

THE COUNTERCYCLICAL CAPITAL BUFFER RATE

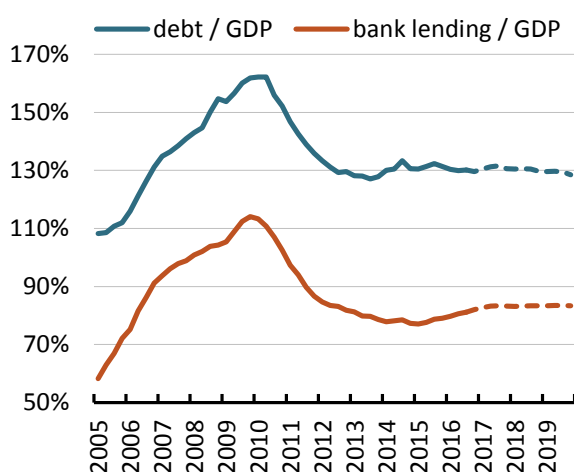
Eesti Pank's assessment of the countercyclical capital buffer rate (Q1 2017)¹

Eesti Pank decided on 6 March 2017 to keep the countercyclical capital buffer rate at 0%.

- The applicable countercyclical capital buffer rate: **0%**
- The standardised credit-to-GDP ratio: **130%**; its deviation from the long-term trend: **-11 percentage points**
- The buffer rate: **0%**
- Reasoning for the buffer rate: there has been no change in indebtedness in the real economy and it remains stable. Increasing corporate investment and the passing out of the effect of changes in foreign borrowing in previous years have led the rate of debt growth to rise this year, but it will remain at the level of GDP growth in the years ahead. The main risk in the near term is a faster loan growth if prices should start rising faster in the real estate market and the share of credit financing increases. The risks from credit growth have so far been reduced by the strong growth in household incomes and the maintenance of bank lending standards. If the risk of rapid credit growth were to increase, Eesti Pank would consider raising the rate of the countercyclical capital buffer.

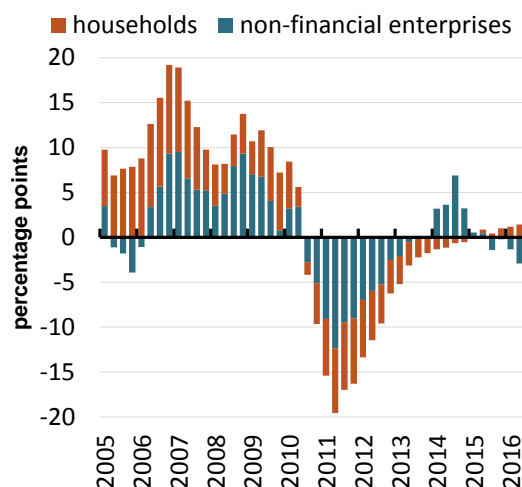
There was no change in the indebtedness of the real economy in Estonia in the third quarter of 2016. The debt-to-GDP ratio has held relatively stable at 130% since 2014 (see Figure 1). Corporate debt has declined slightly in the past year while the debt of households has continued to increase as a ratio to GDP (see Figure 2). However, the share of household income that is from wage income has increased particularly, so there has been no increase in household debt as a ratio to wages. The Eesti Pank December forecast expects that the total debt of the non-financial sector will remain at its current level as a ratio to GDP for the next two years.

Figure 1. Real sector indebtedness



Sources: Statistics Estonia, Eesti Pank

Figure 2. Annual change of debt-to-GDP ratio



Sources: Statistics Estonia, Eesti Pank

¹ The assessment methodology is described in more detail in the Eesti Pank document ["Countercyclical Capital Buffer. The principles and indicators for setting the buffer rate in Estonia". October 2015.](#)

The credit-to-GDP gap will remain negative for the next few years. The standardised gap² calculated using the methodology of the Basel Committee on Banking Supervision was –11 percentage points in the third quarter of 2016 and the additional gap³, which is also used by Eesti Pank, was –22 percentage points (see Figure 3). The gap calculated as a ratio to the long-term trend has been negative since 2009, and in recent years it has narrowed mainly because of the declining trend.

