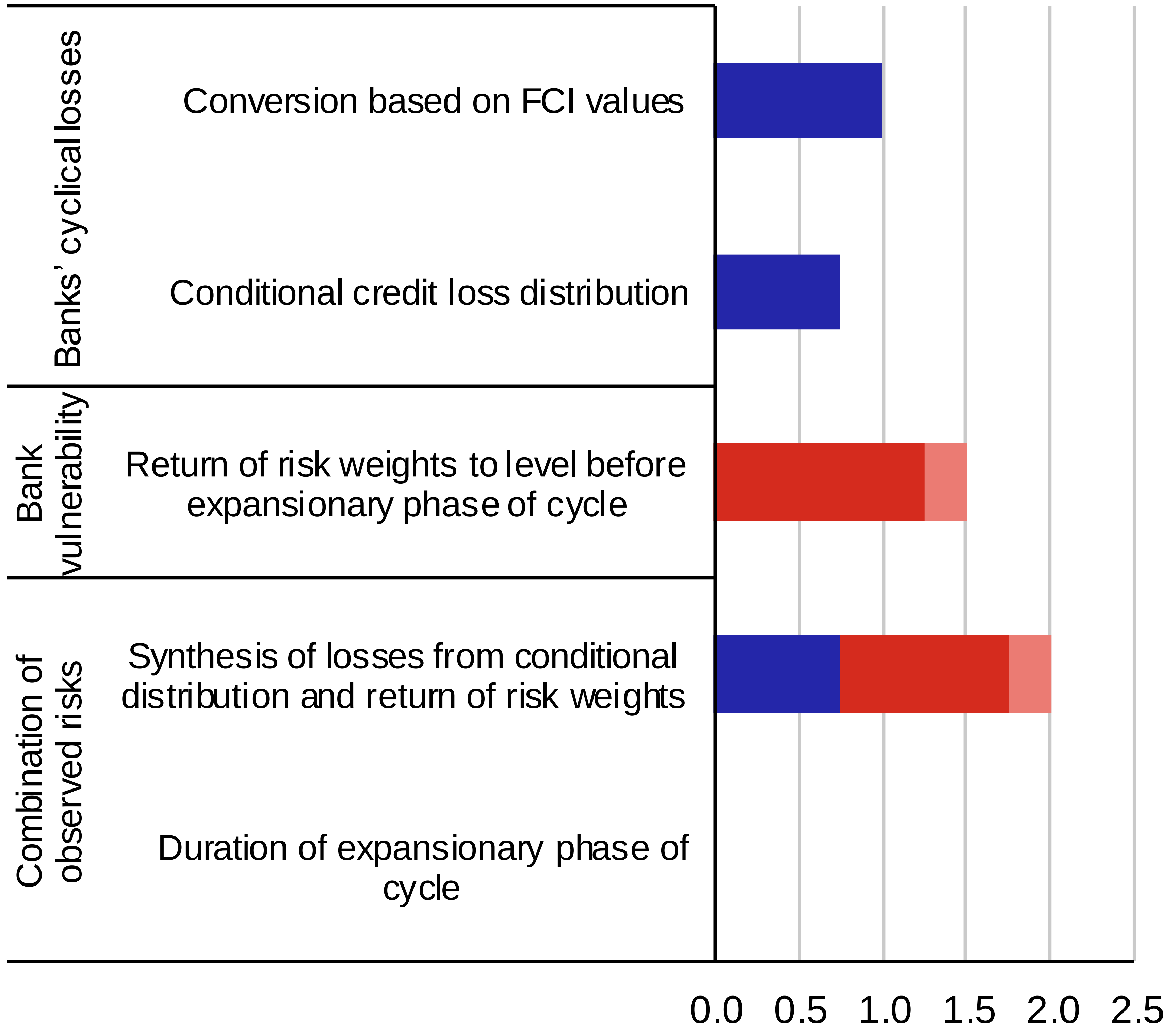


- With their current capitalisation, banks are able to withstand stress with no major problems (solid blue and red lines).
- In the **Baseline Scenario**, the sector's capital ratio declines to 20.9% (with no bank falling below the 8% regulatory minimum). In the **Adverse Scenario**, it decreases to 18.8% (with one bank falling negligibly below the 8% threshold).
- The capital ratios of almost all banks also remained above the overall capital requirement in both scenarios.
- The results also show that the level of the capital surplus may be crucial for maintaining banking sector stability in an adverse economic situation (dashed blue and red lines).

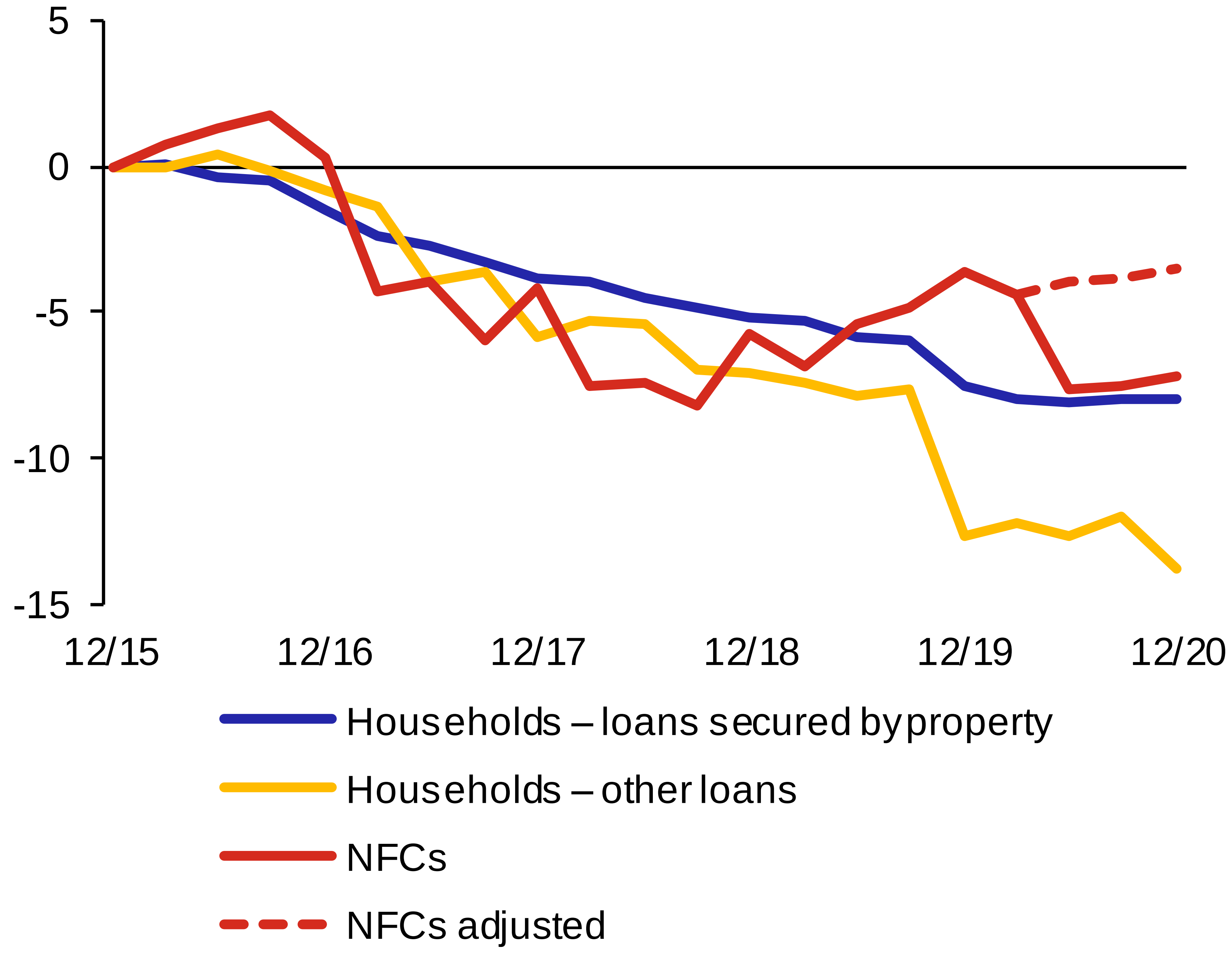
CCyB rate

- Quantitative approaches imply a need to set the CCyB rate at 1.75%.

