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### What drove the rise in bank lending rates in Lithuania during the low-rate era?

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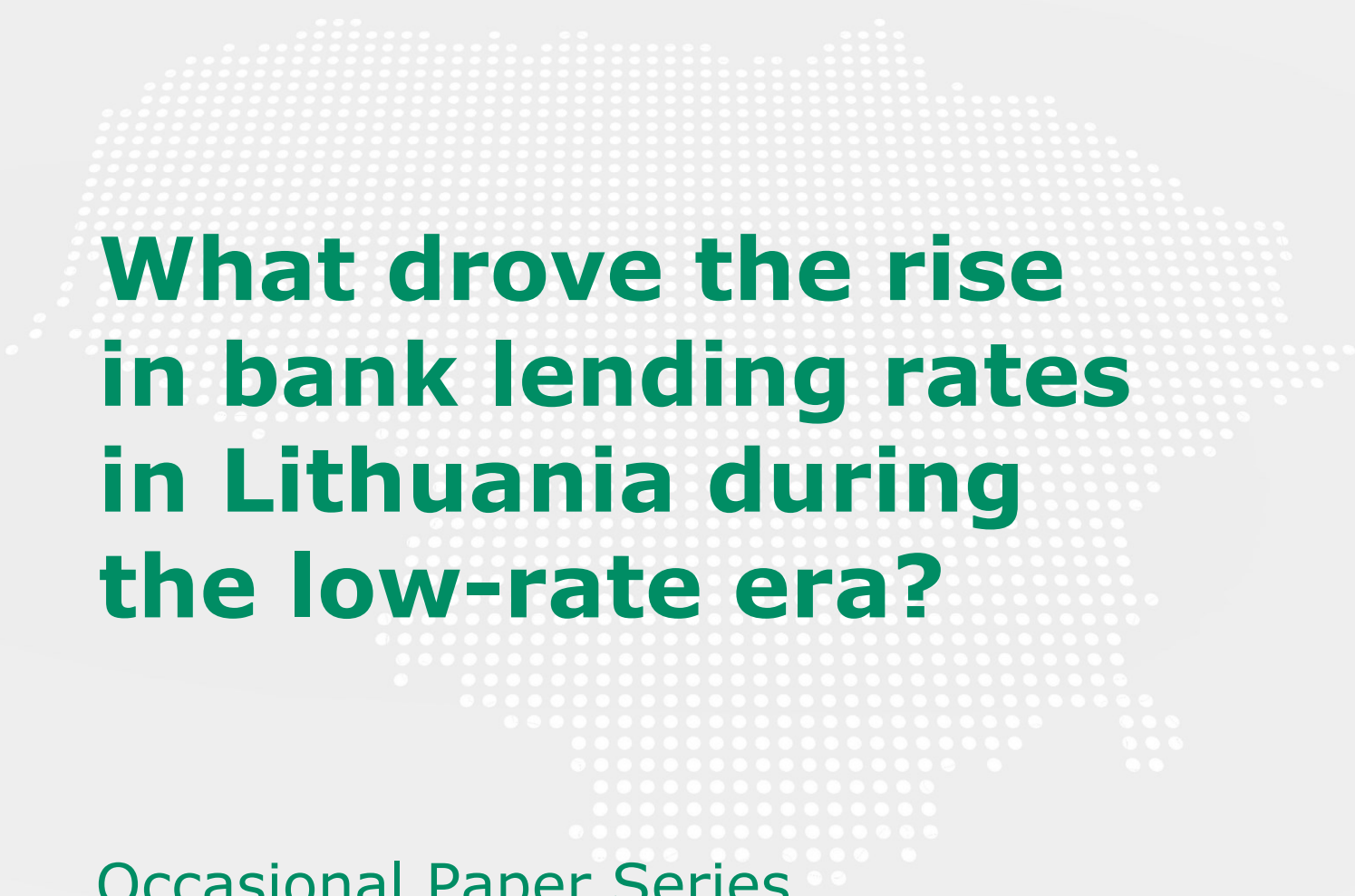
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# **What drove the rise in bank lending rates in Lithuania during the low-rate era?**

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# What drove the rise in bank lending rates in Lithuania during the low-rate era?

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## **ABSTRACT**

While Euro area interest rates were responding to accommodative monetary policy and decreasing throughout 2015-19, in stark contrast, Lithuania's bank lending rates increased. Although the rates have slightly dropped around the onset of the pandemic, they are still elevated and well above the EA figures. This paper calls into question, what were the drivers of such interest rate dynamics in Lithuania? By analysing the historical events and practical aspects of loan pricing in Lithuania's banking industry, we build an empirical model that exploits lending rate variation across banks, time and lending segments, and maps it to different drivers of pricing. We find that the recent changes in lending rates can be attributed to average bank margins, which moved largely in response to changes in market concentration.

Keywords: interest rates, loan pricing, banking, concentration, capital requirements.

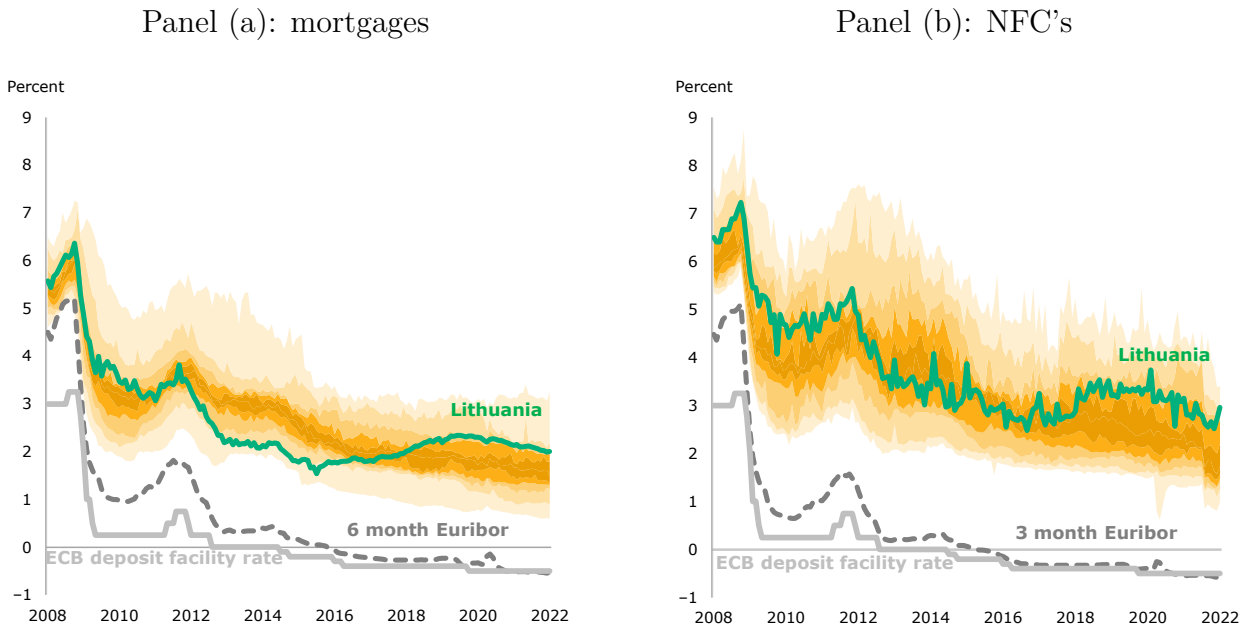
JEL: D22, D40, E43, G21, L11.

# 1 Introduction

The great shift in monetary policy stance since the Global Financial Crisis has created a low interest rate environment, where businesses, households, and governments can fund their activities at historically cheap rates. As monetary policy further eased throughout 2015-19 and the ECB deposit facility rate went below zero, so did the interbank Euribor rate, putting downward pressure on retail lending rates. For example, Euro area (EA) average mortgage interest rates decreased from 2.4% to 2%, and lending rates for non-financial corporations (NFC, up to 1 M EUR) went from 3% to 2.7%.<sup>1</sup>

Contrary to most EA countries, between 2015 and 2019 Lithuania experienced a pick-up in mortgage and corporate lending rates, thereafter having one of the highest rates in the EA (see Figure 1 below). In fact, during this period, Lithuania's average mortgage interest rate, being the 2nd smallest in the EA and equalling 1.5%, increased to 2.3% – becoming the 5th largest. In a similar fashion, albeit less extreme, interest rates for NFC's increased from 2.9% to 3.4%, and rank-wise moved from the 6th smallest to the 5th largest in the EA. Interestingly, during the second half of 2019 and throughout the Covid-19 pandemic, Lithuanian lending rates started falling and returned to the 2018 levels. However, the rates are still elevated above the 2015 figures and, more importantly, well above the EA median.

Figure 1: Loan interest rates in Lithuania and the EA



Notes: loan (granted in EUR) interest rates for mortgages and NFC's (up to 1 M EUR) for Lithuania are in green. The distribution of interest rates of other EA countries is in yellow.

The aforementioned recent pick-up in Lithuania, which contrasts to other EA countries' experience, deserves notice, as it is important from at least two angles. First and foremost, if the lowered key ECB rates are not fully passed through to the borrower, monetary policy

<sup>1</sup>The terms mortgage, housing loan and loan for house purchase will be used interchangeably. Likewise, for NFC loans we will also use terms such as corporate, commercial or business loans.

transmission mechanism may be dysfunctional.<sup>2</sup> Second, interest rate levels and their variability have significance from the financial stability perspective. For example, rising interest rates may have a countercyclical effect on the expansion of credit and asset prices, potentially dampening bubble formation, however, it leaves borrowers vulnerable. Future rises of ECB policy rates would increase Euribor and top up the heightened margins, amplifying their effect and putting debtors at risk.

The widened gap between loan interest rates and the Euribor suggests that bank lending margins were heightened, what may be linked to concurrent increases in market concentration and bank capital requirements. However, there may be other factors that were at play, such as high loan demand, increased lenders' perception of credit risk, or even the negative deposit facility rate.

In this paper, we comprehensively investigate the recent mortgage and NFC interest rate pick-up by looking at the history of lending rate dynamics and the concurring events that may have shaped it. On the basis of some practical aspects of loan pricing in the banking industry, as well as a stylised model of interest rate setting, we estimate a bank-segment-level panel data model for lending margins. The model relates the historical lending margin variation across banks and different loan segments, including mortgages, NFC loans, consumer and other loans, to pricing determinants, such as funding costs, market concentration, capital requirements and others. The inclusion of consumer loans in our analysis is very important, as their lending margin dynamics was entirely different from other loan segments throughout 2015-19. Specifically, while the NFC and mortgage rates increased along with increasing market concentration, consumer rates were falling together with consumer lending concentration. By exploiting this cross-segment variation, we can better infer about the impact of concentration and other potential factors.

We find that although capital requirements may have elevated lending rates by on average 0.1 p.p., the primary driver behind the interest rate rise in 2015-19 and the subsequent fall is market concentration, which may have altered lending structure and bank conduct. While other factors played a limited role, the reduced number of competitors and high credit demand have created favourable conditions for bank management to seek higher returns, and thus to raise the lending rates. The findings for the business segment are approved by a loan-level pricing model, which suggests that the rise in NFC rates cannot be explained by loan quality, however, it can be mostly attributed to the reduction in the volume of lending by competitors.

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<sup>2</sup>The literature on interest rate pass-through, which considers how monetary policy and reference rates are transmitted to lending rates, is quite large and the results are varied by country. For example, Leroy and Lucotte (2015) study a panel of EA countries and find a significant degree of heterogeneity in pass-through across countries, which can be explained by structural factors, such as level of banking competition or development of financial markets. Similarly, a meta analysis carried out by Gregor et al. (2021) suggests that the pass-through is impacted by country's macro-financial and institutional factors, depth of capital markets and central bank independence. Although the literature on pass-through is related to our topic, we do not consider the estimation of money market rate pass through, as money markets play a limited role in Lithuania's banking industry, which is mostly retail funded. Moreover, the vast majority of loan contracts use variable rate, which is directly tied to the Euribor rate, implying a one-to-one pass-through, also confirmed by a bank-level error-correction analysis of Naruševičius (2017). We rather focus on deconstructing potential drivers behind the lending rate rise, which occurred over 2015-19.

The paper is organised as follows. Section 2 discusses the historical dynamics of interest rate margins and its potential determinants. Section 3 looks into the practical aspects of loan pricing and describes a stylised model, upon which Section 4 builds an empirical model and discusses its results. Lastly, we conclude by summarising our findings.

## 2 Bank interest rate margins in Lithuania

Lithuanian banking industry can be best characterised as a traditional banking business that accepts deposits and issues loans.<sup>3</sup> The banking profits are mainly generated from the lending business and strong fee and commission revenue, bolstered by high efficiency and relatively low loan impairment levels. Asset structure is mainly comprised of mortgages (30%), loans to NFC's (29%), cash and central bank reserves (20%) and consumer loans (9%), based on 2019 data. As per the liabilities side in 2019, retail deposits were the dominant form of funding, amounting to around 80% of total assets, with bonds share being less than 1%.

Bank subsidiaries and branches from the Nordic region have historically had the strongest foothold compared to domestic banks, as in the other two Baltic countries. During the boom of the 2000's, the banking sector heavily relied on wholesale funding from the Nordic parent banks. While foreign-bank deposits were as high as 45% of total banking assets in 2008, this source of funding became negligible over time, now amounting to around 1%.

Regarding the lending rates in Lithuania, they may be either variable or (semi-)fixed.<sup>4</sup> However, variable rates are most prevalent and became even more so in the low-rate environment, amounting to around 98% of new loan issuance. The rates are contractually arranged as a mark-up over a zero-floored reference rate, such as the Euribor.<sup>5</sup> The latter varies over the life cycle of the loan and is usually reset at 6-month or 3-month intervals. Since the Euribor rate is exogenous and taken as given, banks have direct influence only over the non-variable part of the rate, namely the margin, which is our main focus hereafter. The historical dynamics of average lending margins is depicted in Figure 2.

### 2.1 Pre-2015 period

Up until mid-2015 the history of loan margin rates can be loosely split into three periods: low-margin, recessionary and normalisation.

