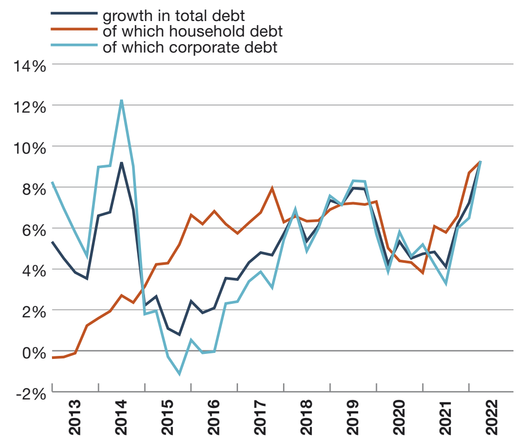
FAST GROWTH IN CREDIT COULD LEAD TO LARGER LOAN LOSSES IN THE FUTURE

The economy in Estonia over the past few years has seen strong demand coupled with rapid growth in incomes and savings, and with interest rates low, the increase in borrowing has been substantial. Growth in borrowing has been particularly fast in the real estate sector, where the rise in real estate prices has been accompanied by increases in housing loans and in the amount borrowed by companies to finance real estate. The debt liabilities of companies and households have grown faster in the past year than the economy. This means that the non-financial sector is more vulnerable to a deterioration in the economic climate, and this could lead to larger loan losses for the banks if events take a turn to the negative. Eesti Pank has set the countercyclical capital buffer requirement for the banks at a base level of 1%, but the increase in risk has increased the need to raise the buffer requirement.

BORROWING BY BOTH COMPANIES AND HOUSEHOLDS HAS BEEN STRONG THIS YEAR

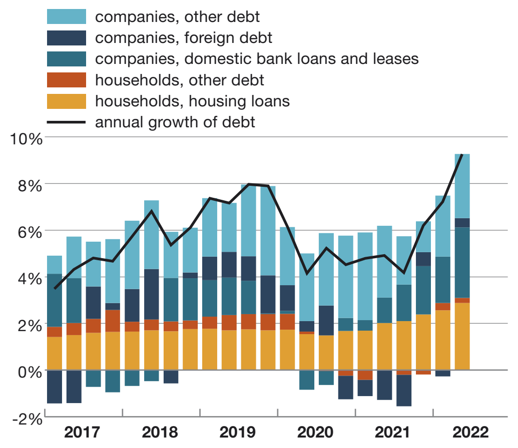
Annual growth in the debt liabilities of households and companies has been accelerating since the final quarter of 2021. Growth in household debt first picked up in the first half of 2021, and in the fourth quarter of the year the rate of growth in corporate debt also increased, causing the yearly growth in the total debt of the non-financial sector to accelerate to 9% in the second quarter of 2022 (see Figure 16). Faster growth in debt was driven by a strong demand environment, rising incomes, and increased capacity to borrow on the back of savings built up as deposits. The growth in debt liabilities has also been supported by low interest rates and the strong growth in deposits, and by the large supply of credit that the high level of capitalisation of the banks has allowed. Higher prices of late for real estate and various other goods and services have also increased the amounts borrowed. The main source of financing for the rapid growth in debt in the past year has been domestic bank loans and leases (see Figure 17), which will probably also decide the rate of growth in total debt in the coming quarters.

Figure 16. Annual growth in the debt of the non-financial sector



Source: Eesti Pank

Figure 17. Contributions to the growth of non-financial sector debt

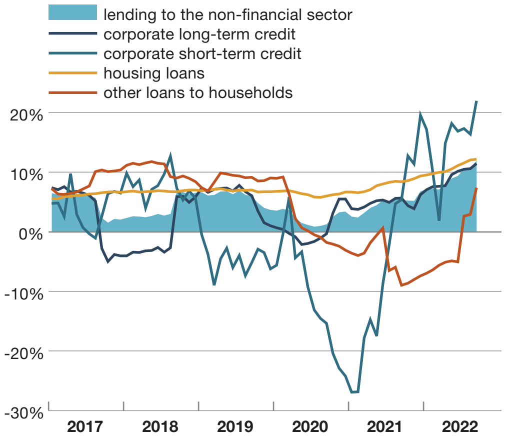


Source: Eesti Pank

The rate of growth in borrowing from banks accelerated further in the third quarter and the amount issued in loans and leases to companies and households was 12% more by the end of September 2022 than it was a year earlier (see Figure 18). Growth in the loan portfolio in recent years has been driven mainly by strong demand for housing loans, and the housing loan portfolio increased by 12% over the year. Demand for consumer loans has remained relatively strong as well, though the portfolio of them grew by a more moderate 7% over the year as the money withdrawn from the second pension pillar was partly used to repay consumer loans. The growth in corporate bank loans and leases, like that in total debt, started to accelerate in the final quarter of 2021 to reach 12.5% by the end of September 2022, which is a similar rate to that for households.