CCyB rate covering financial cycle effects monitored
(% of total risk exposure)



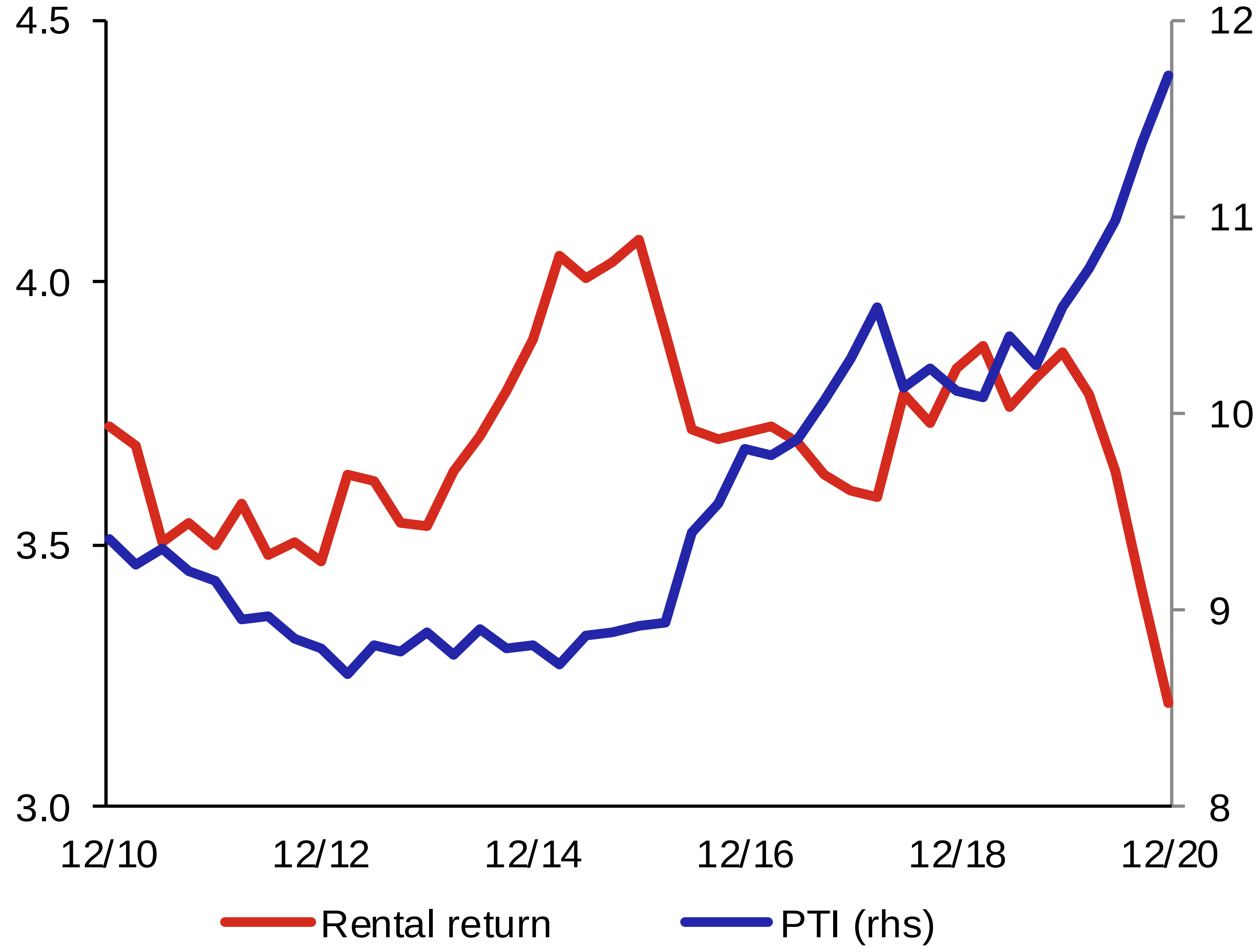
Change in risk weights compared with the start of the strongly expansionary phase of the financial cycle
(pp)



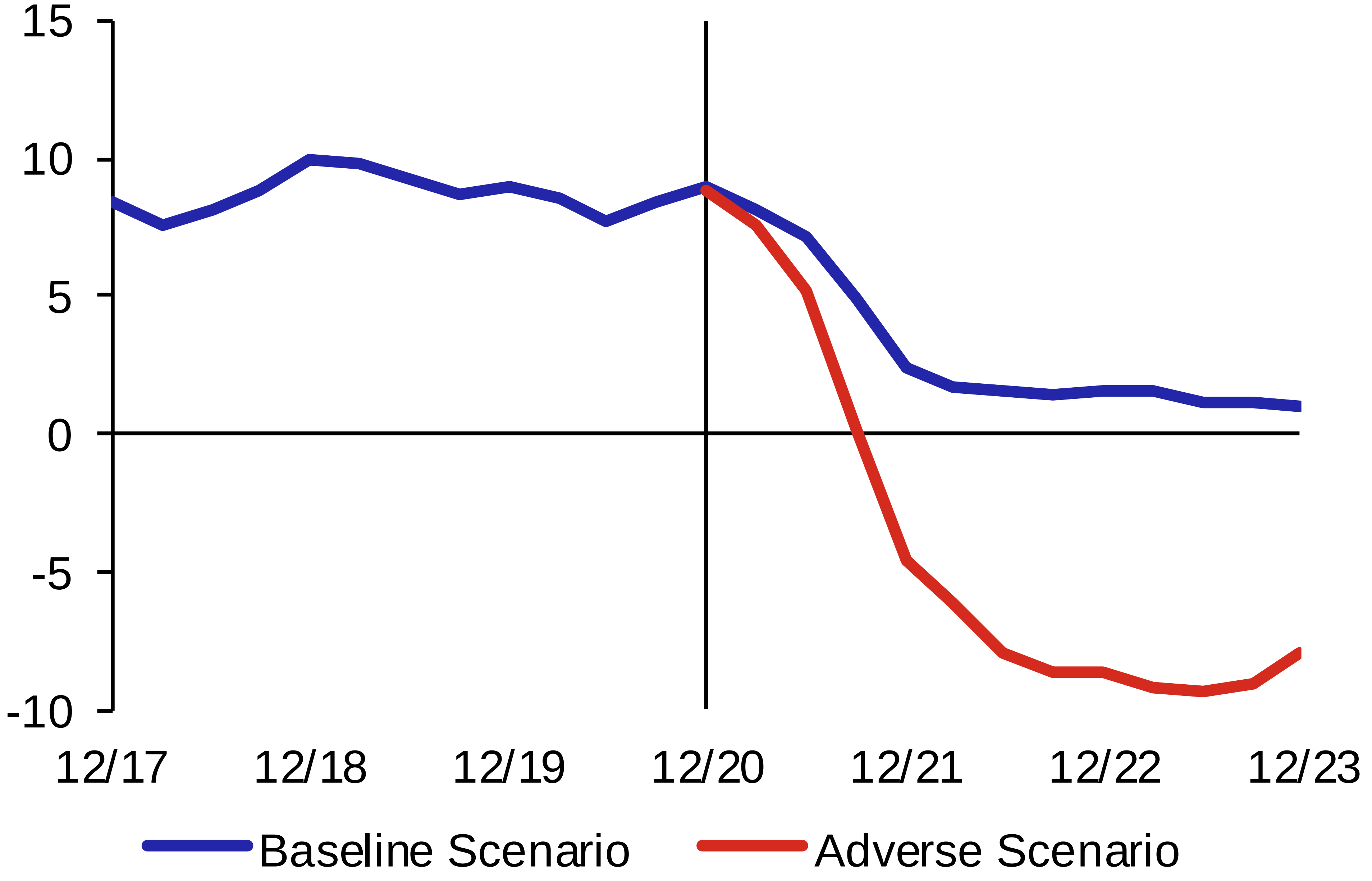
Residential property market

- Housing is becoming less affordable in the Czech Republic and rental returns are at historical lows.
- The **Baseline Scenario** foresees continued growth in house prices, albeit at a much slower pace.