The **low-margin period** can be highlighted by financial deepening, fierce competition, risk-taking behaviour and under-pricing of risks by credit institutions, what also contributed to the boom-and-bust cycle of the 2000's.<sup>6</sup> The expansion of inexpensive credit has been enabled

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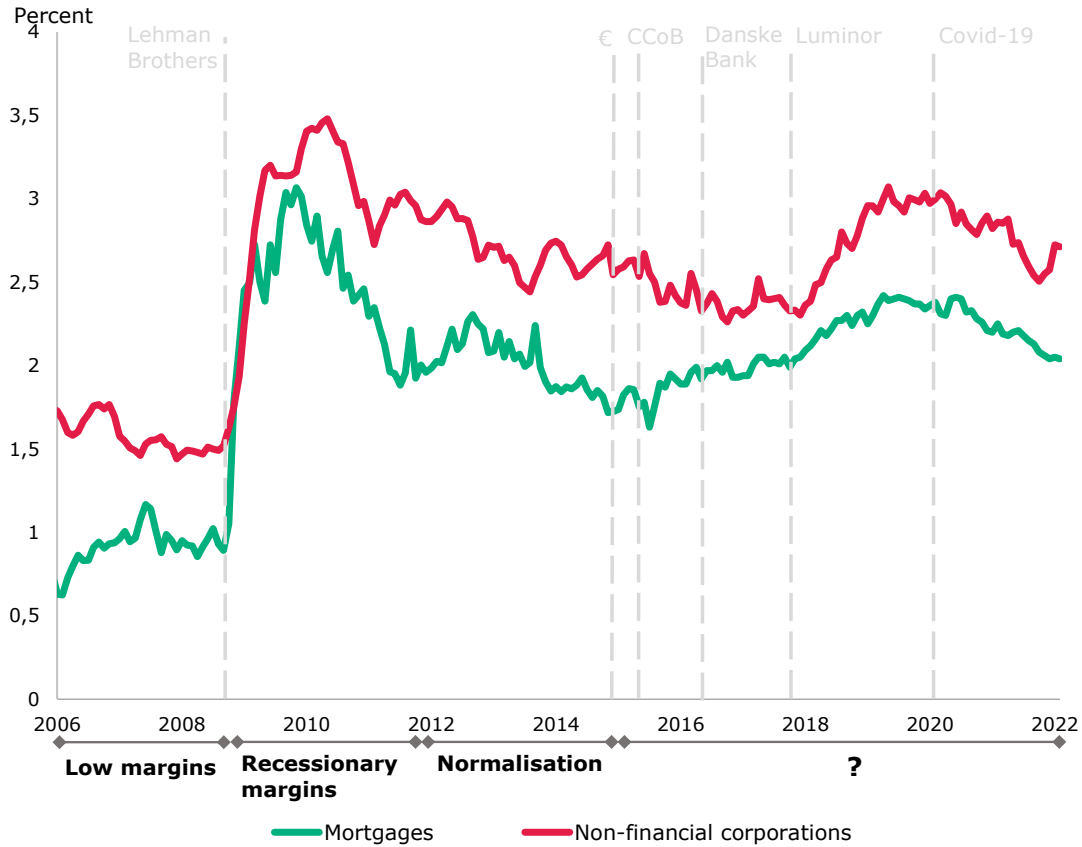
<sup>3</sup>For detailed information on the banking industry and its recent developments, please see Jočienė (2015) and Markevičius (2018). For a general overview of the financial sector, take a look at the OECD (2017) report.

<sup>4</sup>The fixation period is mostly for 2 to 5, to 10 years, after which the loan rate becomes variable.

<sup>5</sup>Until 2015 the reference rate for loans in Litas was the Vilibor – Vilnius interbank offer rate. Moreover, in some rare cases banks also used prime pricing, i.e. internally computed reference rates that directly reflect bank's short-term funding costs, or a combination of Euribor and some other reference rate, such as EBIFN.

<sup>6</sup>For extensive coverage of the pre-crisis period, please see Ramanauskas (2005, 2007, 2011), Kuodis and Ramanauskas (2009), Ramanauskas et al. (2018).

Figure 2: Historical variation of average loan interest margins in Lithuania



Notes: includes only new loan agreements granted in EUR. The margins are computed as the difference between the interest rate and zero-floored Euribor – 6-month for mortgages and 3-month for NFC's. The vertical dashed lines mark the following events: 1) the collapse of Lehman Brothers; 2) the adoption of Euro (€) in Lithuania; 3) the introduction of the Capital Conservation Buffer (CCoB) and other capital requirements in Lithuania; 4) withdrawal of Danske Bank from Lithuanian lending market; 5) pan-Baltic DNB-Nordea merger into Luminor; 6) the beginning of the first Covid-19 quarantine in Lithuania.

by cheap, but short-term, funding obtained from the Scandinavian parent-banks that pooled resources from their respective domestic deposits and the financial markets.

After the collapse of the Lehman Brothers, during the **recessionary period**, the financial markets closed and parent-banks found it difficult to obtain stable and cheap funding, what contributed to the withdrawal of resources from Lithuanian banking system, and increased pressure for local loan rates.<sup>7</sup> As the crisis of 2008-09 hit and non-performing loans (NPL) started accumulating, the perception of risk changed radically and lenders started to better price credit risk in their loan rates. Most importantly, drained funding and huge losses, which led to significant depletion in capital, forced banks to decrease loan supply, putting upward pressure on the margins.

The **normalisation period** began around 2012-13, when the EA sovereign debt crisis subdued and the spreads in the financial markets declined. The panic of 2008-09 was long over and banks were more self-reliant, primarily funded by cheap domestic deposits. On January 1st, 2015, Lithuania adopted the Euro and entered the EA. This structural change implied that there were no more currency mismatches and foreign exchange risk, what helped boost

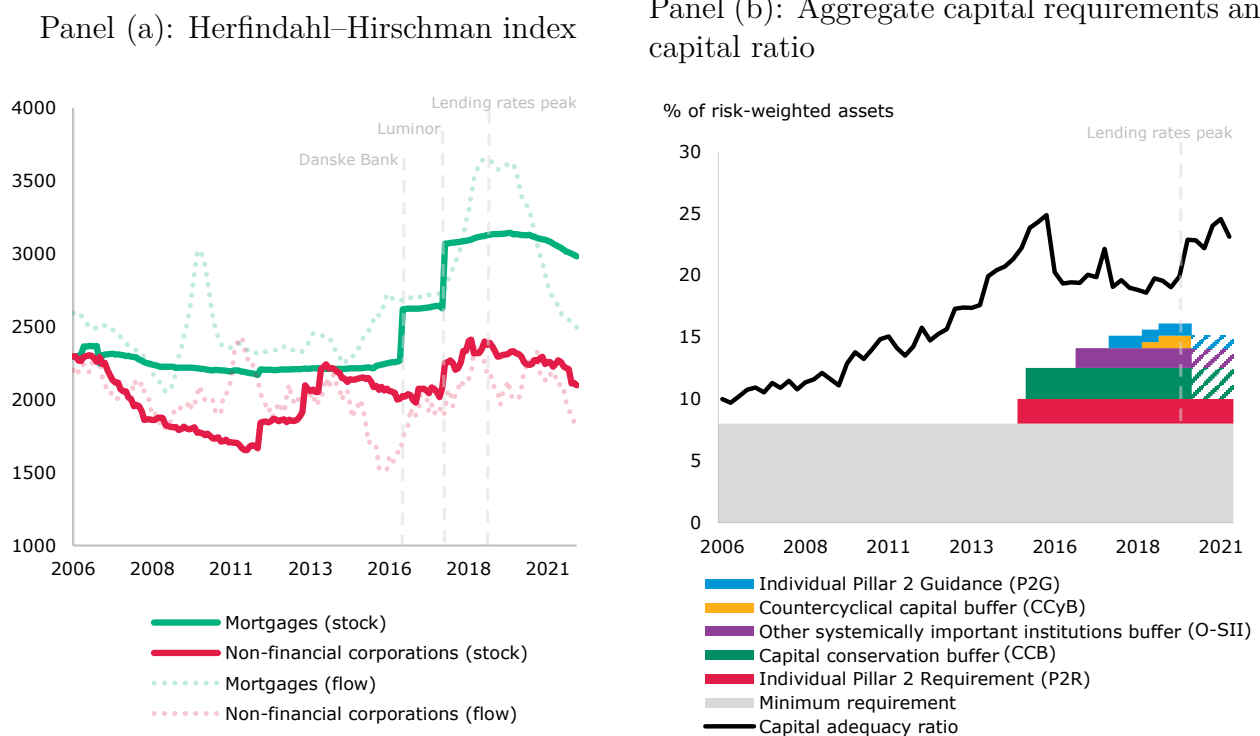
<sup>7</sup>For a discussion of the crisis and its drivers, also the increase in Vilibor and subsequent rise in Litas-denominated loan rates, see Jakeliūnas (2010), Šiaudinis (2010), Ramanauskas (2011) and Ramanauskas et al. (2018).

access to cheap funding from the markets. These events, as well as lessons from past mistakes of under-pricing, have helped loan rates to normalise and better reflect the underlying credit risk and financing costs.<sup>8</sup>

## 2.2 mid-2015 to 2019 period

In mid-2015 average mortgage margins were around 1.7%, just before they started to rise and reached 2.4% in 2019. Margins for loans to NFC's started increasing later, at around the end of 2017, moving from 2.3% to 3% in 2019. During the period, the ECB's monetary policy was highly accommodative and pressed the Euribor downwards, therefore there must be some factors that drove the rates upwards. Here we outline the key events and some of the potential drivers for the 2015-19 rise in margins (see Figure 2) that also drove the lending rates (see Figure 1).

Figure 3: Capital and concentration in Lithuania's banking sector



### a) Concentration.

A distinct element of the banking landscape in Lithuania was the changing structure of the market, i.e. the decrease in the number of significant lenders and loan portfolio sales, which translated into higher concentration levels in both mortgage and NFC markets (see Figure 3

<sup>8</sup>Bear in mind that the word "normalise" is not necessarily a good description of the mortgage rates dynamics in 2012-2014, as they became relatively low compared to the rest of the EA.

Panel (a)). In fact, according to the ECB data, Lithuanian banking industry in 2019 became the 4th most concentrated in the EU in terms of assets, and 5th most in terms of credit portfolio.

In September 2015, Danske Bank announced plans to sell its Baltic retail portfolio to Swedbank, with the deal being finalised in June 2016.<sup>9</sup> The transfer was associated with around 484 M EUR worth of retail loans in Lithuania, what significantly increased housing loan market concentration levels from 2260 to 2620 points, as measured by the HHI index for mortgage portfolio. However, market concentration, in terms of mortgage flow, had been steadily increasing even before the deal was announced or finalised, as Danske Bank had already been reducing the scale of its retail lending.

In August 2016, it was announced about a plan to merge Nordea and DNB banks that were operating in the Baltic region.<sup>10</sup> The merger was finalised in October, 2017, with the new bank being named Luminor.<sup>11</sup> As Nordea and DNB banks had had a relatively significant combined share of the Lithuanian market, the emergence of Luminor markedly increased the concentration in both corporate and housing loan markets. The HHI index for mortgage portfolio concentration increased by a further 440 points from 2630 to 3070, and by 170 points for the NFC market – from 2080 to 2250.

The newly merged bank aimed to gain self-sustainable funding and become independent from parent banks, which at the time were still Nordea and DNB. The bank also worked to reshape its loan portfolio “to focus on sound credit quality and efforts to right-size and reprice the portfolio, in order to ensure adequate risk adjusted profitability”.<sup>12</sup> These processes led to a significant decrease in the flow of credit from the institution, thus exacerbated the already-increased level of concentration. This can be seen from Figure 3 Panel (a), where the HHI was increasing for both markets in terms of stock and flow up until 2018-19.<sup>13</sup>

It is worth to add that the number of physical branches across Lithuanian territory decreased from 366 in 2015 to 202 in 2019.<sup>14</sup> The latter change signifies not only the decreasing number of market participants, but more importantly the movement to the digital marketplace, and higher efficiency. However, as some customers prefer physical contact or are unable to use e-banking, reduction in the number of branches may have an impact on concentration at the local level as well.

Concentration, however, is not a synonym of competition or bank conduct, as it merely reflects the number of participants and their shares in the market. For example, a simple Bertrand duopoly model suggests that in a highly concentrated market, firm conduct could be the same as in a competitive market. Non-competitive behaviour can occur when there is product differentiation, or producers experience Edgeworth-type capacity constraints, such as capital or liquidity requirements, or asymmetric information (e.g. see Stroebel, 2016; Crawford

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<sup>9</sup>See announcement of agreement and deal finalisation news.

<sup>10</sup>See announcement news on Delfi (in Lithuanian).

<sup>11</sup>See merger finalisation news on Verslo žinios (in Lithuanian) and on Luminor website.

<sup>12</sup>See p. 12-13 of Luminor group AB Financial statement 2018.

<sup>13</sup>For more information about the changing concentration in NFC lending, with special emphasis on small and medium enterprises, see Bank of Lithuania and Competition Council study (2021).

<sup>14</sup>Source: Lithuanian Banking Association website.

et al., 2018) is present – all standard features of banking.

The recent change in the number of credit providers might have altered the conduct of the incumbent banks, as well as their pricing behaviour. One potential source of higher average loan margins is the breakdown of relationships between the exiting banks and their clients. Customers needed to find new credit providers, who were at an informational disadvantage in terms of screening, or had higher overall funding costs and lower efficiency. Also, it may be the case that the incumbent banks, that then faced lower competition, started to more accurately price the underlying customer credit risk – a competition-risk pricing channel, highlighted by Müller et al. (2021), using Norwegian micro-data. Another source is that the incumbent banks simply exerted more market power during the loan contract negotiation process and offered higher lending rates, as the number of competitors decreased and clients' bargaining power eroded. On the other hand, increased market concentration could have contributed to higher efficiency and to some extent lowered funding costs, as highlighted by Markevičius (2018). The concentration-efficiency channel could have at least partially outweighed the pressure to increase lending margins. For empirical analyses of bank competition's effect on lending rates, see examples in Corvoisier and Gropp (2002), Maudos and Fernandez de Guevara (2004), Gambacorta (2008), van Leuvensteijn et al. (2013), and literature review therein.

#### b) Capital requirements.

Year 2015 marked the introduction of bank capital buffer requirements, namely, the capital conservation buffer (CCB) of 2.5% and the institution-specific Pillar 2 Requirement (P2R) of 2% (average). As can be seen from Figure 3 Panel (b), preceding 2015, there was only a flat capital requirement of 8% of the risk-weighted assets (RWA). In 2015-19 a gradual build-up of various other buffer requirements occurred, i.e. the counter-cyclical capital buffer (CCyB) of 1%, and other-systemically important institution's buffer (O-SII) of 1.6% (average), and Pillar 2 Guidance (P2G) of 1% (average). Over time, banks were required to hold a combined 8.1 p.p. capital buffer, in addition to the usual 8% minimum – essentially a doubling of capital requirements.

From the theoretical perspective, assuming that Modigliani-Miller theorem does not hold and capital financing is more expensive than debt financing, capital requirements could have been priced in higher loan rates, depending on the Modigliani-Miller offset.<sup>15</sup> For empirical evidence on the positive effect on lending spreads see, e.g., BIS (2010), Kashyap et al. (2010), King (2010), Martins and Schechtman (2013), Baker and Wurgler (2015), with more recent results in Glancy and Kurtzman (2021), Bichsel et al. (2022), de Bandt et al. (2022). The estimate of a 1 p.p. impact of increased capital requirement on loan rates usually ranges from 0 to 20 BP.