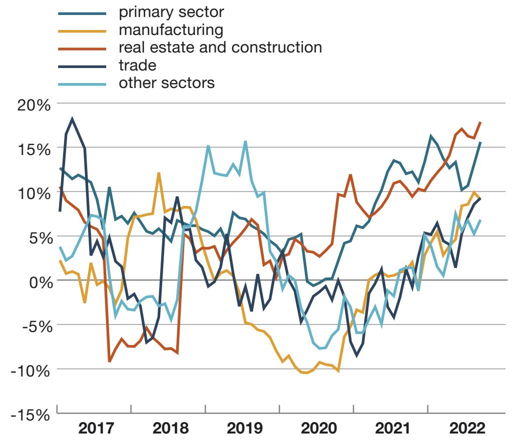
The main driver of the rapid growth in the corporate loan portfolio was financing for the real estate and construction sector. Although the yearly rate of growth in loans accelerated in various other business sectors too

Figure 18. Annual growth of bank loans and leases



Source: Eesti Pank

Figure 19. Annual growth of loans to companies by economic sector



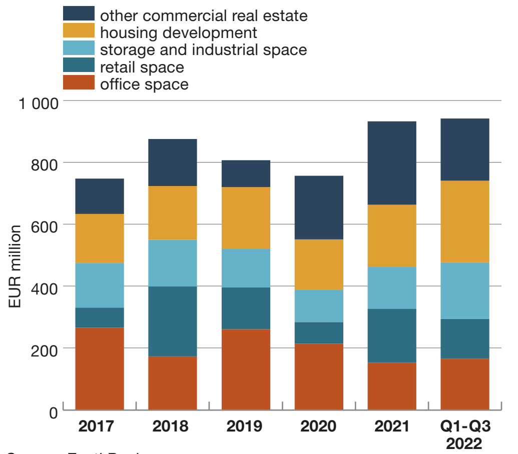
Source: Eesti Pank

(see Figure 19), the yearly growth in the large portfolio of the real estate and construction sector has remained above 10% for more than a year now. The share of the loan portfolio accounted for by companies working in areas related to real estate development has consequently increased to 41%, increasing the concentration in the loan portfolio and making it more exposed to the risks from the highly cyclical market for residential and commercial real estate. An average of 19% more has been granted this year in short-term loans as volumes of business and inventories have grown, and the largest part of those loans has been corporate overdrafts.

Larger amounts of new loans have been granted than last year to finance almost all the main segments of commercial real estate. Loans were granted most in the first half of the year for storage and production space and for development projects for residential property, and the value of loans in that segment was more than double what it was a year earlier (see Figure 20). The growth in lending for commercial real estate has been affected by demand-side factors and by the sharp rise in construction prices and low interest rates. Tight competition between the banks has also steered the dynamics of loan growth in this sector, as the share of small banks in the turnover of lending in the past couple of years has increased to around a third.

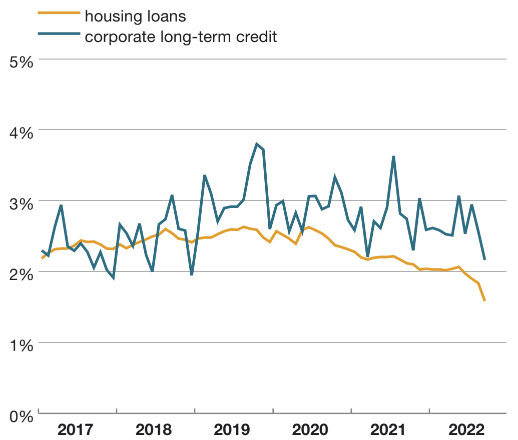
The lending conditions of the banks have encouraged borrowing. The bank lending survey shows that some banks have tightened their lending standards and conditions for corporate loans, but overall there has been no major change. The conditions on housing loans have eased