Selected apartment affordability indicators
(PTI in years; return in %)



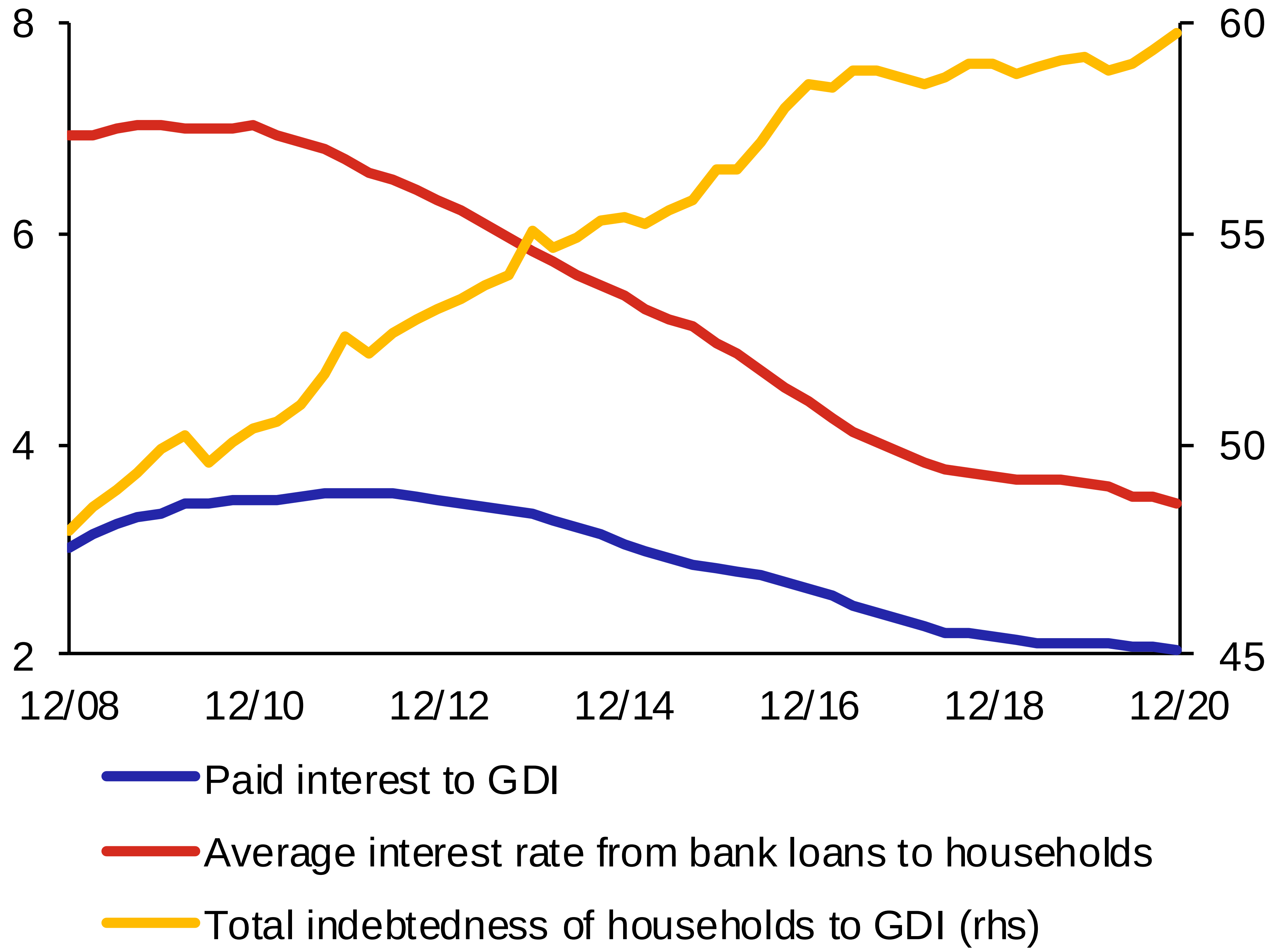
Alternative scenarios: residential property prices
(%)



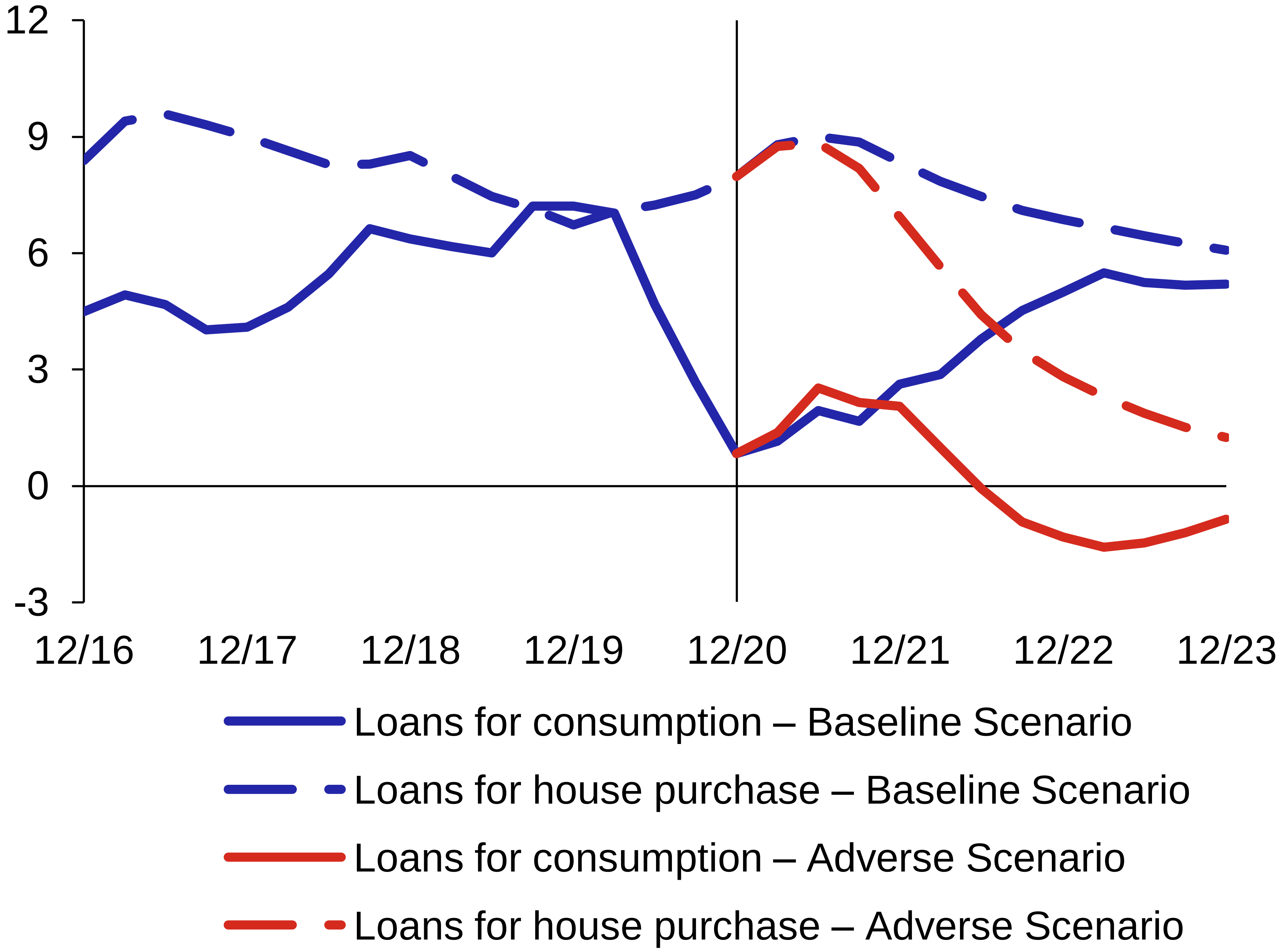
Loans to households and their outlook

- Relative household debt increased only slightly.
- The **Baseline Scenario** expects continued growth in the stock of housing loans, with a slowdown not occurring until 2022.

Indebtedness and interest paid by households
(%; right-hand scale: share in GDI in %)