However, there are a couple of elements that diminish the effect of capital requirements on pricing decisions. Firstly, Lithuania's banking system has always had a significantly higher actual capital ratio over the combined buffer requirement (see Figure 3). Therefore, the rise in total capital requirements was not too restrictive for the industry as a whole, suppressing the

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<sup>15</sup>See Hanson et al. (2011), Dagher et al. (2016), Birn et al. (2020).

impact on final interest rates.<sup>16</sup>

Secondly, the build-up of higher capital requirements was a European-wide process, which should have put pressure on other countries' loan rates as well. As can be seen from Figure 1 and the discussion in the Introduction, loan rates were following Euribor and decreasing across most of the EA, including countries which had thinner voluntary capital buffers.

Lastly, average risk weights, which measure the relative riskiness of each asset type and can be thought of as intensity of capital requirements, were decreasing over the course of 2015-19 (see Valinskytė et al., 2018). Decreasing risk weights act as a compensatory measure to partially offset the impact of capital buffer requirements on the absolute required level of capital, hence loan pricing. This has been the case at least for the banks, which use the Internal Ratings-Based (IRB) method for risk weight determination. The primary reason for such IRB model outcomes and risk weight dynamics is the appreciation in asset prices, good macroeconomic conditions, as well as the increasing time-distance from the crisis of 2008-09, and the gradual clean-up of legacy NPL's.

c) Other factors.

Beyond increases in concentration and bank capital requirements, there were other concurrent factors that affected the banking industry and could have possibly influenced pricing decisions. We itemise and briefly discuss each of the potential non-exhaustive factors:

- In 2015-19 Lithuania's economy experienced high economic and wage growth, historically low unemployment, which could have contributed to the lending rate rise through **heightened credit demand**. For example, based on a disequilibrium model for small-scale corporate lending, the demand for business loans was increasing throughout 2015-18, and there was a shortage of credit supply in around 2017-18 (see Box 2 in the Financial Stability Review of Lietuvos bankas, 2021). In addition to that, Karmelavičius et al. (2022) find that the demand for mortgage credit increased and an excess demand-supply gap emerged, which could have exerted upward pressure on mortgage lending rates. While increased demand might not be the main determinant behind the increase in credit margins, it may have created favourable conditions for banks to raise interest rates.
- While the general economy was growing, there were increasing **signs of a slowdown**, highlighted by a downward revision of economic forecasts by the Bank of Lithuania.<sup>17</sup> These tensions were mostly related to positive output gap estimates and high real estate price growth, amid US-China trade conflict and Brexit, and the EU Mobility package.<sup>18</sup> In particular, expectations arose about a slowdown of certain sectors in transportation, construction and real estate development, which became treated more conservatively by

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<sup>16</sup>One has to acknowledge the possibility that a bank's management prices-in the actual level of capital, rather than the requirement. However, around 2016-17 some subsidiary banks had capital ratios over 30% of RWA, because of their group-wide capital allocation decisions, yet the interest rate increases were relatively small. The latter example suggests of a limited significance of voluntary buffers in pricing decisions.

<sup>17</sup>This paragraph is mostly based on the Bank of Lithuania and Competition Council study, 2021.

<sup>18</sup>For more information on the Mobility package, see link, and Lithuanian Economic Review of Lietuvos bankas (2019).

some credit institutions. It is likely that these trends contributed to the increased perception and repricing of credit risk, as well as discretionary hikes in interest rates, in order to limit credit exposures.

- During the period analysed, some banks experienced **higher operating costs**, which could have been transmitted into higher lending rates. The increase in costs may be related to several different factors, including, but not limited to, high salary growth and investment in digitalisation. Although the gradual closure of physical branches offset salary growth and to some extent reduced operating expenses, investment in innovation and e-banking became increasingly important. Expensive upgrading of IT systems was required for other objectives as well, including the development of AnaCredit (nPRDB), responding to technological competition from the Fintech industry, as well as complying with new regulation, e.g. Mortgage Credit Directive and 4th Anti-Money Laundering Directive (4AMLD) that came into effect in 2016 and 2017, respectively. However, according to bank financial statements data, the increase in operating expenses was largely offset by increasing efficiency and banking asset size in relative terms, as well as greater generation of fee and commission income.
- Other expenses and **contributions paid to regulatory authorities** may have partially added to an increase in lending margins. Besides contributions to the national Deposit Insurance Fund (DIF), since 2015 banks pay annual contributions to the European Single Resolution Fund (SRF) which amount to around 0.02% of banking assets. In addition, due to the applied negative deposit facility rate on excess reserves, in 2015-2019 banks were paying interest amounting to around 0.06% of their asset size on an annual basis. While the deposit base and excess reserves increased, banks did not impose negative deposit rates on households, but may have transferred a fraction of these expenses to the borrower side in terms of heightened lending margins by a couple of basis points, or raised their commission fees. On the other hand, it must be noted that the relative increases in SRF and deposit facility payments have been largely offset by the reduction in the DIF contribution rate, which was lowered since mid-2017.
- Lastly, there may have been **discrete bank management decisions** to unilaterally increase margins – especially for institutions that were undergoing transformation, due to profitability pressures. It must be highlighted that during the period, Lithuanian lending rates, that initially were the lowest among the Baltic countries, increased and converged to levels observed in Latvia and Estonia. One can only speculate that this happened as a banking group-wide policy to equalise rates across the Baltic region, in order to reach uniform profitability targets.

## 2.3 Late 2019 and the Covid-19 pandemic

During the second half of 2019, bank lending rates peaked and started falling. Although the turmoil at the beginning of the Covid-19 pandemic in early 2020 shortly raised the margins by

a couple of basis points, the process of declining rates continued throughout the rest of 2020 and in 2021. For example, mortgage rates went from a peak of 2.4% in mid-2019 to 2% by the start of 2022. The rates fell by around 40 BP, however, they are still above 2017 levels, and well above the levels of 2015 (see Figures 1 and 2). As it is not entirely clear what drove the increase in interest rates in 2015-19, it is also not clear why they fell afterwards, in 2019-21. We shortly discuss the potential factors behind the interest rate decline.

a) Concentration.

Very importantly, lending market concentration levels reached their historical highs around mid-2019, what coincided with peaking lending rates (see Figure 3 Panel (a)). Right around this episode, both, concentration in the two markets, as measured by the HHI, and lending rates started falling. Lending flows became more diverse, as some of the banks, which had undergone structural changes, started to more actively compete and increased their loan issuance. For example, between the end of 2018 and 2021 Luminor successfully issued bonds (covered and non-covered), attracting at least 1.75 B EUR in cheap long-term financing, which significantly increased the bank's self-sustainability and boosted their lending capacity.<sup>19</sup>

b) Capital requirements.

In response to the pandemic and only after the interest rates had peaked and started decreasing, capital requirements were partly relaxed, i.e. the CCyB was set to 0% and banks were allowed to temporarily deviate from the P2G, as well as from the CCB and O-SII buffer requirements (see Figure 3 Panel (b)). Assuming that banks take these buffers into account when making pricing decisions, the relaxation of these requirements may have accelerated the downward revision of lending rates.

c) Other factors.

Additionally, there are at least four other possible factors that could have affected interest rates throughout late 2019 to 2021, and thus are worth mentioning.

- Monetary policy stance further eased in 2019-21. For example, the deposit facility rate of -0.4% was further decreased to -0.5% in September 2019 (see also Figure 1). However, such change did not have a big downward impact on lending rates, as the Euribor had already been negative, and zero-floored in credit contracts. Additionally, the ECB introduced the two-tier reserve system, which effectively reduced the amount of interest that banks were to pay for excess reserves. The two-tier system may have slightly alleviated the pressure to increase lending rates as a compensation for the negative deposit facility rate.

Later, during the initial stage of the Covid-19 pandemic, in the time of large uncertainty, bank wholesale funding costs rose, but they were quickly suppressed by the ECB's asset purchase programmes, including the pandemic emergency purchase programme (PEPP) and asset purchase programme (APP). As wholesale funding and capital markets are

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<sup>19</sup>See announcements of issuance on Luminor website, by year: 2018, 2019, 2020, 2020, 2021.

nowadays less important for banks that operate in Lithuania, the ECB’s targeted long-term refinancing operations (TLTRO) programme was more prominent in attracting cheap and long-term funding. As TLTRO was associated with ultra low interest rates (from -1% to -0.5%, to 0%, depending on reaching the lending growth target), it may be that the TLTRO III programme contributed to the decline in lending margins over the course of 2019-21, especially for corporate lending, since it did not target mortgages.<sup>20</sup> Nevertheless, not all banks used the TLTRO III facility and their lending margins still decreased, suggesting that other more important factors were at play.

- On one hand, due to the lockdown and Covid-19 uncertainty, the demand for investment credit fell and may have exhibited downward pressure on lending rates. On the other hand, the drag on demand was short-lived, since the economic downturn did not last long.
- Effective from January 1st, 2020, the bank profit tax rate was raised by 5 p.p. – from 15% to 20%.<sup>21</sup> A rule of thumb calculation, using equation (8) of Section 3.2, suggests that the net impact of higher taxes on mortgage rates would amount to 4 BP, and on NFC rates to around 8 BP.<sup>22</sup> However, based on an extended version of Karmelavičius (2021) DSGE model, the impact estimates are minuscule and equal to less than 1 BP.<sup>23</sup>
- Since 2020, systemically significant banks are required to comply with the new minimum requirements for own funds and eligible liabilities (MREL), and thus to close the MREL shortfall by attracting at least around 600 M EUR, or 3% of their assets, in unsecured bonds or subordinated liabilities.<sup>24</sup> As these types of unsecured liabilities would be the first used for bail-in, right after the capital instruments, they are more expensive than, e.g., government-insured retail deposits. Therefore it is quite likely that some of the additional costs associated with MREL funding were transferred to the borrowers, thus reduced the fall in lending rates.

While all these above-mentioned factors have potentially contributed to the lending margin dynamics throughout 2015-21, such argumentation is susceptible to the *post hoc ergo propter hoc* fallacy, and does not offer any quantification of the drivers’ importance. However, the discussed episodes and bank-level data contain enough variation that we will exploit econometrically, using a panel model, described in Section 4. But before describing the results of

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<sup>20</sup>To our knowledge, based on public sources, at least Šiaulių bankas (see here and here) and Luminor (see page 99 in report) participated in the programme.

<sup>21</sup>The higher tax rate is applied for banks, whose taxable income exceeds 2 M EUR. See news on Verslo žinios (in Lithuanian).

<sup>22</sup>If the cost of capital funding would be equal to  $ROE_t^{i*} \cdot \mu_t \cdot \omega_t^i / (1 - \tau)$ , where  $\tau$  is the profit tax rate.

<sup>23</sup>After accounting for  $\tau$  profit tax rate in Karmelavičius (2021) model, the steady state capital ratio would be equal to:

$$CR = \mu - a + \gamma \frac{1 - \beta_B r^D (1 - \tau)}{1 - \beta_B r^D (1 - \tau) - \beta_B},$$

which positively affects lending rates through overall cost of capital  $\mathcal{M}$  and risk weights  $\omega_i$ . See equations (35)-(37) in Karmelavičius (2021).

<sup>24</sup>See announcement at the Bank of Lithuania website.

the empirical model, the next section will discuss the practical aspects of loan pricing from a bank's perspective.

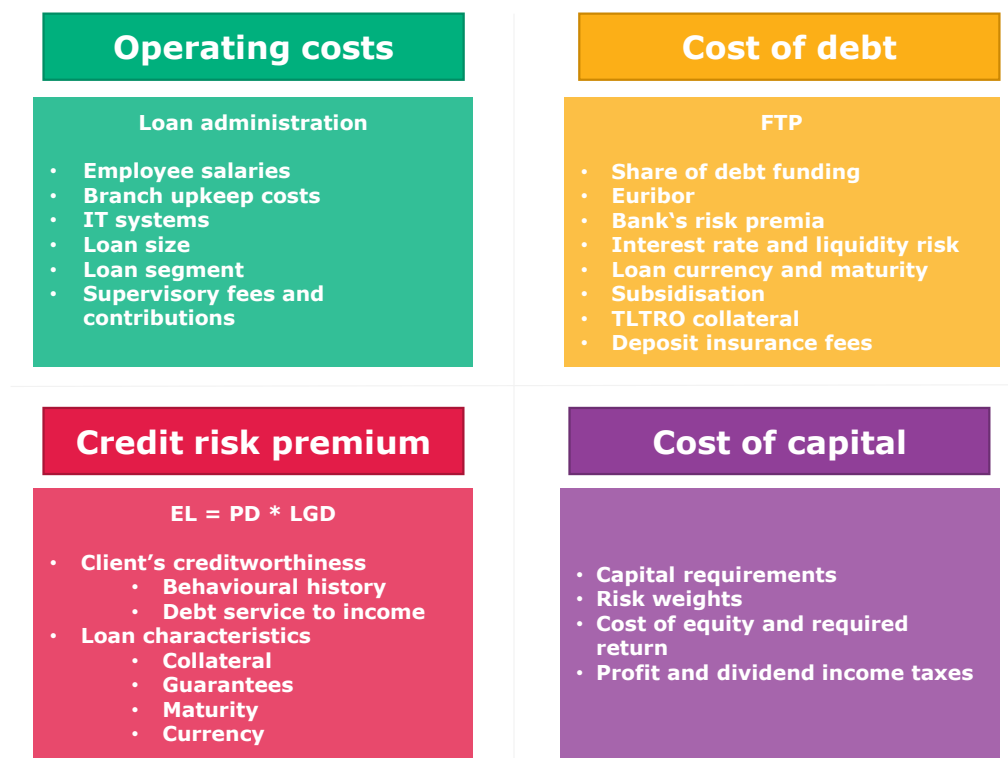
### 3 Loan pricing determinants

Here we shed some light on the practical aspects of interest rate setting, and building on that, develop a stylised model, which will serve as a basis for the empirical analysis of Section 4.

#### 3.1 Interest rate setting in practice

Although borrowers usually perceive their credit interest rates as the zero-floored Euribor plus a mark-up, the factual calculus is more nuanced. The international practice of banking usually views lending rates as a sum of four key components: operating costs, cost of debt, credit risk premium, and the cost of capital (see Figure 4). If any of these components are incorrectly accounted for, lending business may be either unprofitable, or on the other hand, uncompetitive. In this subsection we overview some of the practical aspects of interest rate setting by briefly discussing each major component of pricing.

Figure 4: Key components of loan interest rates



Notes: the explicit sub-components are non-exhaustive examples of each major pricing component.

## Operating costs

This component of the lending rate is dedicated to cover the administrative costs of issuing and book-keeping of a loan. Credit institutions may also elect to include some fraction of operating expenses not in the interest rate, but in the administrative fee that is covered by the client during the initiation phase of a loan.

Operating costs typically cover employee compensation such as salaries and bonuses, as well as physical branch upkeep costs, such as rental fees and expenses on equipment. As IT systems become more sophisticated, they also have a significant impact on credit institution's operating costs and investment outlays that also need to be covered by revenues from the lending business. Other costs, such as supervisory fees and contributions, can also be accounted for.