Figure 20. New long-term loans issued for commercial real estate purposes



Source: Eesti Pank

Figure 21. Average interest rate margin over six-month Euribor



A negative Euribor rate has been taken as zero
Source: Eesti Pank

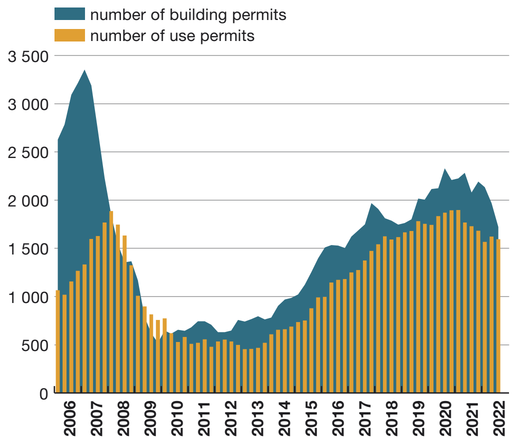
a little[15]. With base interest rates rising and competition between the banks tight, the interest margins on loans have fallen. The average annual interest margins on housing loans and long-term loans issued to companies have been falling since 2021 (see Figure 21).

STRONG DEMAND IN THE REAL ESTATE MARKET HAS ACCELERATED THE GROWTH IN HOUSEHOLD DEBT

Demand in the housing market remained strong in the first half of 2022, and prices rose fast. Demand was boosted by the rise in the average wage, accumulated savings, and the money withdrawn from second pillar pension funds[16]. Supply did not keep up with the increased demand as the addition of new residential space has been held back by higher prices for construction materials and supply difficulties (see Figure 22). In the secondary market, supply may not have grown as fast as it might, since sellers expected prices for housing to continue rising fast. The combined impact of these factors pushed the yearly growth in the price index for housing to 27% by the end of the second quarter of 2022 according to Statistics Estonia (see Figure 23).

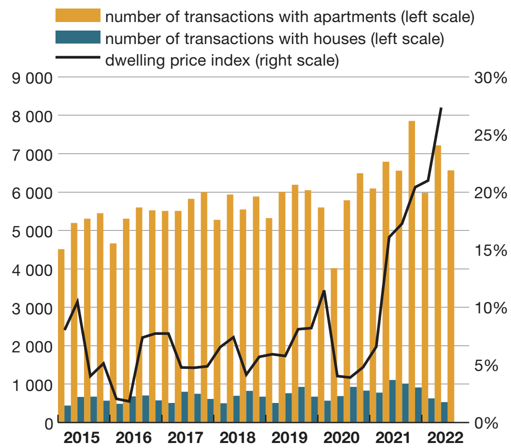
Demand for housing declined in the third quarter, and prices rose less quickly. High inflation reduced consumer confidence and the purchasing power of households, and so the demand for housing loans also fell. At the same time the impact of withdrawals in the second pension pillar on demand for housing loans has become steadily weaker. Data from websites for selling real estate show that the supply of residential real estate on the market has started to increase. The number of purchase and sale transactions of single family homes started to fall at the start of the year, and in September and October the number of transactions with apartments was also notably smaller than it was a year earlier[17]. Preliminary data from the Land Board show that the average square metre price of transactions with apartments in the third quarter remained broadly around the levels reached in the second quarter. The average price of transactions with new apartments has fallen in most recent months, though this indicator is quite volatile as the small size of the market means the monthly average is influenced more by the specific characteristics of the real estate sold during the month, but the rise in apartment prices on the secondary market has also slowed (see Figure 24).

Figure 22. Four-quarter moving average of building and use permits for dwellings



Source: Statistics Estonia

Figure 23. Annual growth in housing prices and number of transactions

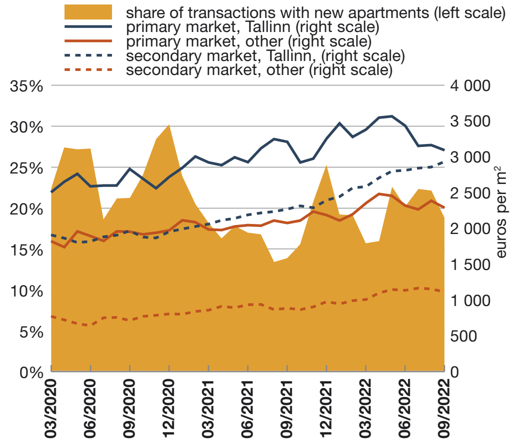


Sources: Statistics Estonia, Estonian Land Board

The rapid rise in prices for residential real estate means that the housing market is overpriced. Changes in housing prices are explained in the Eesti Pank model by incomes, the number of dwellings, and changes in interest rates. The factor that has affected housing prices the most over the years has been the rise in incomes. The increase in the number of dwellings has had a smaller impact. Interest rates have at different times pushed prices up and down. The rise in prices in 2021 and 2022 was supported by rapid rises in incomes, and the