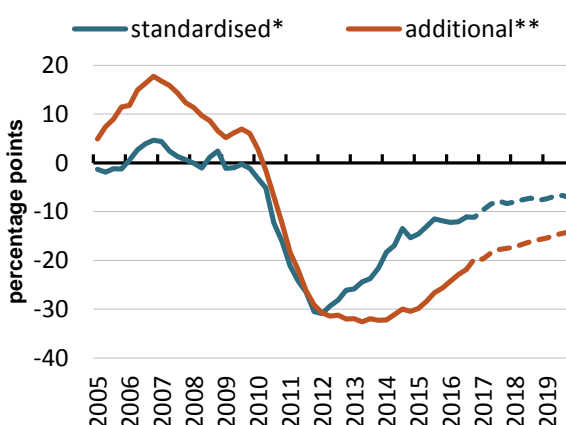
The gap will remain negative in the years of the forecast, 2017–2019, and so the buffer guide is 0%. Given the wide range of the previous credit cycle in Estonia and the rapid recovery from the recession, the credit-to-GDP gap is not an appropriate indicator to use for assessing the need for the buffer in the years ahead. Other indicators that give a better picture of the possible development of the credit cycle and debt should be used instead.

Yearly growth in real sector debt slowed to 0.9% in the third quarter of 2016. This meant that yearly growth in debt was lower than the nominal growth of 2.8% in GDP (see Figure 4). Debt grew relatively modestly because of a reduction of 1.7% in corporate debt liabilities that was not offset by the quite strong growth in household debt liabilities. The Eesti Pank December forecast expects that the rate of growth of the total debt of the non-financial sector will rise until it matches nominal GDP growth.

Growth in corporate debt has been restrained by the modest level of investment and the reduction in borrowing from abroad. The value

of loans and leases taken by companies from domestic banks grew relatively strongly in 2016, by around 8% (see Figure 5). This change reflects the trend of recent years for increased borrowing by companies in sectors like real estate that are mainly financed by domestic banks. The growth in borrowing from domestic banks has also been supported by relatively favourable lending conditions

Figure 3. Credit-to-GDP gap

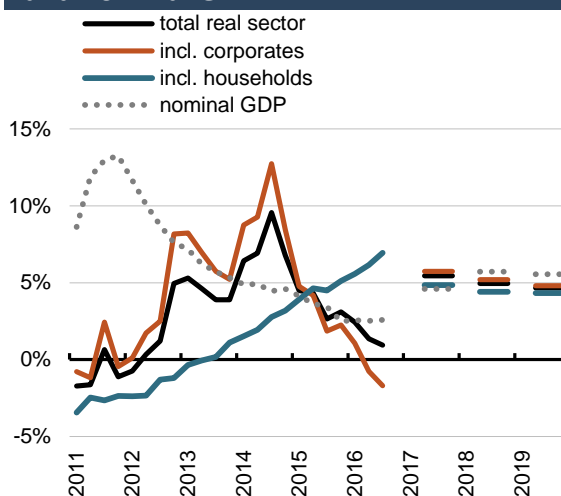


* based on total debt data

** based on domestic bank loans and leases data

Sources: Statistics Estonia, Eesti Pank

Figure 4. Annual growth of real sector debt and nominal GDP



Sources: Eesti Pank, Statistics Estonia

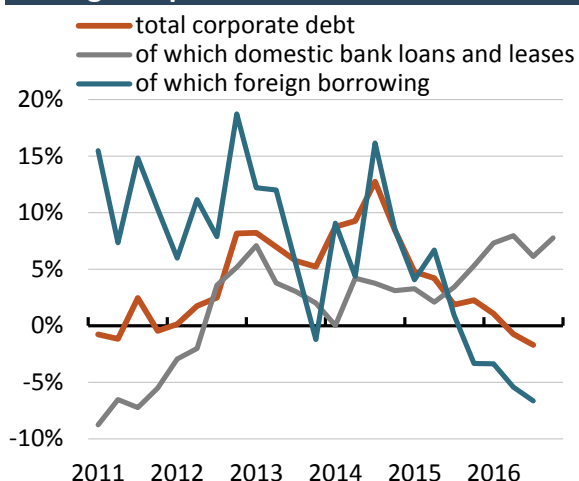
² In calculating the standardised credit-to-GDP ratio, Eesti Pank uses the quarterly statistics of the financial account from the system of national accounts for finding the debt level. This covers resources borrowed and bonds issued by the Estonian private sector both within Estonia and abroad. This is an unconsolidated indicator.