Since loans differ by type of segment (e.g. corporate, mortgage, consumer) and size, they may differ in their operating cost-intensity. For instance, large corporate loans, in spite of typically requiring more due diligence, their administrative costs are rather negligible compared to the interest revenue – an economies of scale argument. If a consumer loan is granted using an automated machine learning solution, operating expenses are less impactful for the interest rate.

## Cost of debt

The debt funding component is probably the most important one, as it reflects the traditional banking business of taking deposits and issuing loans, profiting off the spread between lending and deposit rates. Traditionally, banks separate funding and lending operations into distinct departments, where the credit department acquires funds from the treasury. In modern times, in a number of large institutions, the price at which these funds are transferred is called a funds transfer price (FTP). The FTP concept came into prominence after the Global Financial Crisis, during which banks were hurt partly because they had previously mispriced their funding costs and the associated risks (see Dermine, 2013; Moss and Kunghehian, 2018). The aim of the usage of an FTP framework is to ensure that all funding costs are correctly priced in the lending business, and all other risks, such as liquidity or market, are accounted for.

Loan-specific FTP, a mapping from bank's debt funding costs and loan characteristics to a per cent scale, is a major component of loan interest rate. The exact FTP for a given loan usually considers all debt instruments that are pooled to finance the lending activity.<sup>25</sup> It reflects the overall weight and cost of various items on the liabilities side, either retail, such as sight and term deposits, or wholesale, such as bonds and subordinated debt.

The pricing of liability instruments can be based on average factual costs (backward looking), marginal costs (forward looking) or opportunity costs. The average cost approach considers the current debt service expenses that a bank incurs, whereas the marginal costs describe how much it would cost to acquire new funds. Using the marginal cost approach, the FTP could include a base rate such as the swap, Euribor or Libor, and bank-specific risk premium (Wyle

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<sup>25</sup>FTP method can be adjusted to include not only the debt funding costs but capital costs, and credit risk component, as well.

and Tsaig, 2011).

As funding is typically short-term and loans, especially mortgages, have longer maturities, a term liquidity premium is usually added, which increases along the maturity term of a loan (for more details see Grant, 2011). In some cases, e.g. to meet the LCR requirement, banks hold a significant portion of assets in the form of liquid instruments, such as bonds or excess central bank reserves, that usually carry low or negative returns. An FTP can also reflect an add-on rate for new credit agreements in order to subsidise the holding of these liquid assets (see Moss and Kunghehian, 2018). For banks where significant amount of funding is obtained using retail deposits that are covered by the deposit insurance scheme, an FTP framework can include deposit insurance fees.

If an extended loan is fixed-rate or denominated in foreign currency, the FTP should entail a premium to hedge against interest rate and foreign exchange risks. Additionally, if a credit agreement can be collateralised when obtaining funds from the markets, i.e. covered bonds, or from the central bank, say TLTRO programme, the FTP for that particular instrument can be downward-adjusted.

### **Credit risk premium**

A loan's interest rate typically includes a credit risk premium in order to compensate for the expected credit losses. Most importantly, as the true credit risk is an unobservable factor and unknown to the bank, the premium reflects the credit risk that is perceived or expected at the inception of a loan. Such expectations are based on the historical performance of bank's portfolio and associated modelling solutions, as well as the state of the general economy or a specific sector, and non-performing loans level.

The credit risk premium can be thought of as a product of the probability of default (PD) and loss-given default (LGD). These two parameters are tied to the client's as well as the instrument's features. For example, the PD of a loan can depend on the borrower's behavioural history, income, indebtedness, various household characteristics, external credit ratings, etc. In some cases it may also include macroeconomic variables which describe either the point-in-time or the through-the-cycle environment. As per loan features, they may include loan size and type of loan, the time to maturity, which usually increases credit risk, loan to collateral value (LTV), etc. An LGD parameter is mostly related to the collateral of a loan and its (stressed) market value, but can also reflect government or personal guarantees, which act as risk-mitigating instruments, in addition to other factors, such as recourse and legal environment, administrative fees, associated with foreclosure and bankruptcy.

### **Cost of capital**

While the above-discussed elements are aimed to cover the actual costs of lending, the cost of capital component can be understood as a profit margin.<sup>26</sup> The inclusion of capital costs in the

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<sup>26</sup>Not to be confused with the weighted average cost of capital (WACC), used in the capital asset pricing model (CAPM), which refers to the general cost of financing, including both debt and equity. By the term *cost*

pricing formulae is mainly intended to compensate the shareholders for the provision of their own funds.

Some level of capital is required by the regulatory agencies to have bankers' *skin in the game* to mitigate the moral hazard problem, and to account for the unexpected losses. Therefore, capital requirements influence the overall cost of capital that is included in the lending rate. The exact amount which is required for a certain loan is governed by the risk weight that is attached to the exposure. Risk weights are designed by regulation to generally increase with the riskiness of the loan, either using the standardised approach (SA) or the previously-mentioned IRB method, which takes into account the PD and LGD parameters.

Based on the level of bank capital, shareholders require a certain return which is usually expressed as a return on equity (ROE), or risk-adjusted return on capital ratio (RAROC), which can be specific to each loan segment. The required returns are based on the market cost of equity, and adjusted for the relevant profit and dividend tax rates. In an environment where market returns are high, the opportunity costs of investment into a bank will also be high, thus there will be mounting pressure on bank's profitability as well.

The cost of capital is the part where credit demand, concentration and market power enter the pricing puzzle. The shareholders derive their profitability targets not only on the basis of the cost of equity, but also on the credit market conditions. If the market allows it, e.g. high credit demand and few competitors, bank owners may expect a high return on equity. On the other hand, if the demand for credit is subdued and there is a number of low-cost competitors, high required rates of return could not be justifiable.

### 3.2 Stylised model of interest rates

Here we develop a stylised model of interest rates, which is based on the practical pricing features that were outlined in the previous subsection. The pricing model will be later used as a base for the general specification in econometric analysis, carried out in Section 4.

The model builds on the main features of the Lithuanian banking industry, which were mentioned in Section 2. We assume a representative bank that has only one type of asset – loans ( $L$ ), and funds its lending activities using deposits ( $D$ ), foreign funding ( $F$ ), and equity ( $E$ ) which approximates bank capital. The bank's structure can be described by the following static balance sheet identity:

$$L_t = D_t + F_t + E_t, \quad (1)$$

where all variables are end of time  $t$  stocks. The profit ( $\pi_t$ ) of such bank can be expressed as:

$$\pi_t = r_t L_t - r_t^D D_t - r_t^F F_t - \chi_t L_t - O_t, \quad (2)$$

where  $r_t$ ,  $r_t^D$ ,  $r_t^F$  respectively denote interest rates on loans, deposits and cost of borrowing from abroad.  $\chi_t$  is the credit loss rate, arising due to customer insolvency, and  $O_t$  denotes operating

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of capital, we refer to shareholders' equity and bank regulatory capital, which is mostly comprised of the CET1 capital in Lithuania.

expenses.

Suppose, shareholders require a level of profit ( $\pi_t^*$ ), and seek an interest rate ( $r_t^*$ ) that would reach that profit target. After rearranging equation (2), we get:

$$r_t^* = \chi_t + r_t^D \frac{D_t}{L_t} + r_t^F \frac{F_t}{L_t} + \frac{O_t}{L_t} + \frac{\pi_t^*}{L_t},$$

with  $\pi_t^*/L_t$  being the required return on assets ( $ROA_t^*$ ). The latter ratio has a close relationship with the return on equity ( $ROE_t^*$ ) and the capital ratio ( $CR_t$ ):

$$ROA_t^* = \frac{\pi_t^*}{L_t} = \frac{\pi_t^*}{L_t} \frac{E_t}{E_t} \frac{\omega_t}{\omega_t} = \left( \frac{\pi_t^*}{E_t} \right) \left( \frac{E_t}{\omega_t L_t} \right) \omega_t = ROE_t^* \cdot CR_t \cdot \omega,$$

where  $\omega_t$  is the average loan risk weight,  $\omega_t L_t$  – risk-weighted assets (RWA). Expression  $CR_t \cdot \omega_t$  can be understood as the bank's (inverse) leverage ratio ( $LR_t := E_t/L_t$ ).

Let us assume that the bank's management bases its pricing decisions not on the actual capital ratio ( $CR_t$ ), but on a capital requirement ( $\mu_t$ ), set by the regulatory authority.<sup>27</sup> The loan interest rate ( $r_t^*$ ) that ensures the  $ROE_t^*$  target would be:

$$r_t^* = \underbrace{r_t^D \frac{D_t}{L_t} + r_t^F \frac{F_t}{L_t}}_{\text{FTP}} + \underbrace{ROE_t^* \cdot \mu_t \cdot \omega_t + \frac{O_t}{L_t}}_{\text{WACC}} + \chi_t. \quad (3)$$

The above formula can be understood as a loan interest rate pricing equation, which is similar to that of Gambacorta (2008), Slovik and Cournède (2011), Glancy and Kurtzman (2021).<sup>28</sup> In fact, equation (3) represents all pricing components that were discussed in the previous subsection. The operating costs component is represented by the average operating costs ( $O_t/L_t$ ), debt funding costs, or the FTP, is the ( $r_t^D D_t/L_t + r_t^F F_t/L_t$ ), capital costs are ( $ROE_t^* \cdot \mu_t \cdot \omega_t$ ), and ( $\chi_t$ ) denotes the credit risk premium. The sum of the FTP term and the cost of capital is the widely-known weighted average cost of capital (WACC) term.<sup>29</sup>

Suppose the bank's loan portfolio is comprised of mortgages, loans to NFC, and loans to households for consumption. The interest rate pricing equation (3) can be generalised for each loan segment:

$$r_t^{i*} = r_t^D \frac{D_t}{L_t} + r_t^F \frac{F_t}{L_t} + ROE_t^{i*} \cdot \mu_t \cdot \omega_t^i + \frac{O_t^i}{L_t^i} + \chi_t^i, \quad (4)$$

where  $ROE_t^{i*}$ ,  $\omega_t^i$ ,  $O_t^i/L_t^i$  and  $\chi_t^i$  stand for variables that are specific to the  $i$ -th loan segment. As was discussed earlier,  $ROE_t^{i*}$  component may take into account the conditions of the given market, cost of equity and other relevant factors. For example, shareholders may require a

<sup>27</sup>If this assumption is too binding, one can add an additional pricing component ( $ROE_t^* \cdot \beta_t \cdot \omega_t$ ), related to the voluntary buffer ( $\beta_t := CR_t - \mu_t$ ). The voluntary buffer component may be more or less stable over time, if bank management's policy is to set the actual level of capital as a constant mark-up over the requirement.

<sup>28</sup>In a DSGE setting, assuming a similar banking structure as well as inter-temporal optimisation, subject to endogenous credit risk, Karmelavičius (2021) derives a steady state loan pricing equation that resembles equation (3).

<sup>29</sup>The term *capital* in the WACC definition, contrary to the general use in this paper, refers to the total sum of debt and equity funding.

high rate of return on mortgages, given the low-risk nature of the asset class, its administrative efficiency, and prevailing market structure. All these asset class-specific features, as well as the funding costs, determine the pricing of lending rates, as illustrated in Figure 4.

### Interest rate margin

The stylised equation (4) considers the pricing of the lending rate, whereas the actual contractual arrangement of a given loan generally includes a base and a margin:

$$r_t^i = \underline{e}_t + m_t^i, \quad (5)$$

where  $\underline{e}_t$  denotes the zero-floored reference rate, such as Euribor, being the variable component, and  $m_t^i$  denotes the margin, which is fixed over the life cycle of the loan.

We turn to show how to express a similar stylised pricing equation (4) for the margin. Similarly to loans, the deposit and parent bank funding rates may be expressed in respect to the reference rate:

$$r_t^D = \underline{e}_t + m_t^D, \quad (6)$$

$$r_t^F = \underline{e}_t + m_t^F, \quad (7)$$

where  $m_t^D$  is a margin on deposits and  $m_t^F$  is the bank spread on funding from parent banks.

Using equations (5)-(7), we rewrite equation (4) in funding margin terms:

$$m_t^{i*} = m_t^D \frac{D_t}{L_t} + m_t^F \frac{F_t}{L_t} + ROE_t^{i*} \cdot \mu_t \cdot \omega_t^i + \frac{O_t^i}{L_t^i} + \chi_t^i. \quad (8)$$

Equation (8) ignores term  $-\underline{e}_t \frac{E_t}{L_t}$ , implicitly assuming a full pass-through of the reference rate ( $\underline{e}_t$ ) to the borrowers. The full pass-through assumption is not binding in our setting for a couple of reasons. First, 98% of loan contracts in Lithuania are set as variable rate, which directly includes a one-to-one pass-through of Euribor. Second, the importance of money markets is limited in Lithuania, as the banking sector is primarily funded using retail deposits, whose interest rate ( $r_t^D$  and  $m_t^D$ ) is already included in the specification above. Third, Naruševičius (2017) finds a full pass-through of money market rates on lending rates, using an error-correction model on Lithuanian banking data. Lastly, the term  $-\underline{e}_t \frac{E_t}{L_t}$  is typically quite small, as the leverage ratio ( $E/L$ ) is usually below 5%.

Overall, this model provides a simple framework, characterising the factors that influence the bank margin, capturing the logic outlined in Subsection 3.1. For instance, the higher the amount of foreign liabilities in the financing structure ( $\uparrow F_t/L_t$ ), the more sensitive the interest rate on loans is to the rate of foreign financing ( $r_t^F$ ). Accordingly, the higher the shareholders' required return ( $\uparrow ROE_t^*$ ), the more the interest rate responds to capital requirements ( $\mu_t$ ).

## 4 Empirical analysis

In the above discussion we found out that the observed rise in lending rates over 2015-19 was associated with an increase in average bank interest margins (see Figures 1 and 2). Here we provide an empirical model that is aimed to explain the dynamics of lending margins, employing historical variation across banks and different loan segments. The exercise dwells on the discussion on practical aspects of pricing in 3.1, while the specification is built on the stylised model outlined in 3.2.

### 4.1 Data and selection of variables

We use quarterly information ranging from 2006 to 2021 for an unbalanced panel of eight banks: Citadele, Danske Bank (Sampo bank until mid-2008), Luminor (DNB until end-2018), Medicinos bankas, Nordea, SEB, Swedbank, Šiaulių bankas, covering around 96% of total banking assets in Lithuania between 2015 and 2021. As our econometric model is trained on data that spans from 2006 to 2021, we use weighted average loan interest rates, including both Euro- and Litas-denominated loans. Likewise, for other items, such as reference interest rates or deposit rates, we also use weighted averages of the respective Euro and Litas rates. This is done to accommodate the fact that a significant portion of loans, other assets and liabilities were denominated in Litas before the adoption of Euro in 2015.