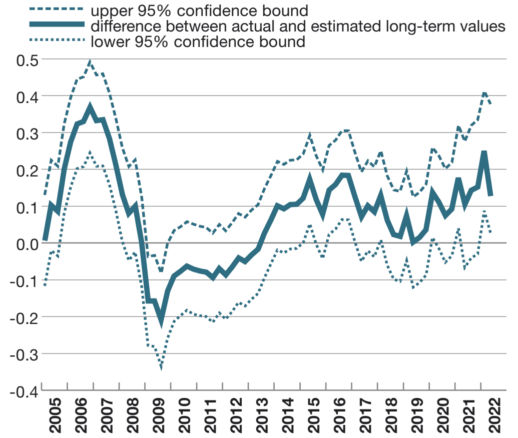
15 Changes in the conditions for housing loans are covered in more detail in Box 2.
16 Households have withdrawn around 1.3 billion euros from the second pension pillar since the third quarter of 2021.
17 It should be noted here that the first and largest withdrawals from the second pension pillar fund were made in September 2021, and they significantly increased the volume of transactions in the housing market.

Figure 24. Share of transactions with new apartments and average price per square metre



Source: Estonian Land Board

Figure 25. Over or undervaluation of the housing market in the baseline model of Eesti Pank



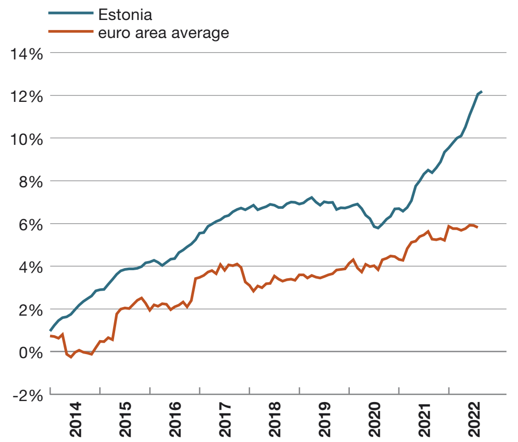
A value of 0.1 denotes overvaluation of 10%
Sources: Statistics Estonia, Eesti Pank

model shows that residential property was slightly overpriced (see Figure 25). The overpricing has been pushed further by high inflation in recent quarters, with the result that the real incomes of households have shrunk.

The active housing market and rapidly rising prices have seen the growth in housing loans accelerate this year. The yearly growth in housing loans reached 12% in September, which is notably faster than the average in the euro area, although the housing markets in several other euro area countries are active and lending is growing relatively fast (see Figure 26). With demand strong, 18% more housing loans were issued in the third quarter of 2022 than a year earlier, and their total value was almost a third higher (see Figure 27). The slowdown in transaction activity is reflected in the value of housing loans with a lag, as some of the loans are issued to purchase new property that is only being finished, and sales transactions are often signed a long time before the money for the loan is transferred. Borrowed money was used less for financing housing transactions in 2020-2021, but it has recovered to its long-term average this year (see Figure 28).

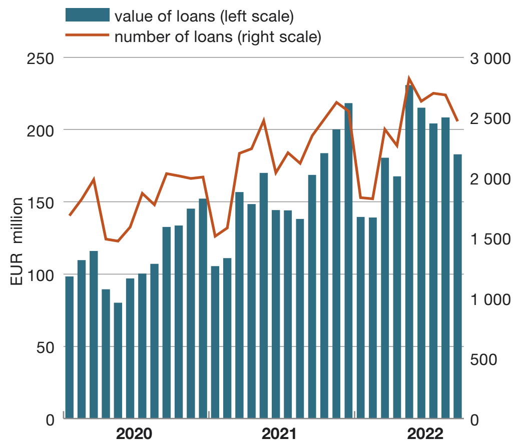
Real estate prices rising faster than incomes and increased competition between the banks have meant that an increasing share of loans are issued at close to the limits set by Eesti Pank for lending by the banks. Eesti Pank has set limits on the conditions on loans issued by the banks in order to help keep balance in the housing loan market and limit excessive growth in lending. There has been an increase