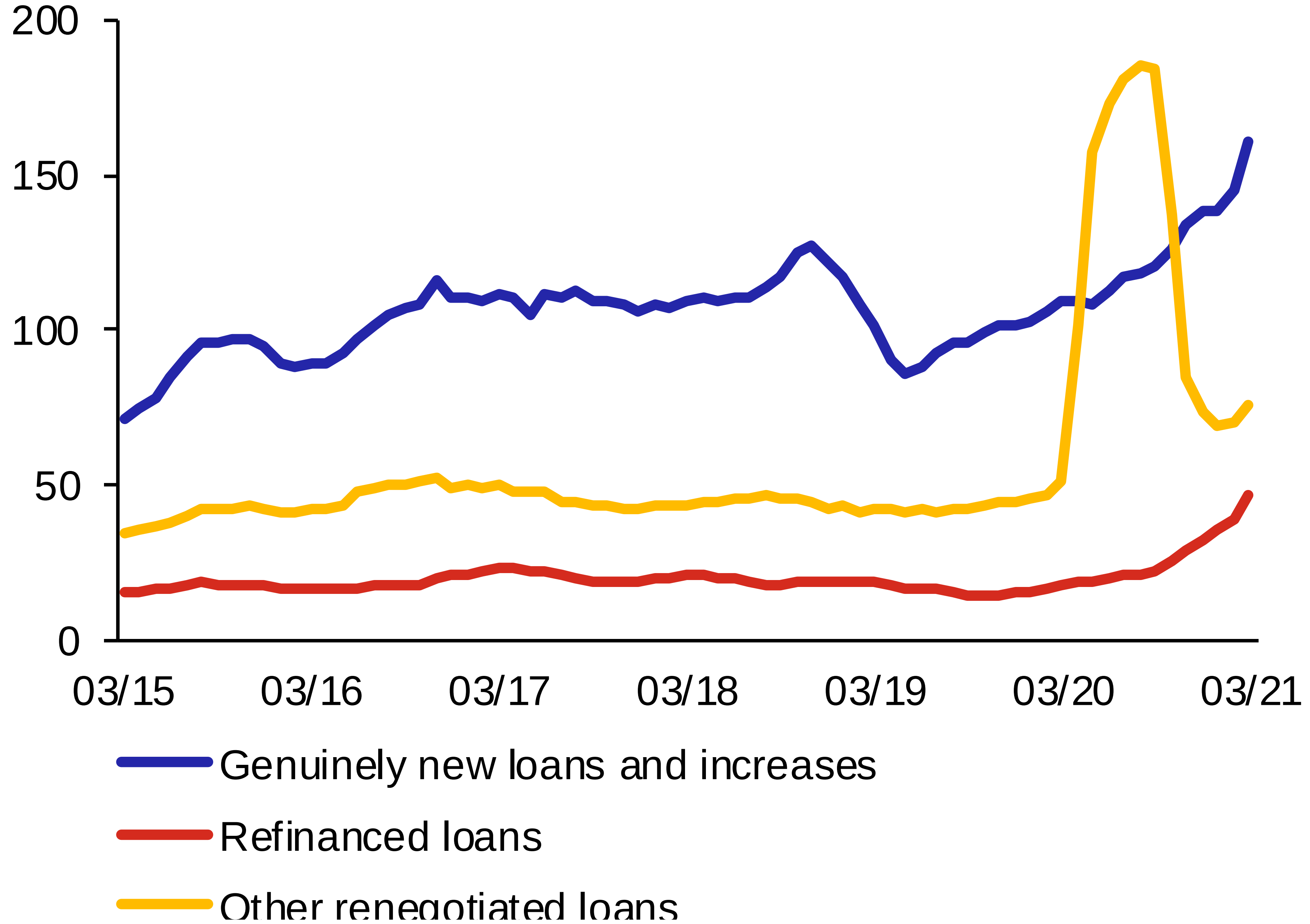
Bank loans in the household sector
(year-on-year in %)



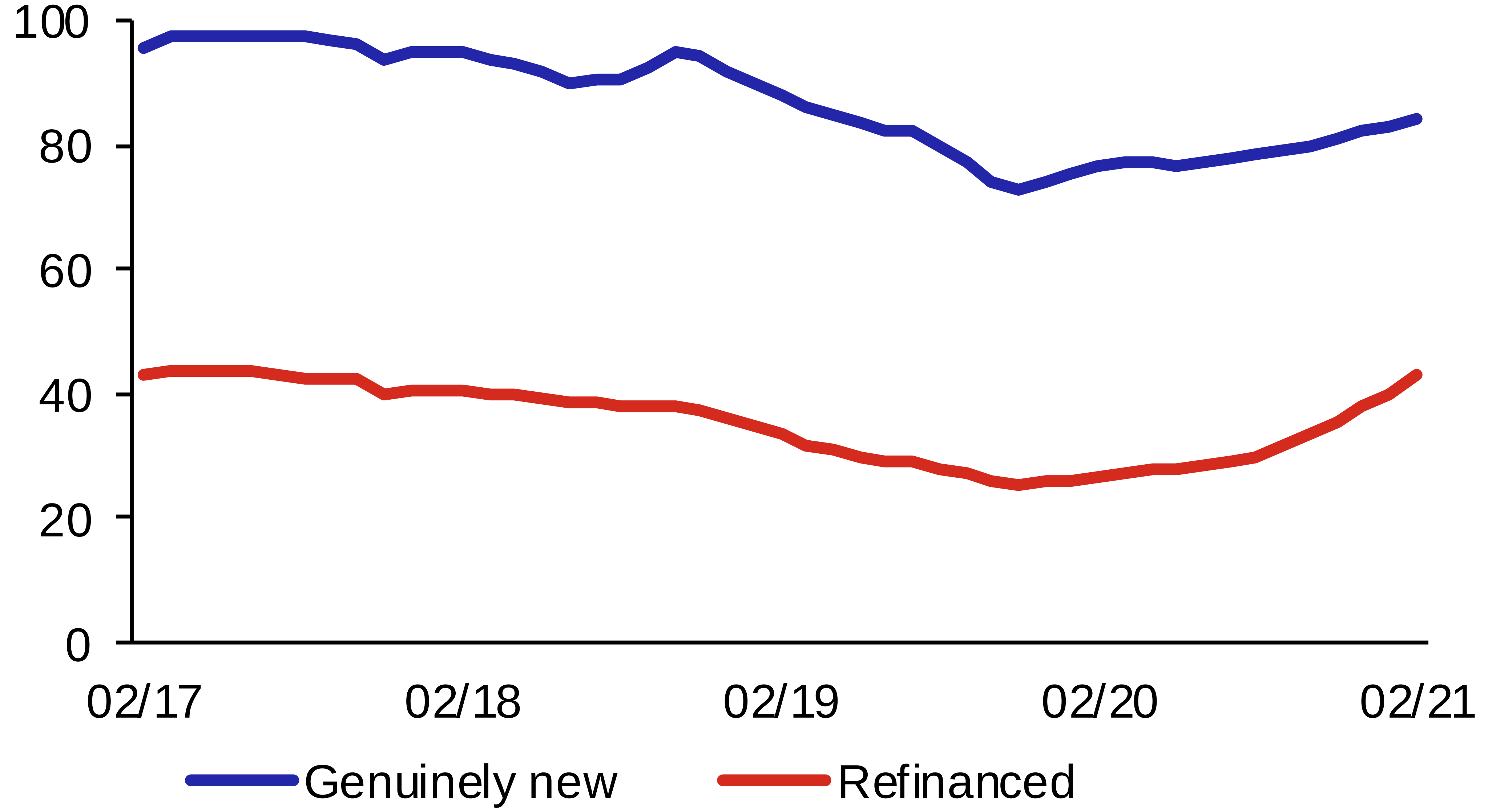
Mortgage loans

- The high volumes of genuinely new mortgage loans are due mainly to a marked rise in the average loan size.
    - The numbers of these loans were not beyond those common in previous years.

Six-month totals of components of new loans for house purchase
(CZK billions; moving six-month totals)

