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CZECH REPUBLIC

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Prague, 16 June 2015

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NOTIFICATION

of the setting the countercyclical capital buffer rate for the Czech Republic II/2015 applicable from 1 July 2016

The Czech National Bank decided at the meeting of its board of 21 May 2015 that the countercyclical capital buffer rate for the Czech Republic shall be set at 0% of the total risk exposure. Banks, credit unions and investment firms shall apply this rate for the purposes of calculating the combined buffer requirement as from 1 July 2016. The decision was published by means of provision of a general nature on 16 June 2015.

Justification for the decision:

1. Pursuant to Article 12f(3) of the Act on Banks, Article 8ac(3) of the Act on Credit Unions and Article 9ac(3) of the Capital Market Undertakings Act, the Czech National Bank shall set the countercyclical capital buffer rate for the Czech Republic, taking into account the countercyclical capital buffer guide calculated pursuant to Article 12f(1) and (2) of the Act on Banks, Article 8ac(1) and (2) of the Act on Credit Unions and Article 9ac(1) and (2) of the Capital Market Undertakings Act, the recommendations issued by the European Systemic Risk Board (ESRB) and any indicators that can identify growth in systemic risk. Pursuant to Article 12f(1) of the Act on Banks, Article 8ac(1) of the Act on Credit Unions and Article 9ac(1) of the Capital Market Undertakings Act, the buffer guide is based on the deviation of the credit-to-GDP ratio from its long-term trend – the credit-to-GDP gap. Pursuant to Article 12f(2) of the Act on Banks, Article 8ac(1) and (2) of the Act on Credit Unions and Article 9ac(1) and (2) of the Capital Market Undertakings Act, when calculating the buffer guide the Czech National Bank shall take into account in particular the credit cycle and growth in loans provided in the Czech Republic, changes in the credit-to-GDP ratio, the specificities of the Czech national economy and the recommendations issued by the ESRB.

2. In accordance with the ESRB Recommendation¹, total credit means the value of all loans provided to the private sector (non-financial corporations, households and non-profit institutions serving households) plus the volume of bonds issued by the domestic private sector. The time series of 1995–2014 and – in line with the ESRB Recommendation – the Hodrick-Prescott filter with a smoothing parameter (λ) of 400,000 were used to calculate the long-term trend. The standardised credit-to-GDP ratio was 77.7% and its deviation from the long-term trend 6.0 percentage points in 2014 Q4. These values imply setting the benchmark countercyclical capital buffer rate pursuant to Article 12f(1) and (2) of the Act on Banks, Article 8ac(1) and (2) of the Act on Credit Unions and Article 9ac(1) and (2) of the Capital Market Undertakings Act at 1.25%. In reaction to the ESRB recommendation, however, the Czech National Bank has repeatedly emphasised in its publications (particularly the Financial Stability Report) that the said calculation method is not appropriate for the Czech economy in view of its specificities and so cannot be taken into account in full when deciding on the rate. The specific features of the Czech economy include the limited length of the time series of the credit-to-GDP ratio, structural (non-cyclical) breaks caused by the banking crisis in the late 1990s and trends typical of converging economies. For this reason, when setting the countercyclical capital buffer rate the Czech National Bank prefers to apply an approach based on a wider set of indicators and taking account of the specific features of converging economies rather than applying the above-mentioned mechanical rule.

3. The estimate of the long-term trend of the credit-to-GDP ratio used to calculate the buffer guide is affected mainly by the fall in loans recorded in the late 1990s and at the start of the 2000s. This was caused by write-offs of non-performing loans from banks' balance sheets. The Czech National Bank therefore deems it necessary to calculate the additional deviation of the credit-to-GDP ratio from its long-term trend based on a shorter time series which does not include periods with write-offs of non-performing loans (i.e. on the time series starting in 2004). The deviation of the trend calculated in this way was -3.4 percentage points in 2014 Q4 and implies a zero countercyclical capital buffer rate. At present, this indicator better characterises the position of the Czech economy in the financial cycle.² Despite this, its values should be regarded only as indicative, and a more comprehensive assessment of the situation based on other relevant indicators should be taken into account when setting the rate.

4. The overall credit market situation is characterised by a moderate recovery. In March 2015, the annual growth rate of bank loans to non-financial corporations was 3.0% and that to households was 4.5%. Both these figures are still below the ten-year average, and the estimate of future growth in bank lending to the private sector contained in Financial Stability Report 2014/2015 does not currently indicate any risk of excessive credit expansion. The lending activity of non-bank intermediaries is also generally subdued: loans to non-financial corporations and households rose by 3.4% and 2.1% year on year in 2014 Q4, respectively.

5. None of the other indicators are at elevated risk levels either. The speed of private sector borrowing relative to income is low by comparison with the pre-crisis period, and total debt service does not represent an excessive burden from the aggregate perspective. The recovery on the residential property market was modest during 2014 and residential property prices are close to their equilibrium values according to the Czech National Bank's analyses. The Czech National Bank does not expect excessive growth of residential property prices over the next few years either. A slight increase in optimism on capital markets is visible following the launch of quantitative easing by the ECB. More importantly, the evolution of the bank lending conditions suggests strengthening tendency of the Czech economy to move towards an expansionary phase of the financial cycle. On the other hand, such strengthening is not identified in other segments of cyclical risks. As a consequence, other tools will be used

¹ Recommendation of the European Systemic Risk Board of 18 June 2014 on guidance for setting countercyclical buffer rates (ESRB/2014/1).

² See the comparison of the indicators of excessive borrowing and accumulation of risks in Table IV.3 in Financial Stability Report 2014/2015.

instead of the countercyclical capital buffer to mitigate the arising fractional risk.³ An aggregate indicator of the financial cycle⁴ combining the above indicators and taking into account their mutual correlation confirms that the Czech economy is still close to the bottom of the financial cycle and the credit recovery is still moderate. Taking into account the additional deviation of the credit-to-GDP ratio from its long-term trend and the other relevant indicators, the value corresponding to the guide for setting the countercyclical capital buffer rate according to the ESRB Recommendation⁵ is 0%.

6. Overall, the indicators that can identify growth in credit risk can be assessed as suggesting that the Czech economy is currently in a phase of incipient recovery in the financial cycle. The credit market situation still does not indicate signs of over-optimistic expectations and the taking on of excessive credit risk. The current level of the time dimension (cyclical source) of systemic risk is still low and does not require the creation of a countercyclical capital buffer for exposures located in the Czech Republic. The Czech National Bank has therefore decided to set the countercyclical capital buffer rate for exposures located in the Czech Republic at 0%. Given the current predictions of future credit growth and developments on the relevant markets, a zero countercyclical capital buffer rate will probably be applied in the next two years as well. However, this probability has decreased as a result of a recovery in credit growth, an easing of bank credit standards and a slight improvement in investment sentiment.

7. The institutions shall apply this rate as from 1 July 2016.

Should there be a need for further explanation, please feel free to contact myself: Jan Frait, Executive Director, Financial Stability Department (Jan.Frait@cnb.cz, +420-224414430).

Yours sincerely

³ See section 4.4 of Financial Stability Report 2014/2015.

⁴ The indicator is described in detail in the article *An indicator of the financial cycle in the Czech economy* published in Financial Stability Report 2013/2014 (pp. 118–127).

⁵ Recommendation B(4).