Figure 26. Annual growth of the housing loan stock



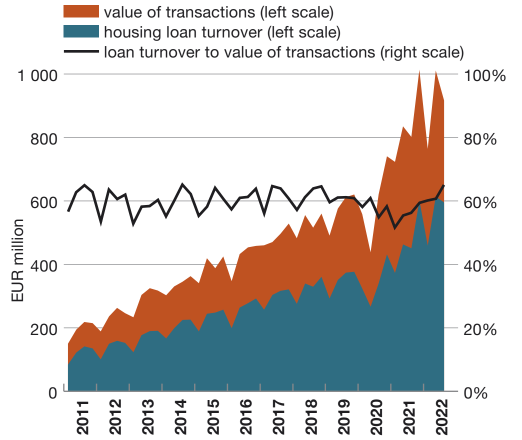
Sources: European Central Bank, Eesti Pank

Figure 27. Number and value of housing loans issued in a month



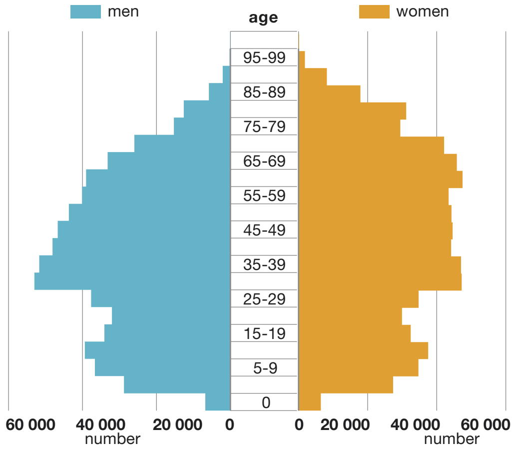
Source: Eesti Pank

Joonis 28. Transactions in the housing market and housing loan turnover in a quarter



Transactions with apartments and land with residential buildings
Sources: Estonian Land Board, Eesti Pank

Figure 29. Population of Estonia by age group in 2022



Source: Statistics Estonia

in the share of new housing loans where the loan repayments remain just below the limit of 50% of the net income of the borrower, given the possible rise in interest rates. There has also been an increase in the share of loans issued with the maximum maturity of 30 years (see Box 2). This could indicate that the profile of the new borrowers has become riskier on average.

Looking forward, the impact of the factors supporting demand for housing and housing loans has weakened. High consumer price inflation has reduced confidence and the capacity to buy housing and take housing loans. The cost of servicing loans is being increased by the rise in base interest rates. However, the September forecast by Eesti Pank expects overall inflation to start to ease in the coming year, allowing the purchasing power of households to recover over time if incomes continue to grow rapidly. The supply of new housing will presumably not, however, increase, as a fall in demand and rising financing costs and other costs have made development more expensive and riskier. At the same time, a rise in supply in the secondary market as demand fades could even push prices downwards. Growth in housing loans is expected to continue, but at a slower rate than before.

Demand in the housing market will at the same time be supported over the long term by the growth in the population. The cohorts in Estonia reaching the age where they tend to leave their childhood homes and rent or purchase their own are notably smaller than earlier ones (see Figure 29), but the population of Estonia has been increased since February 2022 by more than 35,000 refugees under temporary protection[18]. The rapid growth in the population will first of all increase demand for rented property and push prices for it up, but it may be expected that the impact will in future pass more broadly into the housing market.

INCREASING INDEBTEDNESS MEANS THAT BANKS NEED TO ENSURE THEY HAVE SUFFICIENT CAPITAL BUFFERS

Although the outlook for growth in the economy has deteriorated, the growth in borrowing by Estonian households and companies was very strong at the end of summer, pointing to an increase in cyclical risks. Growth in borrowing may be considered high enough to create additional risk if it is consistently faster than growth in nominal GDP, meaning that indebtedness increases. The two main indicators that Eesti Pank uses to assess the growth in lending and the credit cycle are the change in indebtedness in the non-financial sector, and the deviation of the rate of yearly growth in debt from the long-term average nominal growth in the economy over eight years. These indicators suggest that the risks from rapid growth in borrowing have increased in Estonia.