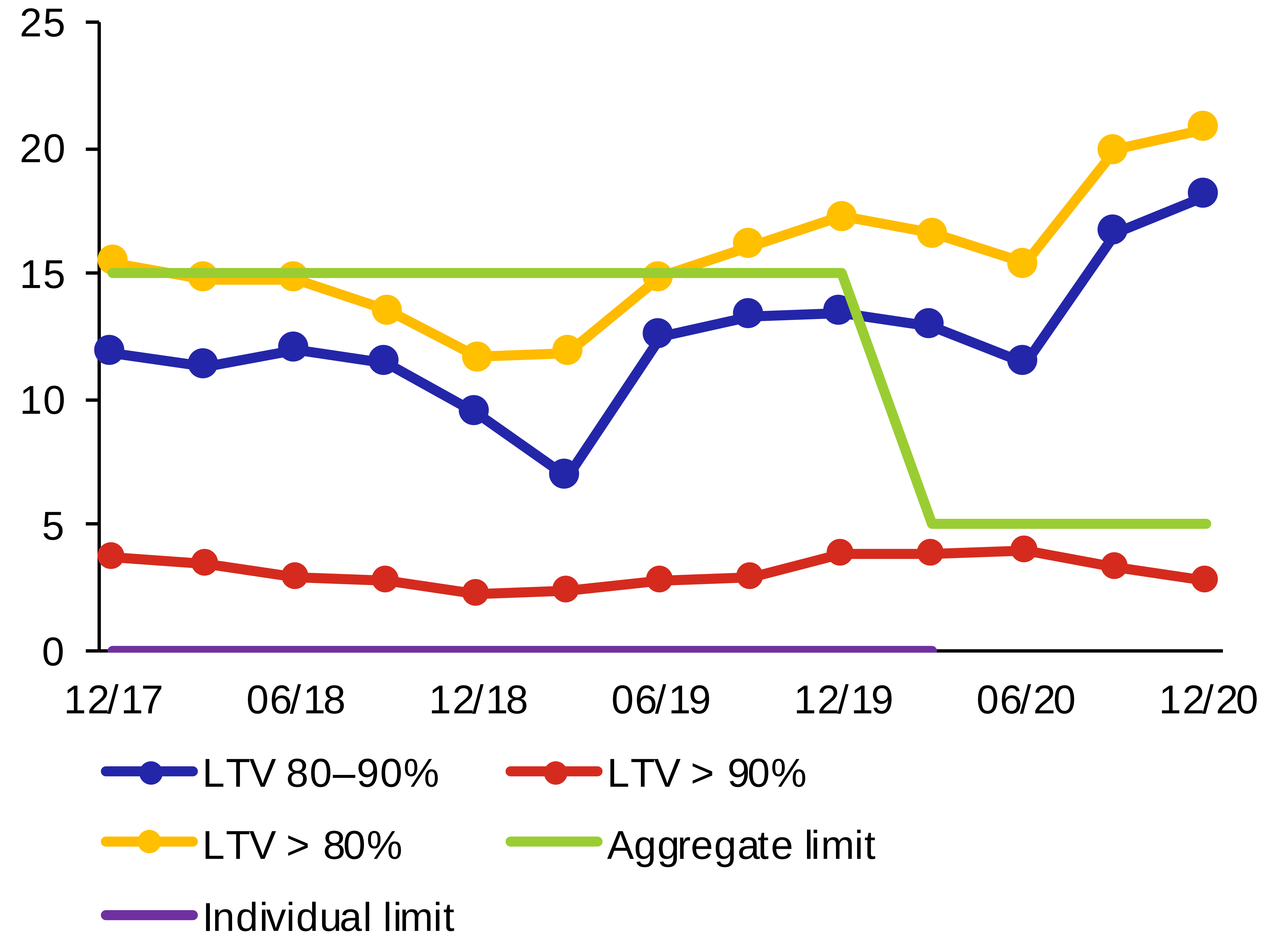


New mortgage loans
(Yearly moving averages in thousands of contracts)

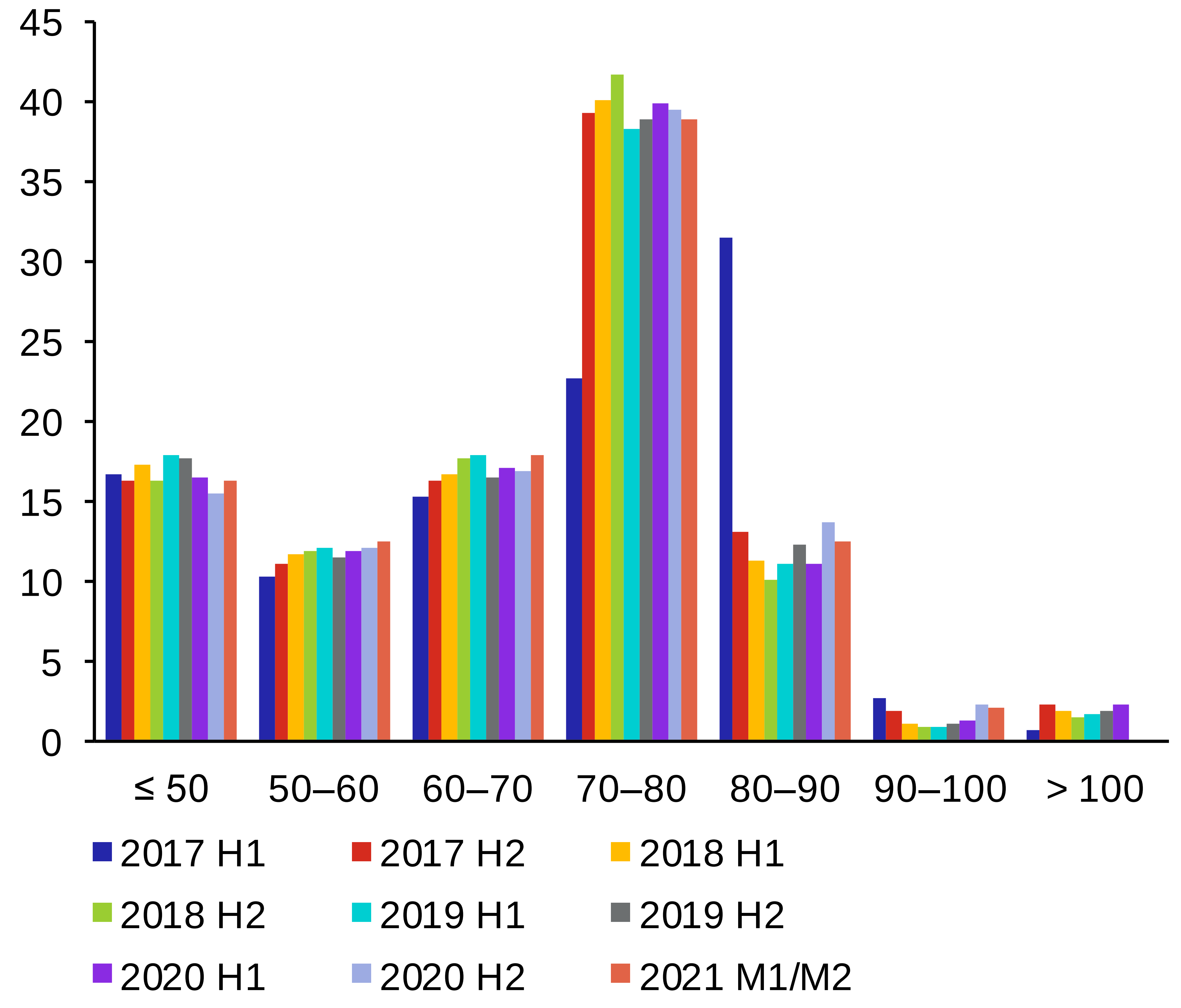


Compliance with LTV limit

Fulfilment of the recommended LTV limits
(share of loans in reference volume provided in %)