#### 4.1.1 Dependent variable: loan margin ( $m_{b,i,t}$ )

In our panel data setting, we define the bank-segment-specific margin  $m_{b,i,t}$  on new loans as the difference between the loan interest rate  $r_{b,i,t}$  and the relevant floored reference rate:

$$m_{b,i,t} := r_{b,i,t} - \underline{e}_{b,i,t}. \quad (9)$$

The average loan interest rate  $r_{b,i,t}$  charged by  $b$ -th bank for the  $i$ -th loan segment at time  $t$  is defined as the weighted average of Litas and Euro respective interest rates for new lending flows. Interest rate and lending flow data is taken from the Bank of Lithuania's Monetary Financial Institution database (MFI), containing bank-specific loan rates for four segments ( $i$ ): loans to non-financial corporations (*NFC's*), mortgages (loans for house purchase, *hh*), consumer loans (*hc*), and other loans to households (*ho*).

The floored reference rate is defined as  $\underline{e}_{b,i,t} := \max \{Avibor_{b,i,t}, 0\}$ .<sup>30</sup> Avibor stands for the weighted average between the Vilibor and Euribor reference rates, as Vilibor was the primary reference rate for Litas-denominated loans until 2015. The aggregation is specific to each bank-segment and reflects the proportions of Litas/Euro loan flows at a given time period. The relevant Euribor, Vilibor and Avibor historical series are depicted in Panel (a) of Figure A1 in the Appendix.

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<sup>30</sup>For mortgages we use the six-month reference rate, while for loans to NFC's, consumer loans and other loans to households we use three-month reference rates.

The average lending margins between 2006 and 2021 are shown in Panel (b) of Figure A1 in the Appendix, with summary statistics of bank-level data for each series tabulated in Table A1(a). We observe that over the sample period, margins on consumer loans were considerably higher than those on mortgages, NFC's and other loans to households, whereas mortgage lending margins were usually the lowest. In addition, loan segments that have the highest loan margins, typically exerted greater variability across banks and over time. Moreover, consumer loan margin dynamics was entirely different from other loan segments throughout 2015-19. Specifically, they have been declining in line with the concentration of consumer loans, while mortgage and NFC margins, on the contrary, have been increasing along with the increasing market concentration (see Panel (c) of Figure A1). These differences between segments are particularly important and will be used to explore the effects of concentration and other factors on margins.

#### 4.1.2 Explanatory variables

We categorise all potential drivers of lending margins into four groups, which correspond to the pricing components discussed in Section 3.

##### **Operating costs** $\left(\frac{O_{b,t}}{L_{b,t}}\right)$

In our empirical specification, we divide operating costs into administrative expenses and contributions paid to regulatory authorities. Less efficient banks operating at higher costs tend to require higher interest margins (see Shamshur and Weill, 2019), therefore, the expected sign of the coefficients of these variables is positive.<sup>31</sup>

*Administrative expenses*  $\left(\frac{A_{b,t}}{L_{b,t}}\right)$  are defined by the ratio of annual administrative expenses to total assets. Specifically, we take into account administrative expenses that are not covered by non-interest income, measured as: [Administrative Expenses - Operating Income - (Interest Income - Interest Expenses)]. This allows us to take full account of income/expenses incurred outside lending activities, such as net fee and commission income and other net operational income. Bank-specific data is taken from FINREP profit-and-loss statement.

*Contributions to regulators*  $\left(\frac{C_{b,t}}{L_{b,t}}\right)$  are defined by the ratio of overall annual contributions paid to regulatory authorities to total assets. Specifically, we consider contributions to the Deposit Insurance Fund, and from 2015 onwards also contributions to the Single Resolution Fund, as well as payments on excess reserves.<sup>32</sup> We use internal Bank of Lithuania bank-level data.

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<sup>31</sup>Operating costs are not broken down by sector, as this data is not available. This is a major limitation as the intensity of operating costs may vary across loan segments.

<sup>32</sup>Alternatively, DIF fees and payments on excess reserves could be assigned to the cost of debt category, however, as the series were lumped together with SRF, we categorised them as operating costs. In addition, the series available from 2015 onwards (i.e. SRF contributions and payments on excess reserves), if used in isolation, could lead to measurement error in the regression model.

### Debt funding costs – FTP ( $m_{b,t}^D \frac{D_{b,t}}{L_{b,t}} + m_{b,t}^F \frac{F_{b,t}}{L_{b,t}}$ )

As discussed in Sections 2 and 3, banks operating in Lithuania typically raise funds through two types of funding: deposits ( $D_t$ ) and parent bank funding ( $F_t$ ). Therefore, each bank’s FTP should be mostly reflected by deposit interest rates and parent bank funding rates.

*Cost of deposit funding* ( $m_{b,t}^D$ ) is defined as a margin on deposits, which is a difference between the bank-specific deposit interest rate and the AVIBOR, as in equation (6). More specifically, we consider a weighted average of household and NFC deposit rates to reflect the overall cost of retail deposits.

*Cost of foreign funding* ( $m_{b,t}^F$ ). Regarding parent bank funding, using historical transaction data on interbank funding, we see that subsidiaries and branches that operate in Lithuania usually borrowed from their respective parent institutions at a Euribor rate. Since the primary source of these funds were usually the financial markets, we assume that banks use bond yields to reflect the cost of parent funding when pricing lending rates. A bank’s parent funding spread ( $m_t^F$ ) can be represented as the difference between a relevant bond yield and Euribor (see equation (7)). In particular, we use covered bond yields for mortgages and senior bond yields for business, consumer and other loans to households.<sup>33</sup>

### Credit risk ( $\chi_{b,t+2}$ )

The two-quarter lead of provision-to-loan ratio is used as a proxy for credit risk.<sup>34</sup> The values of this ratio are taken with a lead, because the actual credit risk cannot be reflected in the data contemporaneously, since banks book provisions based on an estimate of expected future loan losses. Banks with higher loan credit risk are likely to require a higher risk premium as a compensation and therefore this variable is expected to have a positive sign on the interest margin. We use bank-specific data from FINREP database.

### Cost of capital ( $\mu_{b,t} \cdot \omega_{b,i,t} \cdot ROE_t^{i*}$ )

The last element of the stylised model in equation (8) is the cost of capital. It takes into account a level of capital required by regulators, including capital requirements ( $\mu_{b,t}$ ) and risk weights ( $\omega_{b,i,t}$ ), as well as a return on equity, which is required by shareholders ( $ROE_t^{i*}$ ). Since the bank-segment-specific required return is unobserved and essentially reflects market conditions, it is proxied by market concentration and loan demand indicators, as discussed in Section 3.

*Capital requirements* ( $\mu_{b,t} \cdot \omega_{b,i,t}$ ) are defined as the product of regulatory capital requirements and risk weights. The latter product is equivalent to a loan segment-specific leverage requirement.<sup>35</sup> The bank-specific capital requirements ( $\mu_{b,t}$ ) are composed of the minimum Pil-

<sup>33</sup>We use Danish banks’ bond yields for Danske Bank parent funding costs; Swedish – for Swedbank and SEB bank; Scandinavian (Norwegian) – for DNB, Luminor and Nordea banks; and European – for the remaining banks. We take bond yields from *Refinitiv* database.

<sup>34</sup>Several studies use this ratio to proxy credit risk, including Hainz et al. (2014), Cruz-García and de Guevara (2020). Similarly, Ehrenbergerova et al. (2020) use four-quarter lead of NPL ratios.

<sup>35</sup>To see this, note that the  $\mu$  capital requirement entails the following inequality:  $E \geq \mu\omega L$ . After rearranging terms, we get:  $E/L \geq \mu\omega$ , which is essentially a leverage ratio requirement.

lar 1 requirement, the institution-specific Pillar 2 requirement and the combined capital buffer requirements including the CCoB, the CCyB, the O-SII capital buffer and the P2G. The risk weights ( $\omega_{b,i,t}$ ) are measured by the ratio of risk exposure amount to the original exposure, which is bank-segment-specific. A positive sign is expected, as the cost of maintaining the required high levels of bank capital is needed to compensate the shareholders for the provision of their own funds.

*Market concentration* in loan segment  $i$  is measured by the Herfindahl-Hirschman index ( $HHI_{i,t}$ ), which is computed as a sum of squared market shares for each loan segment:

$$HHI_{i,t} = \sum_b \left( \frac{L_{b,i,t}^{flow}}{L_{i,t}^{flow}} \times 100 \right)^2$$

where  $L_{b,i,t}^{flow}$  is new annual lending flows of bank  $b$  in the loan segment  $i$ .<sup>36</sup> Market concentration is expected to allow shareholders to require higher returns, thus positively contribute to loan margins, as theorised in the traditional structure-conduct-performance hypothesis.

*Loan demand* ( $\Delta L_{i,t}^{flow}$ ) is measured by the average annual logarithmic difference of sector-wide loan flow in segment  $i$ . A positive sign of the coefficient is expected, as banks gain greater market power when credit demand increases, allowing them to be more selective towards borrowers and increase interest margins (Gambacorta, 2008).

Weighted averages of explanatory variables used in the empirical model are presented in Panel (c) of Figure A1, with summary statistics of bank-level data for each series tabulated in Panel (b) of Table A1 in the Appendix. Overall, the descriptive statistics suggest that the development of interest margins and their determinants exhibit different tendencies for different loan segments over time. The following subsection analyses the quantitative impact of these determinants on the interest margin by the means of regression analysis.

## 4.2 Econometric specification

Our empirical approach is entailed by regressing loan interest margins  $m_{b,i,t}$  on the explanatory variables, described in the previous subsection. Specifically, on the basis of the discussion in Section 3.2 and the stylised pricing equation (8), we consider a panel data regression model of the following form:

$$m_{b,i,t} = \alpha_1 \frac{A_{b,t}}{L_{b,t}} + \alpha_2 \frac{C_{b,t}}{L_{b,t}} + \alpha_3 \left( m_{b,t}^D \frac{D_{b,t}}{L_{b,t}} \right) + \alpha_4 \left( m_{b,t}^F \frac{F_{b,t}}{L_{b,t}} \right) + \alpha_5 \chi_{b,t+2} + \alpha_6 (\mu_{b,t} \cdot \omega_{b,i,t}) + \alpha_8 HHI_{i,t} + \alpha_9 \Delta L_{i,t}^{flow} + \theta_{b,i} + e_{b,i,t}. \quad (10)$$

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<sup>36</sup>HHI calculated using loan flows might be endogenous to loan interest margins, therefore, for robustness check we also compute HHI index using data on loan portfolio. Overall, HHI is a widely used proxy for market concentration (e.g. see Valverde and Fernández, 2007; Corvoisier and Gropp, 2002, among others).

The notations for the explanatory variables are contained in Section 4.1.2.  $\theta_{b,i}$  denotes bank-segment-specific fixed effects, which capture the individual characteristics of each bank  $b$  and segment  $i$ , and  $e_{b,i,t}$  denotes residuals, which reflect all other margin determinants that cannot be captured by the model.<sup>37</sup> It should be noted that we include only the observable features of loan pricing, while other determinants, such as discrete bank management decisions, could be associated with model residuals.

The model is estimated by combining the *within* estimator and a weighted regression method to account for the considerable heterogeneity across banks and loan segments. For weights, we use the share of a bank’s loan flow relative to total loans (granted by all banks) in a given segment, which ensure that a higher weight in the estimate is assigned to larger banks. Finally, since our regression model is essentially an inverse supply equation, i.e. margins regressed on loan growth and other features, we use instruments to be able to identify the supply equation, and to tackle the potential endogeneity problem associated with the loan demand variable ( $\Delta L_{i,t}^{flow}$ ). Specifically, we instrument the loan growth variable with demand-side variables, namely, the annual GDP growth for NFC loans and an indicator of consumer sentiment for mortgages, consumer loans and other household loans.

## 4.3 Results

### 4.3.1 Regression estimates

Based on the general specification in equation (10), we estimate five different models. The first model considers the entire banking sector, pooling four loan segments: loans to NFC’s, mortgages, consumer loans and other loans to households. Second, we consider each of the four loan segments separately. In the former case, we use bank-sector-specific fixed effects,  $\theta_{b,i}$ , and in the latter – bank-specific fixed effects,  $\theta_b$ . The results of the regressions are presented in Table 1. Column (1) shows the estimates for the loan interest margins of the overall banking sector, whereas the results for each loan segment are presented in columns (2)-(5).

The estimates in the first two rows of column (1) show the expected positive sign, indicating that banks’ *operational costs* (i.e. administrative expenses and contributions paid to regulators) are translated into higher interest margins. The coefficient related to administrative expenses, compared to coefficient on contributions to regulators, is considerably smaller and statistically not significant at 10% level. This supports the hypothesis discussed in Section 3.1, according to which credit institutions may include a certain fraction of administrative expenses not in the interest margin, but in other fees and commissions borne by the clients at the origination stage of the loan. However, the segment-specific results in columns (2) to (5) differ in sign and magnitude, confirming the intuition that different loan types might differ in their operational cost-intensity. For instance, we find that the strongest effect of operational expenses is on consumer loan margins.

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<sup>37</sup>Time fixed effects are not used, as it would not allow to assess the impact of market concentration, which is segment- and not bank-specific. In addition, the use of time fixed effects would also make it potentially difficult to assess the impact of capital requirements, which were increased in 2015 across all banks.

Table 1: Regression results

	Dependent variable: loan interest margins				
	all	nfc	hh	ho	hc
	(1)	(2)	(3)	(4)	(5)
Administrative expenses	0.07 (0.08)	−0.02 (0.09)	0.29*** (0.07)	−0.02 (0.14)	0.74* (0.41)
Contributions to regulators	0.72* (0.40)	1.04** (0.48)	0.63 (0.39)	−3.92*** (1.00)	11.94*** (2.56)
Cost of deposit funding	0.88*** (0.06)	0.66*** (0.05)	0.61*** (0.05)	1.39*** (0.13)	4.94*** (0.27)
Cost of foreign funding	0.20** (0.10)	0.13 (0.13)	0.32*** (0.07)	0.09 (0.24)	−1.67*** (0.44)
Credit risk	0.02* (0.01)	0.02 (0.01)	0.06*** (0.01)	−0.02 (0.02)	0.12** (0.06)
Capital requirements	0.01 (0.01)	0.03** (0.01)	0.01 (0.02)	0.05** (0.03)	0.14** (0.06)
Concentration (flow)	0.44*** (0.07)	0.39*** (0.13)	0.41*** (0.05)	0.51 (0.39)	−0.84** (0.42)
Loan demand	−0.004 (0.004)	−0.004 (0.004)	0.03 (0.14)	−0.31 (0.69)	0.93 (0.96)
Bank-sector FE	YES	-	-	-	-
Bank FE	-	YES	YES	YES	YES
Weighted regression	YES	YES	YES	YES	YES
Robust SE	YES	YES	YES	YES	YES
Adjusted R <sup>2</sup>	0.31	0.3	0.6	0.26	0.54
Observations	1,708	483	408	431	386

Note: column (1) shows the estimates for a model that considers the overall banking sector, and columns (2-5) show estimates for each loan segment separately, respectively, for margins on loans to NFC's (*nfc*), mortgages (*hh*), other loans to households (*ho*) and consumer loans *hc*. All the estimates are weighted by the size of the bank's loan portfolio, in order to account for a considerable heterogeneity with respect to the volume of loans issued by banks operating in Lithuania. The sample period is 2006-21. Robust standard errors are presented in the parentheses. \*\*\*, \*\*, \* denote statistical significance at 1%, 5% and 10% levels, respectively. *Within* R-squared values are reported.