- **Indebtedness in the non-financial sector in Estonia will increase in the coming years.** Indebtedness continued to decline in 2022 despite the rapid growth in debt, and by the end of the second quarter the debt-to-GDP ratio had come down to its level of 2005

18 https://www.politsei.ee/et/ajutise-ja-rahvusvahelise-kaitse-taotlejate-arv.

at 109%. The ratio fell largely because the steep rise in inflation meant the nominal size of the economy increased sharply this year. The Eesti Pank September forecast suggests that inflation will be lower in the years ahead and with economic growth still moderate it may be expected that indebtedness will soon start to increase gradually (see Figure 30).

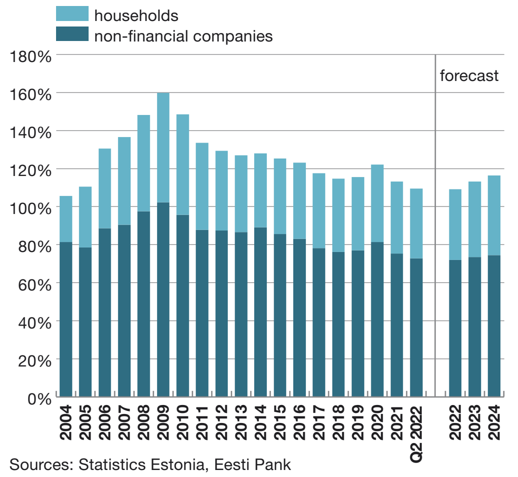
- **Growth in debt is faster than long-term growth in the economy.** Revised data show that the yearly growth in the debt of the non-financial sector was already a little faster than the eight-year average nominal growth in the economy at the end of 2021, and that the difference in growth rates widened further in the first half of this year. The Eesti Pank September forecast expects debt to continue to grow fast in the coming years, exceeding both long-term GDP growth and growth in the current year (see Figure 31).

Borrowing growing faster than incomes will increase the vulnerability of the non-financial sector. This means that companies and households will have to be ready to cope with larger loan repayment burdens. If the macroeconomic circumstances should unexpectedly and sharply deteriorate, there could be problems in repaying loans that could be made worse by the earlier rapid growth in borrowing. This makes it important for the banks to hold additional own funds while lending grows fast so that they can cope with increased loan losses in future.

The European Systemic Risk Board (ESRB) also believes it is important to ensure the resilience of the financial system. In a warning issued at the end of September 2022[19], the ESRB emphasised that the substantially increased risks this year mean that member states should consider all micro and macroprudential measures that could help ensure the resilience of the financial system. For the banking sector, this means increasing the cyclical capital buffers, managing risk conservatively, and setting aside sufficient provisions. The banks also need to consider the increased risks when planning their capital and making decisions about distributing profits.

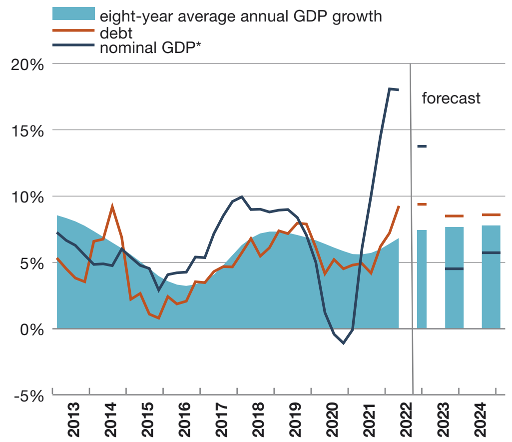
Many countries in Europe have in the past couple of years decided to raise their countercyclical capital buffer rates. The harm that the Covid-19 pandemic caused to economies proved short lived in most countries, and the pandemic

Figure 30. Non-financial sector debt to GDP ratio



Sources: Statistics Estonia, Eesti Pank

Figure 31. Annual growth of non-financial sector debt and nominal GDP



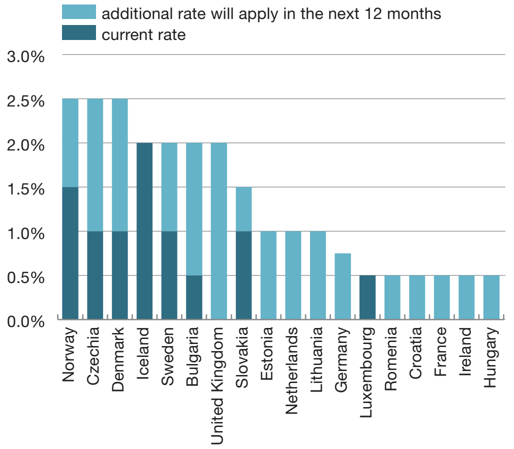
* Four-quarter moving average yearly GDP growth
Sources: Eesti Pank, Statistics Estonia