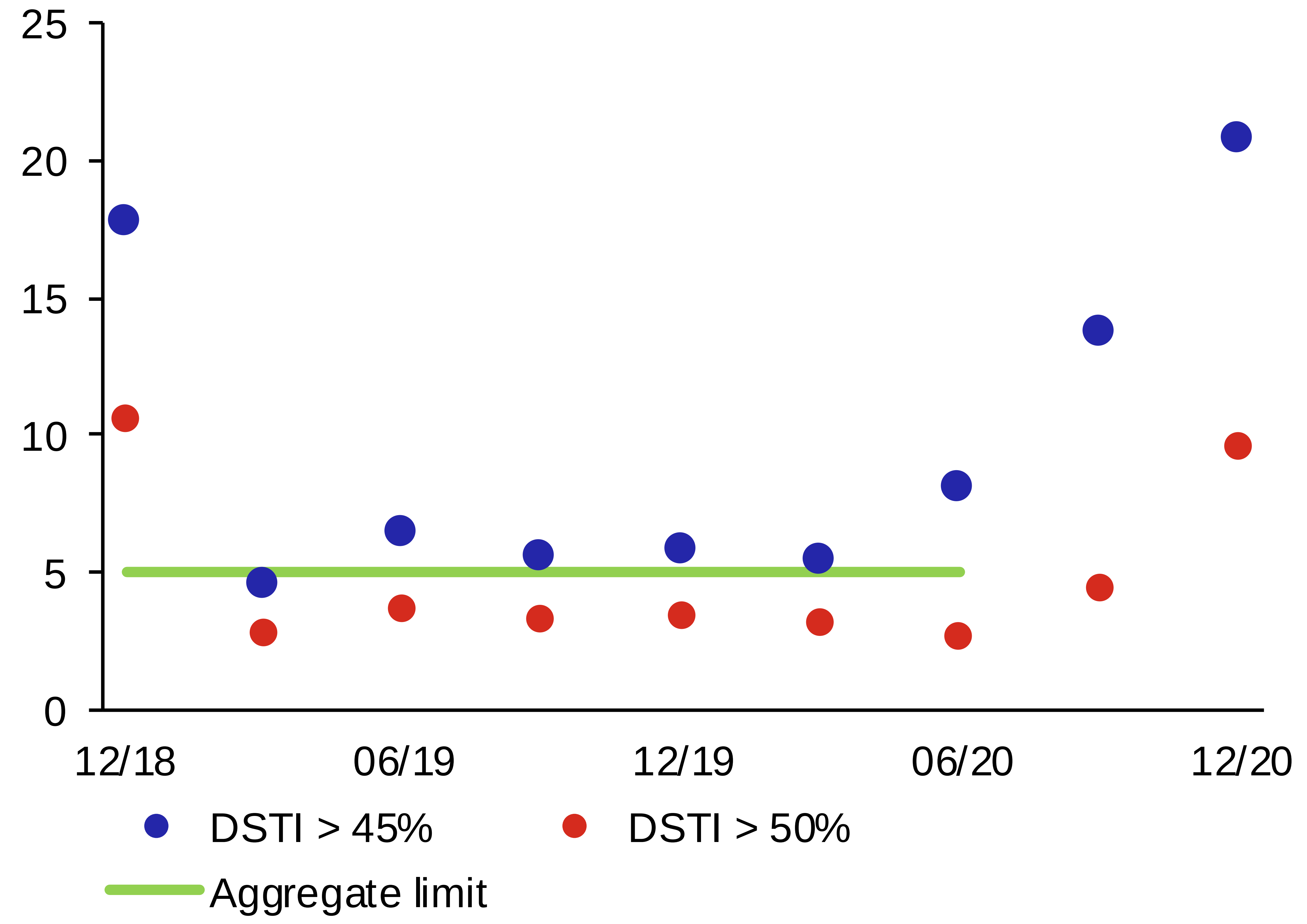


LTV distribution of loans
(x-axis: LTV in %; y-axis: share of loans in volume in %)

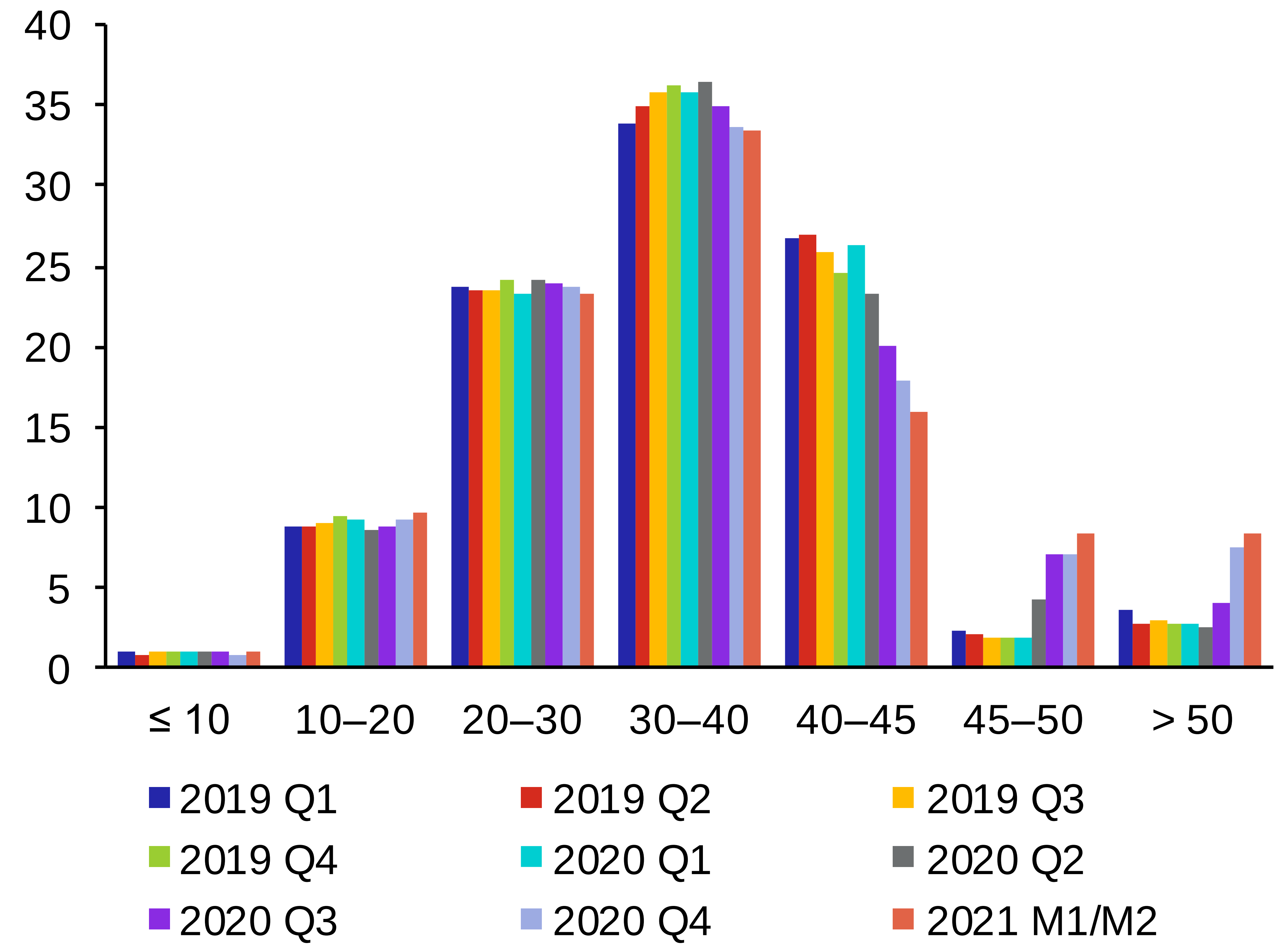


DSTI ratio

Fulfilment of the recommended DSTI limits
(share of loans in reference volume provided in %)

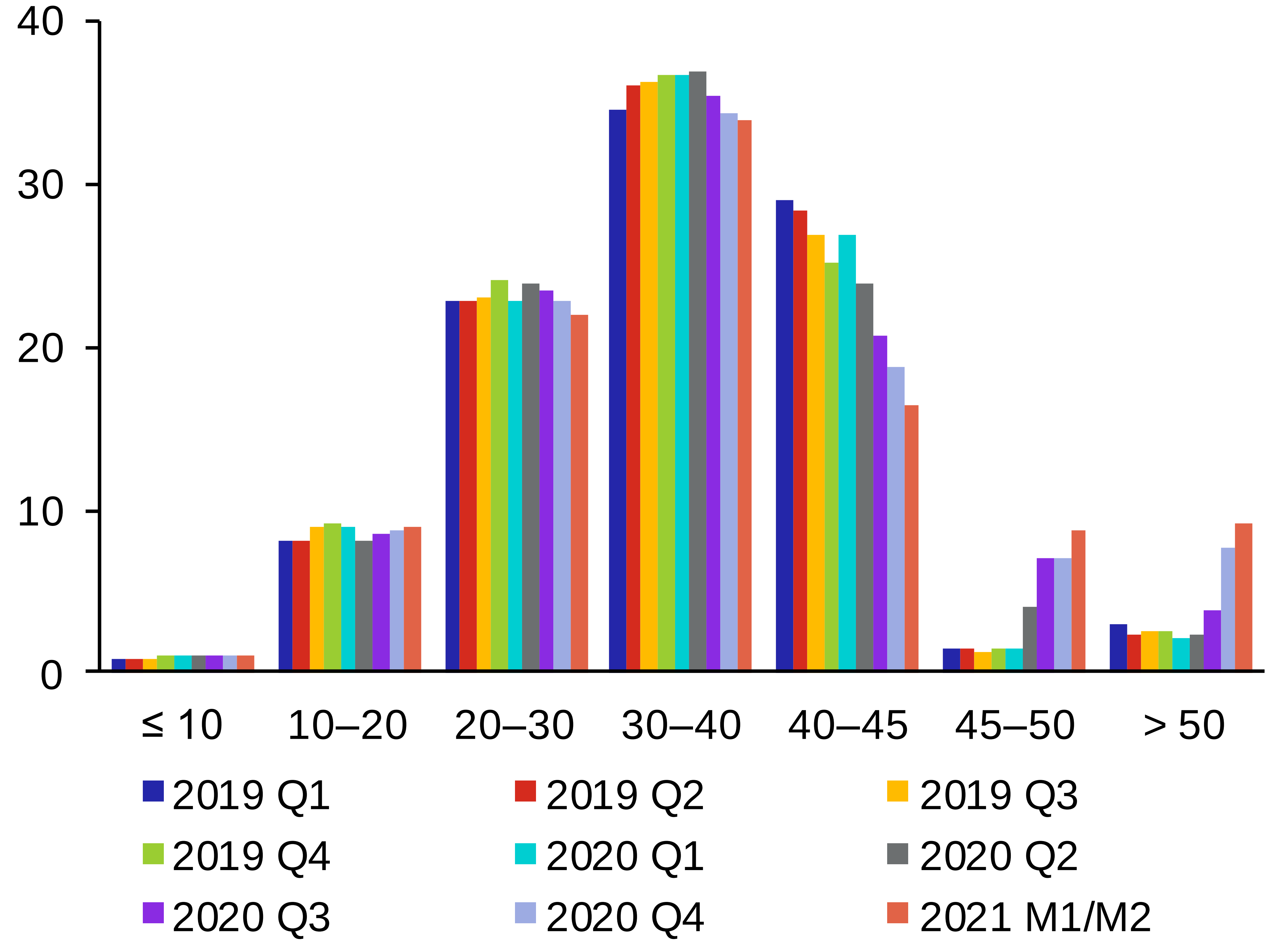


DSTI distribution of new loans
(x-axis: DSTI in %; y-axis: share of loans in volume in %)