The coefficients on *funding costs*, both via deposits and from parent banks, in rows 3 to 4 are positively and statistically significantly related to loan interest margins. As can be seen from the magnitude of the estimates in column (1), it is found that a 1 p.p. increase in funding costs through deposits leads to a 0.88 p.p. increase in the interest margins.<sup>38</sup> The corresponding increase in the funding costs from foreign banks is found to be related only to a 0.20 p.p. increase in margins. However, the magnitude of funding costs varies across the four loan segments analysed (see columns 2 to 5). For example, around 60% of the increase in

<sup>38</sup>It should be noted that the interpretation is based on the assumption made in Section 3.2 that the money market interest rate (Avibor) is fully passed on to the cost of deposits. It therefore implies an increase in the deposit margin.

funding costs via deposits is passed on to the margins of NFC's and mortgage loans, whereas the pass-through is higher for other household and consumer loans.

The coefficients of *credit risk* are positive and statistically significant at 10% level, suggesting that banks demand higher margins to compensate for greater potential losses. On average, a 1 p.p. increase in the loan loss provision to assets ratio would result in a 0.02 p.p. increase in loan interest margins. The effect is stronger in household loan segment, in particular on consumer loan margins (see column 5), where the corresponding increase would lead to an increase in margins of around 0.12 p.p. While the effect is smaller and statistically not significant on NFC margins.<sup>39</sup> We acknowledge that this relationship may be underestimated as we use bank-level data rather than loan-level data. Therefore, in Section 4.4 we will further investigate this effect at the micro level.

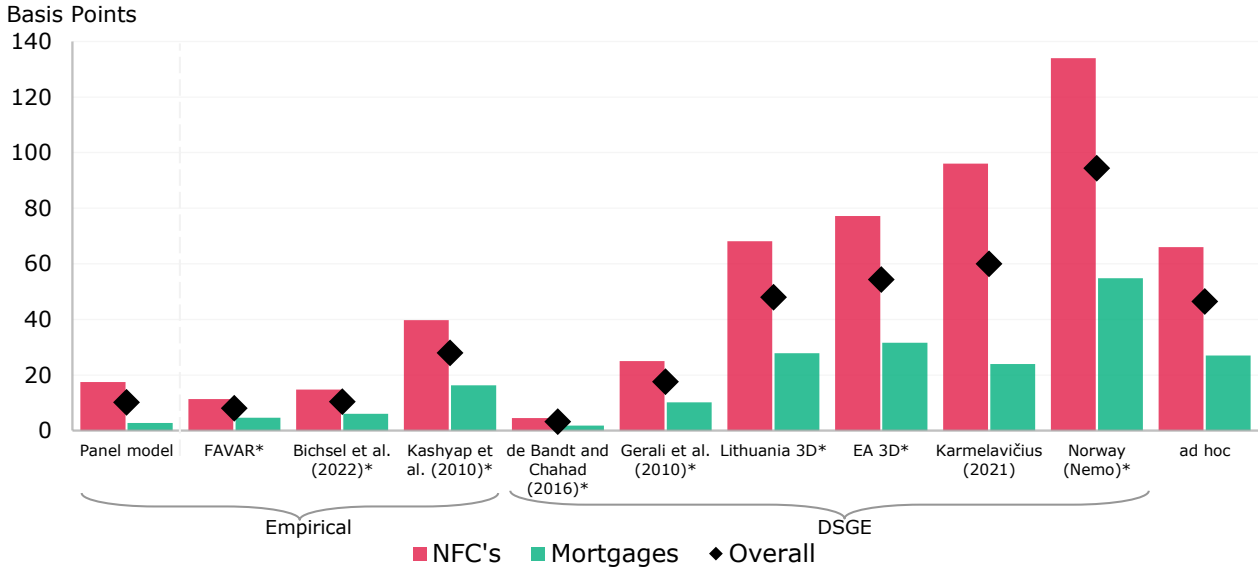
Turning to *capital requirements*, which are really a product of the required capital ratio and the risk weights ( $\mu_{b,t} \cdot \omega_{b,i,t}$ ), we find that they are positively related to interest margins, but the effect varies across loan segments (see columns (2) to (5)). More specifically, a 1 p.p. increase in the required leverage ratio is on average associated with a 0.14 p.p. increase in consumer loan margins, 0.05 p.p. – in margins on other loans to households, 0.03 p.p. – in NFC's margins and only 0.01 p.p. – in mortgage margins. However, the later effect is not statistically significant. Moreover, the effect is also not significant when the entire banking sector in column (1) is considered. This weak and statistically insignificant effect might reflect the fact that banks operating in Lithuania typically had high capital buffers, thus, changes in regulatory capital requirements might have not affected banks' capital ratios, and hence loan margins. Also, in spite of the increased capital ratio requirements across the banking industry, risk weights generally decreased, putting less pressure on banks to increase their margins, rendering the estimated coefficients small and insignificant.

Furthermore, we isolate the effect of changing risk weights and provide estimates for the lending rate impact of an 8.1 p.p. total increase in capital requirements throughout 2015-19 (see Section 2 and Panel (b) of Figure 3). The overall results are compared to other models and depicted in Figure 5. On the basis of the estimated panel model, we see that the net impact on corporate lending rates is around 18 BP, whereas the mortgage impact is much smaller and equal to only 3 BP. To put these numbers into perspective, if risk-sensitive capital requirements were returned to the levels of 2014, lending rates would be on average 0.1 p.p. lower. The magnitude of these estimates is similar to those obtained from a macroeconometric FAVAR model, using Lithuanian time series data, and also in proximity to the figures obtained by Bichsel et al. (2022). In contrast, Kashyap et al. (2010) found the impact on lending rates to be a bit higher, so that the net amount on average lending rates would be around 0.28 p.p. On the other hand, not all authors find capital requirements to be positively, or statistically significantly, linked to lending margins. For example, Ehrenbergerova et al. (2020) estimate the impact of capital ratios to be positive only for corporate lending rates, however, it is statistically insignificant.

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<sup>39</sup>These results are in line with Ehrenbergerova et al. (2020), who study loan interest rate and margin determinants in the Czech Republic over the period 2004–19 and find that banks tend to charge higher margins on loans to households due to generally higher risk premiums compared to corporate loans.

Figure 5: Lending rate impact of 8.1 p.p. increase in capital requirements



(Basis Points)	Panel model	FAVAR*	Bichsel et al. (2022)*	Kashyap et al. (2010)*	de Bandt and Chahad (2016)*	Gerali et al. (2010)*	Lithuania 3D*	EA 3D*	Karmelavičius (2021)	Norway (Nemo)*	ad hoc
Overall	10	8	10	28	3	18	49	55	61	96	47
NFC's	18	11	15	40	5	25	69	78	97	136	67
Mortgages	3	5	6	16	2	10	28	32	24	55	27

Notes: 1) the chart and the corresponding table contain the lending rates impact of an 8.1 p.p. increase in bank capital requirements. The original estimates are based on the effect of a 1 p.p. increment in capital ratios, which is multiplied by 8.1 to compute the total impact; 2) Panel model estimates are based on Table 1, with average risk weights of 66% and 27% for NFC loans and mortgages, respectively; 3) FAVAR\* model estimate is based on Budnik et al. (2019), using Lithuanian data, and kindly provided by L. Naruševičius; 4) Lithuania 3D\* estimates are based on a calibrated model of Clerc et al. (2015), and provided by L. Naruševičius; 5) *ad hoc* is computed using equation (8), with  $ROE^* = 10\%$  and average risk weights of  $\omega^{NFC} = 66\%$  and  $\omega^{mortgage} = 27\%$ , and profit tax rate of 20%; 6) de Bandt and Chahad (2016), Gerali et al. (2010)\*, EA 3D\*, Norway (Nemo)\* estimates are based on Table 4 in de Bandt et al. (2022); 7) \* denoted estimates are original only for the overall impact. The impact on NFC lending rates is assumed to be 2.44 ( $= 66/27 - \text{risk weight ratio}$ ) higher than that for mortgages, and the overall impact is the average of the two.

The estimates become much larger, if based on theoretical DSGE-type models or *ad hoc* rules. For instance, DSGE models that are calibrated to Lithuanian data (3D – Clerc et al., 2015, also Karmelavičius, 2021) suggest the overall impact to be around 0.49-0.61 p.p. – a roughly fivefold higher number, compared to the empirical counterpart (panel model). This discrepancy between the empirical and theoretical model estimates can be also explained by the fact that Lithuania's banks had significant capital surpluses over the requirement. Therefore, as the empirical model suggests, the heightened capital requirements may have been only partially transmitted into higher lending rates.

Regarding the *market concentration*, the obtained results show that a shift to a more concentrated market is generally associated with higher bank loan margins. The estimates suggest that a 1000-point increase in the HHI index would lead to an average increase in loan interest margins by 0.44 p.p. The corresponding increase in the HHI of the NFC and mortgage markets, respectively, would be associated with a similar 0.39 and 0.41 p.p. increase in margins. High statistical significance of this variable supports the market power hypothesis suggesting that banks operating in highly concentrated markets may charge higher lending margins, owing to their dominant position in the market. Finally, our results are robust when using HHI calculated using data of loans outstanding (see Table A2).

Finally, the results on the last row show that *loan demand* the effect of loan demand is estimated to have no significant effect on interest margins.

Overall, we acknowledge that results related to margins on other loans to households and consumer loans, respectively in columns 4 to 5, may not fully reflect the actual margin pricing as they only constitute a small part of the banks' loan portfolio. As a result, some of the price determinants observed at the bank level rather than at the bank and sector level, such as operating costs, may be not accurately assessed. These unobserved factors are more constraining for the smaller segments, which is why in the next section we focus on the two largest loan segments: mortgages and NFC loans.

### 4.3.2 Margin decomposition

Here we further explore the drivers of lending margins through a decomposition analysis, which is based on the regression results presented in Table 1 columns (2) and (3). Figure 6 depicts the historical decomposition of sector-wide lending margins for NFC loans and mortgages. The results show that different factors explain the evolution of margins over the years.

**Until mid-2015**, the main determinants of lending margins were funding costs and credit risk. For instance, between 2006 and 2008, cheap funding from Scandinavia and low perception of the underlying credit risk allowed banks to charge historically low interest margins. In contrast, during and shortly after the Global Financial Crisis, the disruption of financial markets made it difficult for parent banks to obtain stable and cheap funding, which contributed to increased funding costs for the Lithuanian banking system. More concretely, the increase in funding costs between mid-2008 and mid-2010 can be associated with an increase in lending margins by around 1-1.5 p.p. Meanwhile, higher credit losses incurred by banks during the crisis led to a 0.25 p.p. increase in margins on loans to NFC's, and to a 0.5 p.p. rise in mortgage margins. Finally, as funding costs and credit risk declined after the crisis, loan margins normalised.

**From mid-2015 to 2019**, the increase in margins can be mainly attributed to the changing structure of the banking sector and other unobserved factors. The changes in market structure affected average lending rates via two main channels. First, as some banks exited the market during this period, market concentration reached new historical heights and allowed the incumbent banks to enjoy high market power, and thus raise their mortgage rates by 0.4 p.p., and NFC rates by 0.2 p.p.

Second, the compositional effects – weighted averages of bank fixed effects – are also largely responsible for the increase in average margins, especially in the NFC market, where they contributed by around 0.3 p.p.<sup>40</sup> Essentially, after some banks exited the market, clients switched

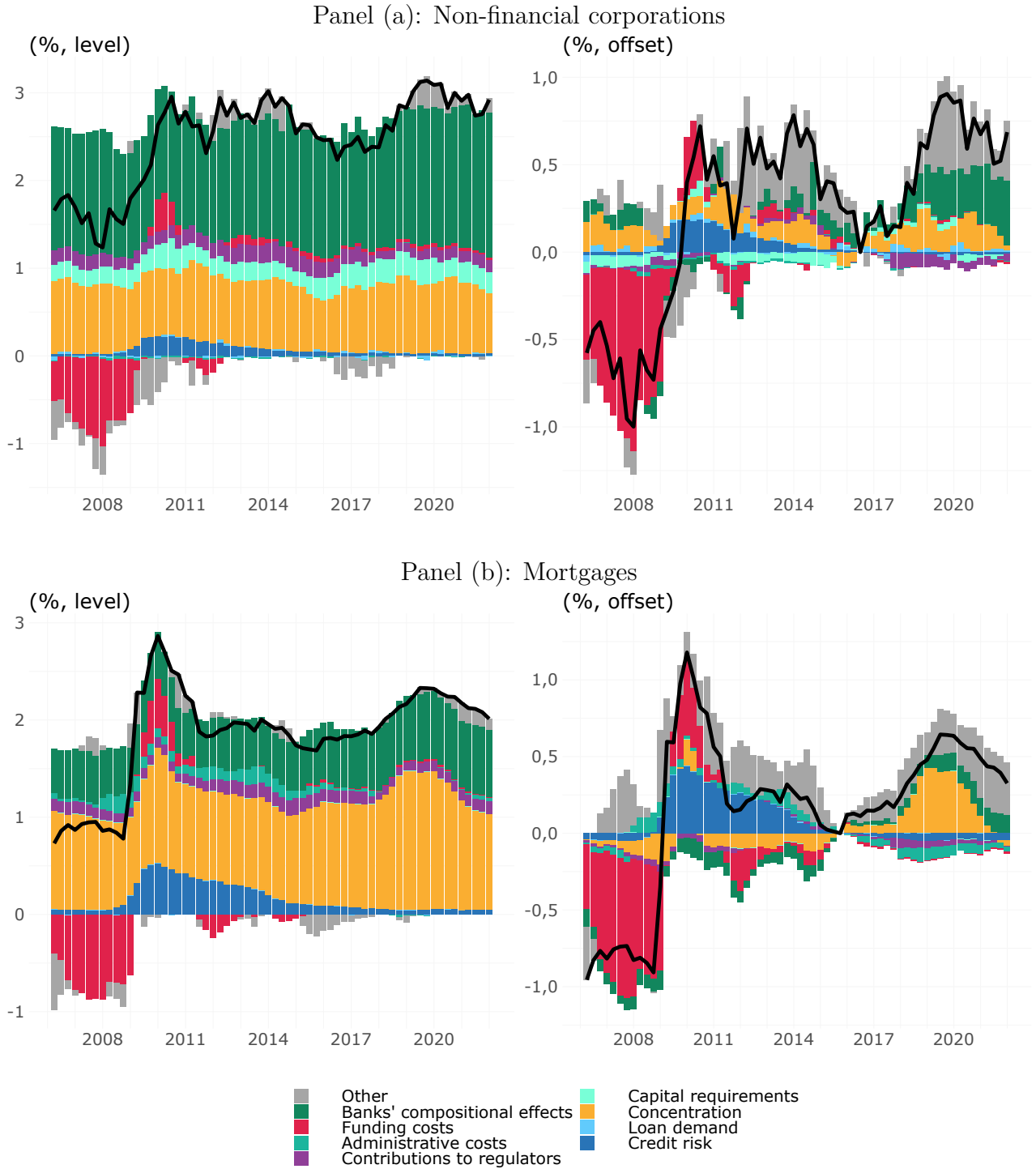
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<sup>40</sup>The compositional effects are the weighted-average of estimated bank fixed effects, with bank lending shares serving as weights  $\left(L_{b,i,t}^{flow}/L_{i,t}^{flow}\right)$ :

$$\sum_b \left( \frac{L_{b,i,t}^{flow}}{L_{i,t}^{flow}} \hat{\theta}_{b,i} \right),$$

where  $i \in \{nfc, hh\}$ . The compositional effects are time-varying with changing bank lending shares in a given

Figure 6: Decomposition of lending margins



Notes: the plots show the decomposition of weighted average loan margins for non-financial corporations (panel a) and mortgage loans (panel b). The plots on the left-hand side decompose the level of margins, while the right-hand side charts contain the decomposition of a cumulative change in margins, compared to a reference point. As reference points we have chosen moments when margins were the lowest: mid-2016 for the NFC segment and mid-2015 for mortgages.

and started borrowing from banks that already had been lending at high rates. As with the impact of concentration, this compositional effect has also to do with the changing structure of the market, i.e. decreasing number of competitors. However, the compositional effect mainly

market. For example, if a bank with generally high interest rates, which cannot be explained by the observable model features, reaches higher market share, the compositional effect will increase.

acts through the changing structure of lending – with banks that used to charge higher interest rates gaining larger market shares.