recession was followed by strong growth, especially in the real estate sector using financing from loans. Several countries have applied various macroprudential measures against cyclical risks, including raising the countercyclical capital buffer rate, and by 30 September 2022, 18 countries in Europe had decided to raise their buffer rate above zero. The higher buffer rate will start to apply in most of those countries within the next 12 months (see Figure 32).

When calculating their institution-specific capital buffers, the banks need to consider the countercyclical capital buffer rates applied not only in Estonia but also in other countries. If a bank operating in Estonia has credit risk positions in a country that has set a positive

19 https://www.esrb.europa.eu/pub/pdf/warnings/esrb.warning220929_on_vulnerabilities_union_financial_system~6ae5572939.en.pdf.

Figure 32. European countries with a countercyclical capital buffer rate above 0% as at 30.09.2022



Sources: ESRB, BIS, Eesti Pank

buffer rate, then the principle of automatic reciprocation applies. This means that the bank has to hold the appropriate amount of additional own funds to cover those positions. Foreign banks that have lent to residents of Estonia have to follow the same principles. Taking account of the locations of the credit risk positions of the banks licensed in Estonia and assuming that the buffer requirements are in force in all the countries, the average institution-specific countercyclical capital buffer rate for the Estonian banking sector is estimated at 0.88%.

The base requirement of the countercyclical capital buffer applies to the banks in Estonia at 1%, and the banks have to meet that requirement from 7 December 2022. This is a buffer rate that remains unchanged under normal circumstances and that is intended to ensure that the capital buffers of the banks cover the systemic risks from the macro environment. Rapid growth in credit means additional risk for the economy and financial system though, which can be counteracted by the cyclical component of the buffer. This part of the countercyclical capital buffer requirement has so far been at 0%, but the quarterly assessment of the credit cycle indicates that Eesti Pank may decide to raise the buffer rate above the base requirement. It should be remembered that the aim of this measure is not to stop credit from growing, but to make sure that the banks hold sufficient capital to prevent a possible crisis. The banks are always able to use the capital buffers they have accumulated to cover loan losses. Eesti Pank can also reduce the buffer requirement quickly so that banks can use the capital released to continue lending to companies and households and so avoid any financing stress that could arise in a crisis.

The indicators for growth in credit suggest that Estonia should consider raising the cyclical component of the countercyclical capital buffer. The risks from the credit cycle have clearly increased over the past year and the relatively good capacity of borrowers to repay their loans, with rapid growth in incomes and relatively large financial buffers at companies and households, and the need for investment suggest that credit will continue to grow fairly quickly in the years ahead. The economy cooling will however probably lead to lending activity slowing a little from its high level in the middle of 2022. The volume of credit has been increased of late by high producer prices, consumer prices and real estate prices, which have acted to increase growth in borrowing, but this factor will weaken over time. It will become clear in the months ahead how much and for how long the weaker confidence in Estonia and in foreign markets will restrain borrowing and so stop cyclical risks building up in future. It is important though for the banks to hold larger capital buffers to cover the risks from the rapid growth that there has already been in lending.

The good position of the banking sector means that access to loans would not particularly be affected by a rise in the capital buffer requirement. The Estonian banking sector currently meets the capital and buffer requirements with sufficient margin. The good profitability of the banks is also supporting capitalisation, and it will probably improve further in the near term as money market interest rates rise. The danger of the banks starting to restrict lending also remains small because most banks have a stable funding base. This means that a small rise in the countercyclical capital buffer rate should not have a significant negative impact on the financing of the economy. All systemically important banks should be able to meet the additional requirement from the own funds they hold voluntarily or from profits. The higher requirement will in any case come into force after a year, allowing the banks sufficient time to accumulate additional capital if needed. Obliging the banks to maintain an additional part of their own funds will help ensure that they have sufficient capital if the credit risks that they took on while lending was growing fast were to materialise. If the Estonian economy were to deteriorate so far that there was a sharp increase in loan losses or serious stresses in financing, Eesti Pank could review its decision to raise the buffer requirement.