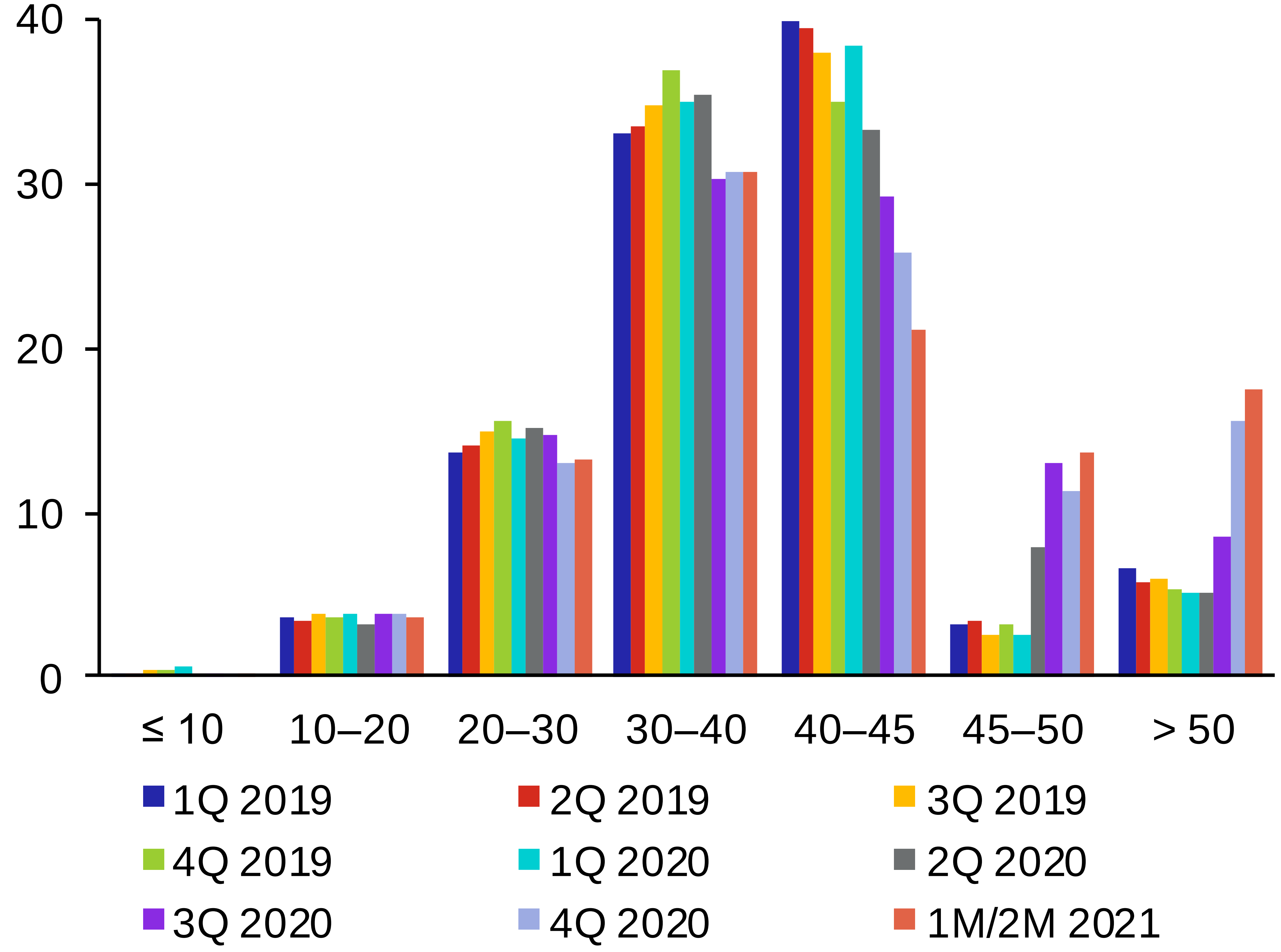


DSTI ratio

DSTI distribution of genuinely new loans
(x-axis: DSTI in %; y-axis: share of loans in volume in %)

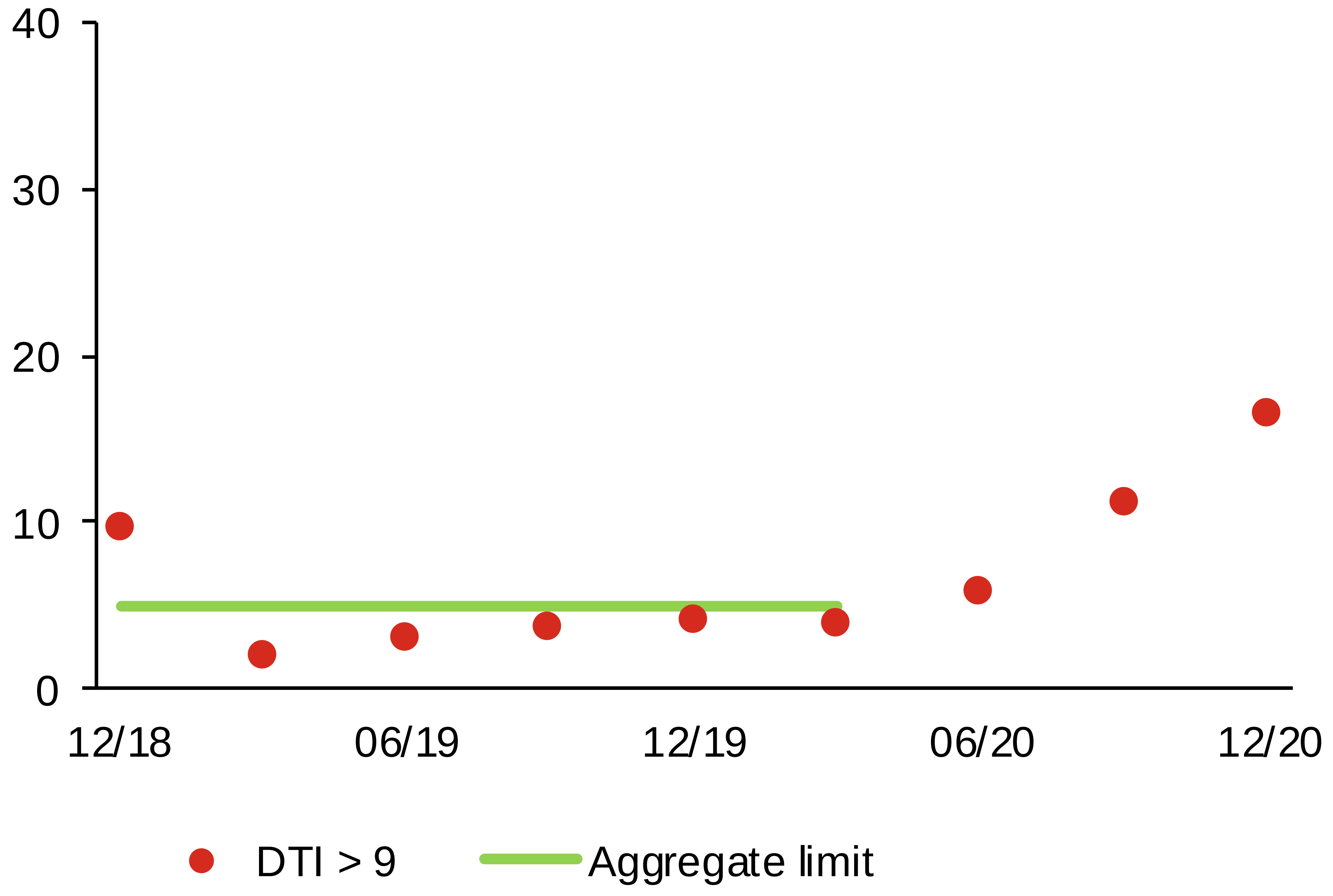


DSTI distribution of second and subsequent genuinely new mortgages
(x-axis: DSTI in %; y-axis: share of loans in volume in %)