Moreover, our modelling results show that the increase in NFC and mortgage margins by around 0.55 p.p. and 0.3 p.p., respectively, remains unexplained by the model and the observable drivers, such as funding costs, credit risk. The rise in average rates may be related to other unobservable factors, such as discrete bank management decisions in pursuit of higher profits, risk aversion or economic growth. Lastly, as in the previous discussion, it does not seem that the tightened capital requirements were a major cause of lending rate variation, with a slight tangible effect only on NFC rates, as they carry higher risk weights and thus are more capital-intensive.

The subsequent decline in bank lending rates **throughout late-2019 and the Covid-19 pandemic** coincides with the decreasing market concentration in the NFC and especially mortgage segments. In addition, the decline in corporate margins is also strongly related with the contraction of other unobserved factors and, to a minor extent, with the relaxation of capital requirements.

#### 4.4 Additional NFC loan-level pricing model

The analysis of the drivers of business loan margins in the previous section showed that bank-level data cannot explain quite a significant part of the increase in loan interest margins over 2015-19. Moreover, the loan provision ratio for NFC loans did not show any material increase in credit risk that could explain the increase in lending margins. However, as the used provision ratio merely captures the realised risk, rather than the actual, it serves only as a proxy. Also, the so-called compositional effects showed that a significant amount of lending rate increase can be attributed to borrowers switching to other more expensive banks.

To address these issues and complement the previous findings, we present a micro-level loan pricing model for NFC's.<sup>41</sup> The model is based on around 61 000 newly issued business loans between 2015-19, utilising Bank of Lithuania's Loan Risk Database (PRDB), firm-level financial statements and *Scorify* credit ratings.<sup>42</sup> These type of rich data allow us to have a more accurate picture of loan-level credit risk, hence understand if there were any changes in the actual risk that could have altered pricing decisions. We briefly describe the model and its estimates, and later provide the drivers of aggregated lending margins.

Similarly to equations (8) and (10), we model loan-level interest rate margin ( $m_i$ ), which is defined as the difference between the  $i$ -th loan's interest rate and the corresponding reference rate, e.g. Euribor. In order to identify which factors influence the issued loan margin, we formulate the following regression:

$$m_i = \theta_b + \gamma_1 \mathbf{X}_i + \gamma_2 \mathbf{Z}_i + e_i,$$

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<sup>41</sup>The model was first presented and published as part of Lietuvos bankas ir Konkurencijos taryba (2021).

<sup>42</sup>The data covers not only the issuance of loans by banks, but also includes credit unions.

where  $\theta_b$  is a creditor (bank) dummy,  $\mathbf{X}_i$  are loan characteristics,  $\mathbf{Z}_i$  are firm characteristics and  $e_i$  are the idiosyncratic residual pricing terms that are not captured by the explanatory variables.<sup>43</sup> The combination of loan characteristics – variables like duration, collateral, guarantees – and firm characteristics, such as credit rating, firm size, financial ratios, allows us to model how different sub-components affect pricing decisions (see components of pricing in Section 3.1).

The estimated regression model is presented in Table A3 of the Appendix, with variables and their coefficients grouped in loan and firm characteristics. We will briefly describe the main qualitative results. Starting with loan-level features, we find that loan size significantly and negatively affects lending rates, what we discussed in Section 3.1. To our surprise, loan duration in years also negatively affects lending margins. On one hand, the higher the duration, the higher the probability of default over the lifetime of the loan, also the higher the liquidity risk, stemming from maturity mismatch. On the other hand, large loans and especially with longer durations yield higher absolute returns for the creditor, thus there is no need to charge high lending rates. This channel may explain the coefficient sign for both variables. Unsurprisingly, we see that if the loan is well-collateralised or guaranteed, the interest rates decrease, as there is lower credit risk via the loss given default (LGD), associated with that loan. Very importantly, if the lending relationship between the firm and the creditor is new, the loan interest rate will be on average higher by 6 BP. This can in part explain the previous finding that after some banks had exited the market, the borrowers needed to form new lending relationships, which were, at least initially, more pricey.

Turning to firm characteristics, modelling results indicate that loan margins are highly dependent on firm size, age and the *Scorify* credit rating. For instance, small and newly established firms that have a bad credit rating are very likely to receive a loan, if any, with relatively high interest rates. The regression results also include coefficient estimates for various financial ratios, however, they are not very significant as the financials are mostly captured in the credit rating, along other variables related to firm’s creditworthiness. Finally, the model also includes various dummy control variables for NFC economic activity types, their geographic location, as well as loan type and purpose, interest reference index type and reset frequency, and creditor dummies ( $\theta_b$ ), which serve as compositional effects.

### Aggregate drivers of loan-level margins

Figure 7(b) shows that the rise in interest margins between 2017 and 2019 covered all major sectors, but was mostly pronounced in the services and construction sector, also mainly due to compositional effects and unexplained factors. These results confirm that the rise in interest margins was not related to an increase in factual credit risk, which did not change according to firms’ financials and credit rating, nor was associated with a deterioration in certain economic sectors. Instead, the increase in average NFC lending rates was rather common to all firms in all sectors, the majority of which is not explained by the granular observable risk factors.

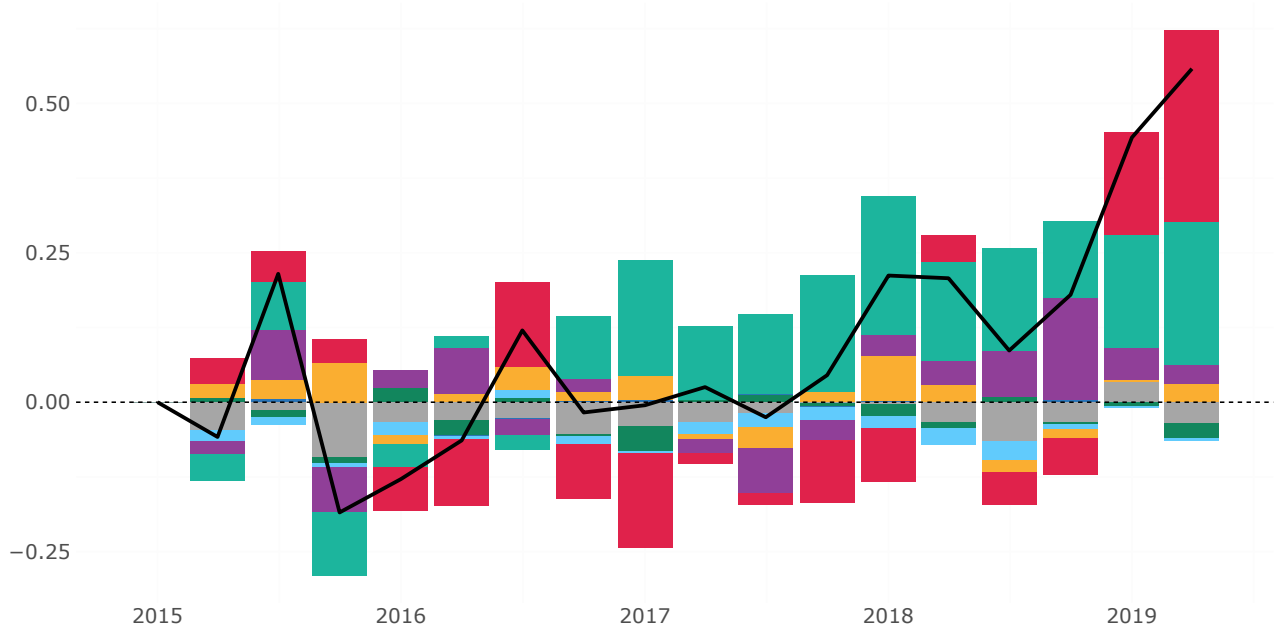
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<sup>43</sup>Note that this type of regression is purely cross-sectional, as we only model interest margins during the initiation phase of each loan.

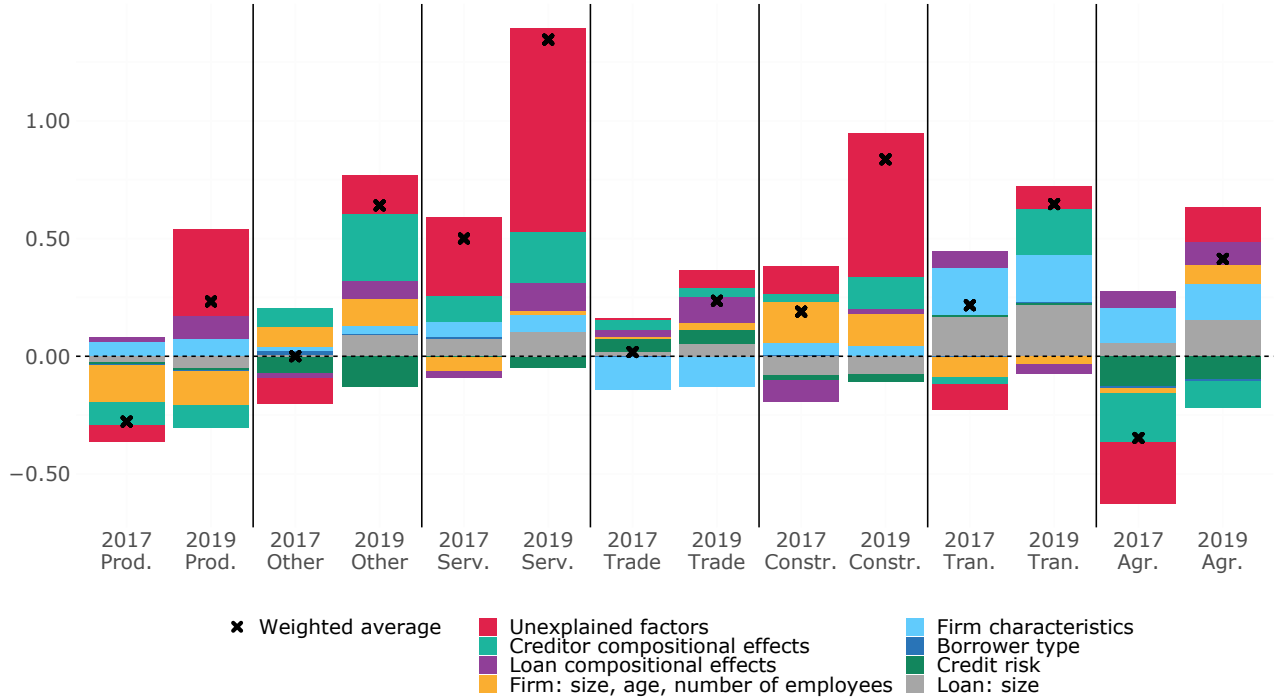
Figure 7: Decomposition of NFC loan interest margins

Panel (a): margin drivers, by quarter

(%, offset)



Panel (b): margin drivers, by economic sector



Notes: the plots show the decomposition of the weighted average loan margins for non-leasing loans up to 1 million EUR from Q1 2015 to Q2 2019 in panel (a), while panel (b) shows the decomposition by sector for 2017 and 2019. All the values are displayed as differences compared to Q1 2015. *Unexplained factors* are the difference between the observed weighted average and the weighted average calculated from the model fitted values. *Creditor compositional effects* consist of indicator variables ( $\theta_b$ ) for banks and credit unions, while *loan compositional effects* include loan type, purpose and index term. *Firm characteristics* cover firm location, economic activity (sector), number of inquiring institutions and number of queries requesting borrower liability information. *Borrower type* indicates new lending relationships. Finally, *credit risk* contains credit rating, ratio of long-term assets, tangible assets and equity to total assets, net profit to equity ratio, current ratio, number of debtors, loan duration, loan amount as well as collateral, guarantees and insurance to the loan amount ratio.

Using the estimated loan-level pricing model, presented in Table A3, we further investigate how different aggregate pricing components affected the average NFC lending margins throughout 2015-19. Panel (a) of Figure 7 shows the drivers of the weighted average interest rate margin on non-leasing NFC loans. We see that, in line with the results of the panel model depicted in Figure 6, the increase in average loan margins in 2015-19 can be primarily explained by creditor compositional effects and unexplained factors, rather than by an increase in the *factual* credit risk, which remained constant. Specifically, the increase in the creditor compositional effects reflects the change in the structure of NFC borrowing, with firms shifting towards creditors that usually charge higher interest margins. In addition, other unaccounted effects add to the rise in interest rates, which may be related to banks' discretionary attempts to limit their credit exposures. As discussed in Section 2, there were some signs of slowdown, which could have altered credit institutions' perception of credit risk, and to some extent feeding into higher lending rates.

## 5 Conclusions

Bank lending rates across the EA are very low by historical standards. However, despite the fact that monetary policy eased, over the last seven years Lithuanian lending margins increased and remain elevated among the EA countries. In this paper we attempted to find the drivers behind the lending rate rise throughout 2015-19 and subsequent fall in 2019-21. Our historical event analysis suggests that many things, including the increased banking concentration, heightened capital requirements, loan demand and other possible factors, may have shaped the dynamics of interest rates. To answer this question, we have estimated a bank-sector-level panel data model to explain the historical lending margin dynamics. We conclude this paper by offering three key findings.

**First**, while the Euribor reference rate remained below zero, loan interest rates have increased in Lithuania, suggesting of heightened bank lending margins. As banks' operating and financing costs were relatively stable and there was no material rise in the observable credit risk, other factors, including the unobserved, may have put pressure for interest rate changes.