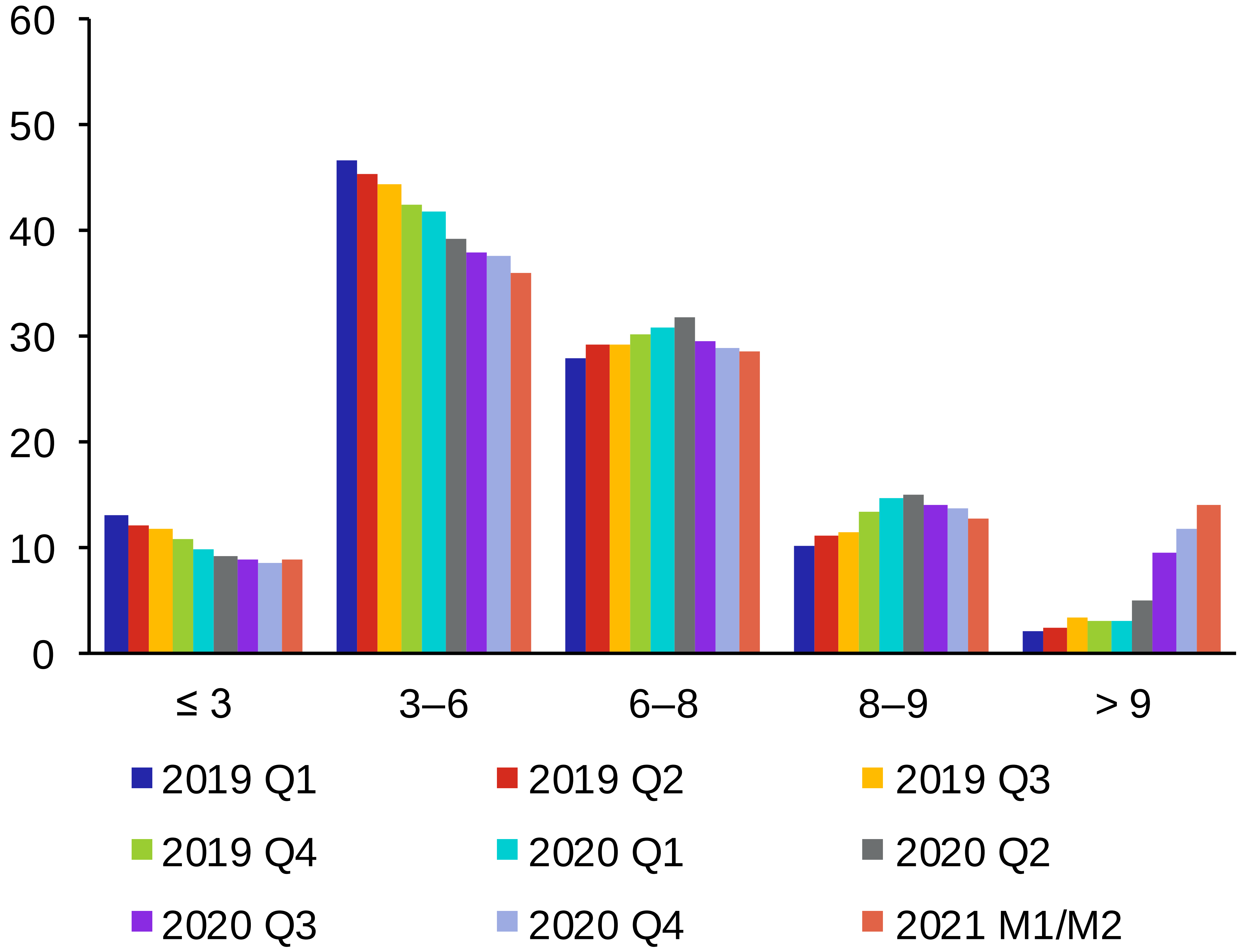


DTI ratio

Fulfilment of the recommended DTI limits
(share of loans in reference volume in %)

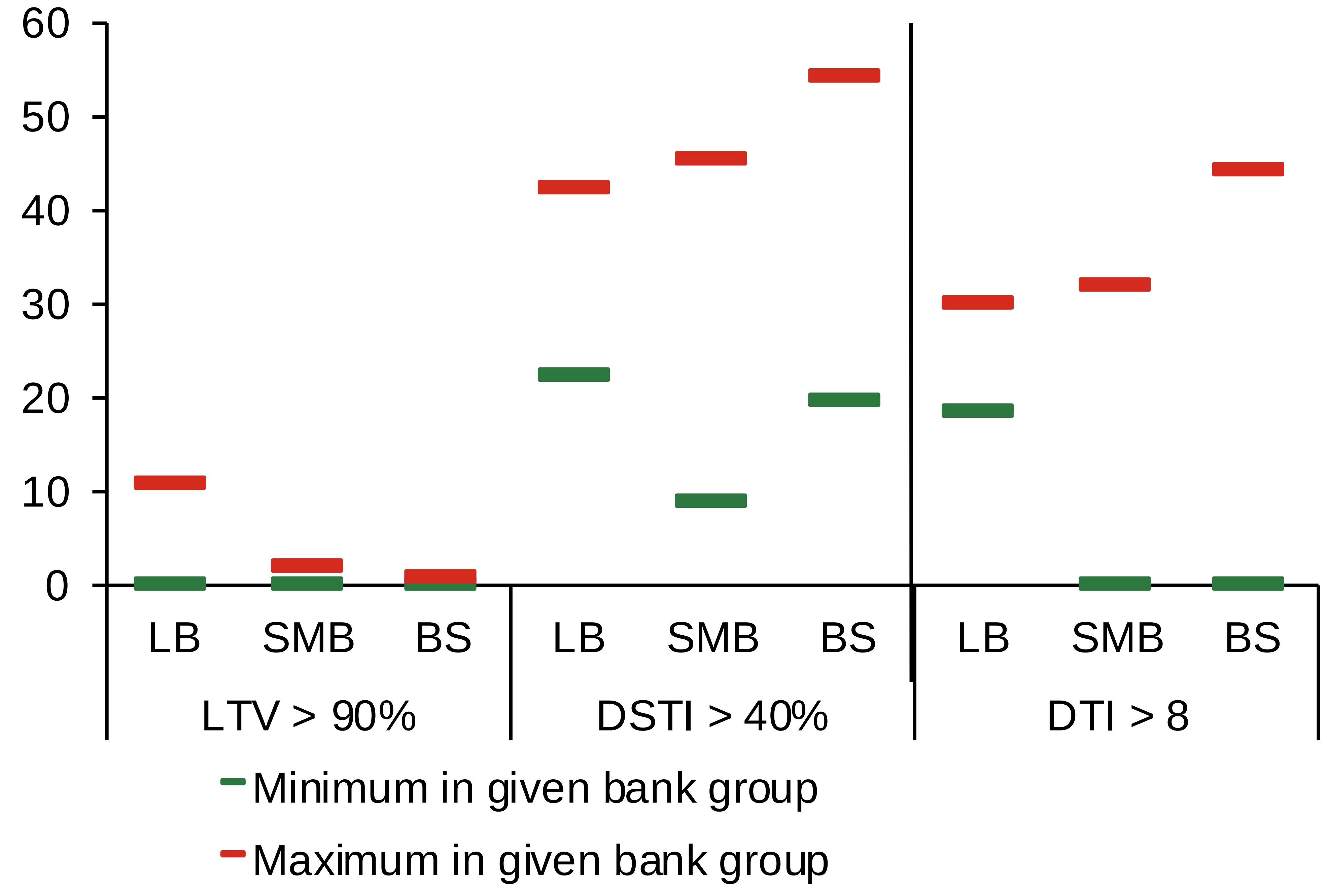


DTI distribution of new loans
(x-axis: DTI in years; y-axis: share of loans in volume in %)



Higher risk profile of mortgages provided by some lenders

Shares of loans exceeding risky LTV, DSTI and DTI levels by bank group in 2020 H2
(% of portfolio of loans for house purchase of given institution)



- Credit standards differ across lenders; some lenders have eased them substantially.
- There is a risk that the currently cautious lenders could react to a potential loss of their market share by easing standards towards the levels applied by their more aggressive competitors.
- The CNB will respond to the fact that the share of new loans with highly risky DTI and DSTI ratios has increased markedly for some lenders using microprudential supervision instruments, such as an additional Pillar 2 capital requirement for risk management systems.

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Thank you for your attention

The following will be published on the CNB website on 15 June 2021:

- *Financial Stability Report 2020/2021*
- *The minutes of the Bank Board meeting on financial stability issues*