**Second**, bank exits, mergers and acquisitions have markedly increased the concentration in Lithuania's banking industry, largely contributing to the interest rate rise throughout 2015-19 in both mortgage and business loan markets. However, the impact of the changing market structure was not uniform across the two lending segments. While the incumbent banks, who then enjoyed less competitive pressures in the mortgage market, raised their interest rates, a significant portion of the NFC lending rate rise can be attributed to compositional or structural effects. More specifically, bank-level and micro loan-level modelling results suggest that the average NFC interest rates increased, mostly since clients had to switch their borrowing from exiting banks to other banks that already had been lending at higher interest rates. Interestingly, as some banks started to more actively issue loans and compete between mid-2019 and 2021, average interest rates fell in both mortgage and NFC markets. Our result that increased

concentration mainly drove the interest rates is consistent with Benkovskis et al. (2021), who find that high spreads of the Baltic NFC market can be partly explained by concentration, in comparison to other EA countries.

**Third**, while the more stringent bank capital requirements may have had some effect on lending rates, the impact was rather small. Based on our modelling results, the 8.1 p.p. rise in capital requirements throughout 2015-19 may have heightened the NFC rates by at most 0.18 p.p., and mortgage rates by only 3 p.p. The estimates are similar in magnitude to other empirical models' results, yet are quite small, compared to figures from more theoretical DSGE settings. The somewhat limited empirical effect on lending rates may be explained by the fact that the Lithuanian banking industry had already had high levels of capital, thus the additional capital requirements were not binding. Furthermore, some of the increases in capital requirements could have been offset by decreasing average risk weights, what limited the capital cost of exposures, especially for banks that use the IRB method.

Overall, our findings imply that the increases in bank lending rates cannot be attributable to costs, but rather to a rise in shareholders' margins. Potentially, and at least to some extent, the increases in lending margins were purposeful discrete bank management decisions that were made in a relatively favourable economic environment with high credit demand, low banking competition and somewhat declining prospects of a few economic sectors. Our results suggest that policy-makers should continue, in a prudent manner, to promote competition in the local banking industry. For example, this can be done by strengthening new market participants and fostering their organic growth, in order to pose greater, yet reasonable, competition for the incumbents. Additionally, as also highlighted by Cuestas et al. (2020) and enacted in Lithuanian law, regulatory bodies should actively *ex ante* assess the impact of banking mergers and acquisitions on competition and systemic risk, and prevent these transactions, in case market or financial stability conditions are likely to deteriorate.<sup>44</sup>

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<sup>44</sup>For example, a recent change in the Lithuanian Law on Banks allows Bank of Lithuania to prevent mergers and acquisitions in order to limit the risk to financial stability that may arise from excessive concentration in the banking sector (news in Lithuanian), ([link in English](#)).

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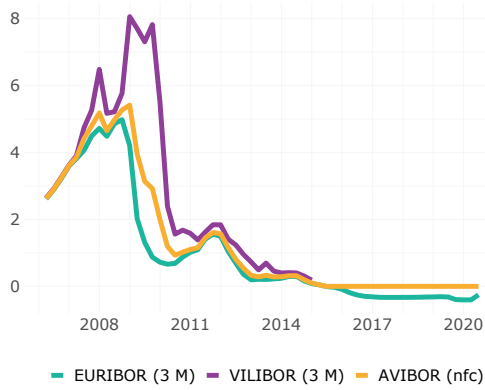
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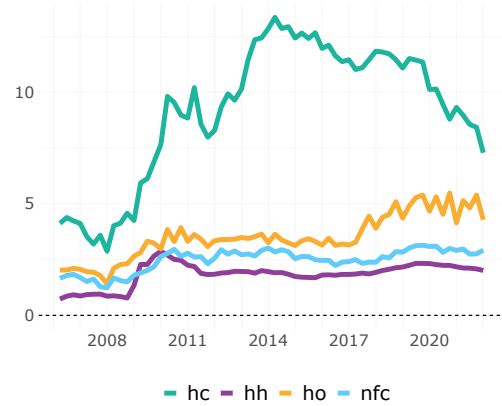
# A Appendix

Figure A1: Dependent and explanatory variables

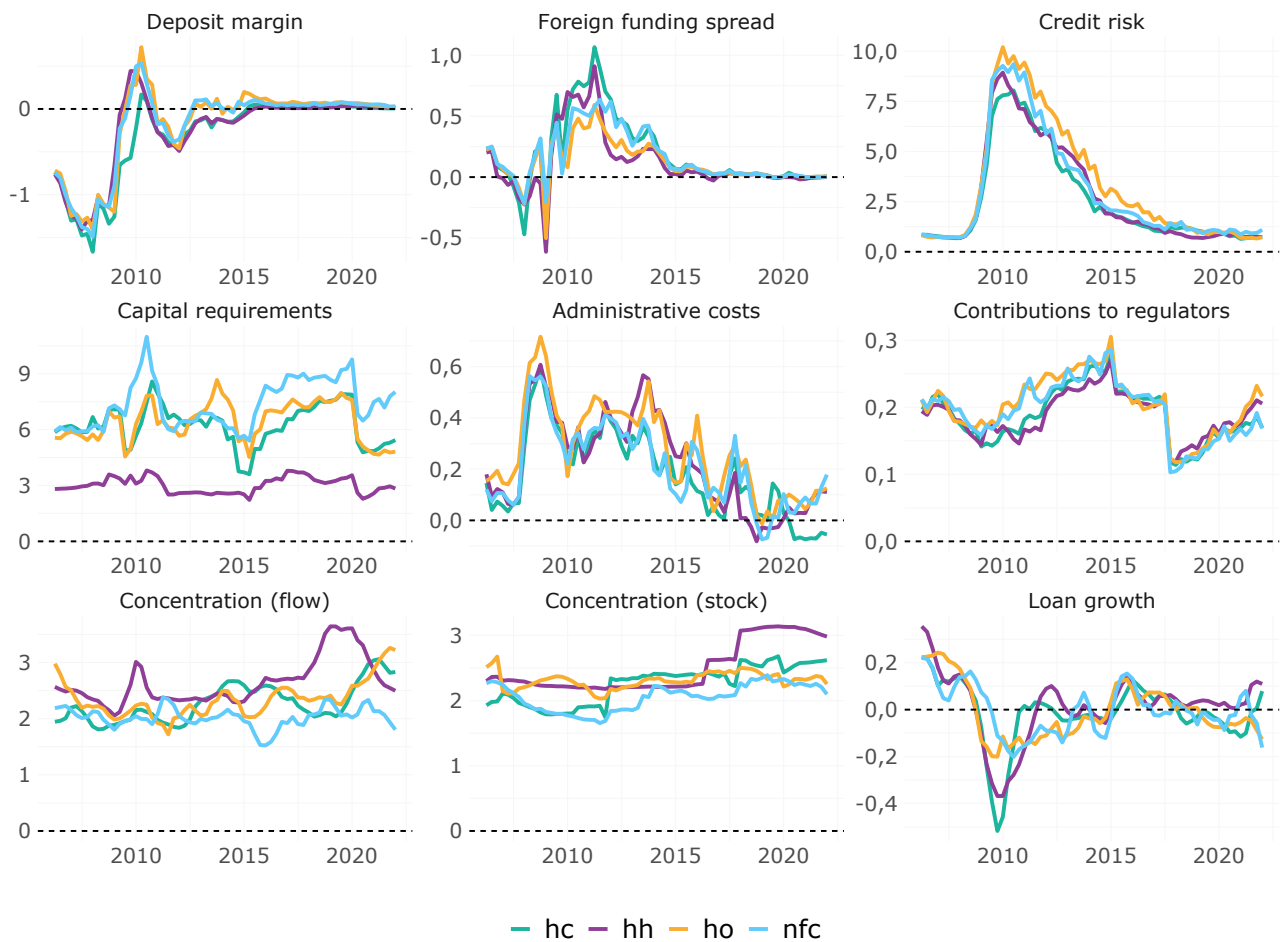
Panel (a): Avibor



Panel (b): Margins



Panel (c): Explanatory variables



Notes: Panel (a) shows Avibor rate, which is a weighted average between the Vilibor and Euribor reference rates computed as: i) weighted average of Euribor and Vilibor (reference rate for Lit-denominated loans) before 2015; ii) Euribor as of Lithuania's adoption of Euro in 2015. Bank-sector-specific loan flows are used as weights. Panel (b) shows the weighted average interest margins on consumer loans (hc), mortgages (hh), other loans to households (ho) and loans to non-financial corporations (nfc). Panel (c) shows the weighted average of the explanatory variables used in the regression analysis. All variables, except those in the last row, are in percentage points. Concentration is measured by the Herfindahl-Hirschman Index (HHI) divided by 1000, loan growth is expressed as an average annual logarithmic difference in sector-specific loan flows.

Table A1: Descriptive statistics of the main bank-level variables

## (a) Dependent variable – loan margins

Statistic	Mean	St. Dev.	Min	Max
Loans to business (NFC)	2.96	1.23	0.28	7.62
Mortgages	2.08	0.89	0.46	5.30
Other loans to households	3.66	1.43	0.62	12.32
Consumer loans	8.05	4.48	1.08	18.67

## (b) Explanatory variables

Statistic	Mean	St. Dev.	Min	Max
Administrative expenses	0.48	0.56	−2.20	2.27
Contributions to regulators	0.19	0.07	0.05	0.37
Cost of deposit funding	−0.03	0.61	−2.80	3.70
Cost of foreign funding	0.17	0.37	−1.52	2.31
Credit risk	3.63	3.86	0.19	21.14
Capital requirements	6.57	2.75	1.42	16.09
Concentration (flow)	2.30	0.38	1.52	3.64
Concentration (stock)	2.26	0.30	1.65	3.14
Loan demand	−0.0003	0.13	−0.52	0.35

Notes: table shows summary statistics of bank-level data for each series used in the regression analysis in Section 4. Concentration is measured by the Herfindahl-Hirschman Index divided by 1000, loan demand is expressed as an average annual logarithmic difference in sector-specific loan flows, other variables are in percentage points. For more details, see Section 4.1.

Table A2: Regression results, using different HHI

	Dependent variable: loan interest margin				
	all	nfc	hh	ho	hc
	(1)	(2)	(3)	(4)	(5)
Administrative expenses	0.14* (0.07)	0.08 (0.09)	0.29*** (0.07)	−0.15 (0.12)	0.85** (0.40)
Contributions to regulators	0.80** (0.38)	1.04** (0.44)	0.89** (0.36)	−4.47*** (1.02)	9.35*** (2.43)
Cost of deposit funding	0.80*** (0.06)	0.59*** (0.05)	0.59*** (0.05)	1.51*** (0.13)	4.14*** (0.32)
Cost of foreign funding	0.32*** (0.10)	0.26* (0.14)	0.40*** (0.08)	−0.01 (0.22)	−1.27*** (0.38)
Credit risk	0.05*** (0.01)	0.06*** (0.02)	0.08*** (0.01)	−0.06** (0.02)	0.23*** (0.06)
Capital requirements	0.004 (0.01)	0.03** (0.01)	0.03* (0.02)	0.07*** (0.02)	0.11* (0.06)
Concentration (stock)	0.81*** (0.09)	0.87*** (0.21)	0.58*** (0.05)	−1.06** (0.50)	1.74** (0.72)
Loan demand	−0.003 (0.004)	−0.002 (0.004)	0.04 (0.14)	0.01 (0.60)	1.30 (1.04)
Bank-sector FE	YES	-	-	-	-
Bank FE	-	YES	YES	YES	YES
Weighted regression	YES	YES	YES	YES	YES
Robust SE	YES	YES	YES	YES	YES
Adjusted R <sup>2</sup>	0.34	0.33	0.59	0.25	0.6
Observations	1,708	483	408	431	386

Note: this table shows the results of robustness checks when replacing the HHI loan flow-based measure of concentration (see results in Table 1) with HHI measured using loan portfolio data. For the comparison of both measures see Panel (c) of Figure A1. Column (1) shows the estimates for a model that considers the overall banking sector, and columns (2-5) show estimates for each loan segment separately, respectively, for margins on loans to NFCs (*nfc*), mortgages (*hh*), other loans to households (*ho*) and consumer loans *hc*. All the estimates are weighted by the size of the bank's loan portfolio, in order to account for a considerable heterogeneity with respect to the volume of loans issued by banks operating in Lithuania. The sample period is 2006 – 2021. Robust standard errors are presented in the parentheses. \*\*\*, \*\*, \* denote statistical significance at 1%, 5% and 10% levels, respectively. *Within* R-squared values are reported.

Table A3: NFC loan-level pricing regression results

Dependent variable: NFC loan interest margin ( $m_i$ )				
		$\gamma$		
Loan	(Intercept)	7.26	***	(0.09)
	Number of debtors	0.05		(0.05)
	Loan duration, years	-0.07	***	(0.003)
	log(Loan size, EUR)	-0.32	***	(0.004)
	(RE Collateral / Loan amount)	-0.001	***	(0.0002)
	(Other Collateral / Loan amount)	-0.0001		(0.001)
	(Personal Gaurantees / Loan amount)	0.06	***	(0.004)
	(Government Gaurantees / Loan amount)	-0.02	***	(0.01)
	(Insurance / Loan amount)	-0.01		(0.01)
	New lending relationship	0.06	***	(0.01)
Firm	Firm size 2: Medium Enterprise	0.31	***	(0.01)
	Firm size 3: Small Enterprise	0.51	***	(0.02)
	Firm size 4: Micro Enterprise	0.84	***	(0.02)
	Firm age: [5,10)	-0.06	***	(0.01)
	Firm age: [10,20)	-0.15	***	(0.01)
	Firm age: 20+	-0.18	***	(0.01)
	Rating: B	0.11	***	(0.01)
	Rating: C	0.17	***	(0.02)
	Rating: D	0.50	***	(0.05)
	Rating: E	0.39	***	(0.14)
	Rating: Not rated	0.08	***	(0.01)
	(Long-term assets / Assets)	-0.16	***	(0.02)
	(Equity / Assets)	0.01		(0.02)
	(Tangible assets / Assets)	0.001		(0.002)
	(Net Profit / Equity)	0.0000		(0.0002)
	Current ratio	-0.0000		(0.0001)
	Number of employees	-0.0000		(0.0000)
	Number of institutions requesting borrower liability information	-0.01	***	(0.004)
	Number of queries requesting borrower liability information	0.0001	***	(0.0000)
Firm	Economic activity effects	YES		
	Municipal effects	YES		
Loan	Creditor compositional effects ( $\theta_b$ )	YES		
	Loan type effects	YES		
	Loan purpose effects	YES		
	Loan index term effects	YES		
Observations		61,380		
R <sup>2</sup>		0.69		
Adjusted R <sup>2</sup>		0.69		

Note: estimation is based on the micro-level loans, that were issued in 2015-19. Standard errors are presented in the parentheses. \*\*\*, \*\*, \* denote statistical significance at 1%, 5% and 10% levels, respectively. The reference category for firm size is large enterprises, for age – less than 5 years and for the rating – an A rating.