³ The additional credit-to-GDP ratio is calculated using a narrow aggregate of credit that covers domestic loans and leases issued by banks operating in Estonia.

and the partial substitution of loans from abroad with domestic loans. The amount taken in loans from abroad or issued as bonds abroad shrank by around 7% in the third quarter compared to last year. Foreign borrowing has mainly declined because of reduced demand for investments in sectors like energy and transport that are financed relatively more with foreign debt, and because of a reduction in intra-group short-term liabilities.

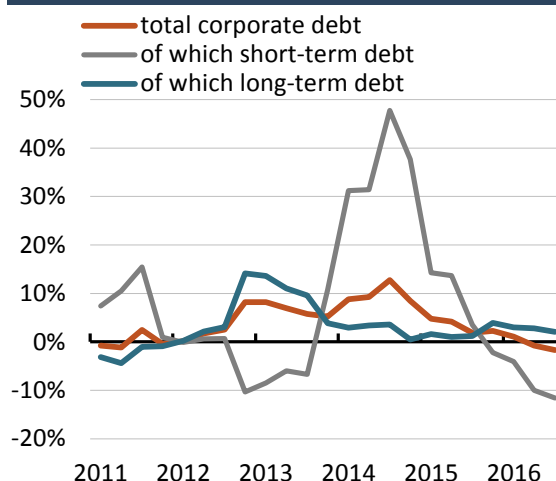
Intra-group loan transactions can increase the volatility of growth in short-term debt liabilities. For that reason an important indicator for assessing and forecasting the change in total corporate debt is the growth in long-term debt liabilities, which was 2.1% higher than a year earlier at the end of the third quarter of 2016 (see Figure 6). In the next few years investments should recover and the effect of intra-group financing fade out, meaning that the growth rates for foreign and domestic debt will come closer and the growth in corporate debt will speed up.

Figure 5. Annual growth of domestic and foreign corporate debt



Source: Eesti Pank

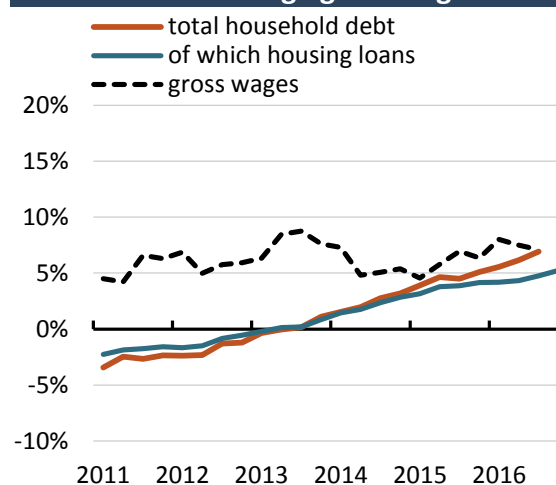
Figure 6. Annual growth of corporate debt



Source: Eesti Pank

The yearly growth in household debt liabilities picked up to 6.9% as housing loans, car leases and other consumption loans all increased. Growth was boosted further in 2016 by the inclusion of data from non-bank lenders and financial intermediaries in the statistics. Without this, the growth in the loan liabilities of households would have been 1.4 percentage points lower at 5.5% in the third quarter. Growth in borrowing by households has been built on strong growth in wages, as the average wage has increased faster than the value of loan liabilities (see Figure 7).

Figure 7. Annual growth of household debt and the average gross wage



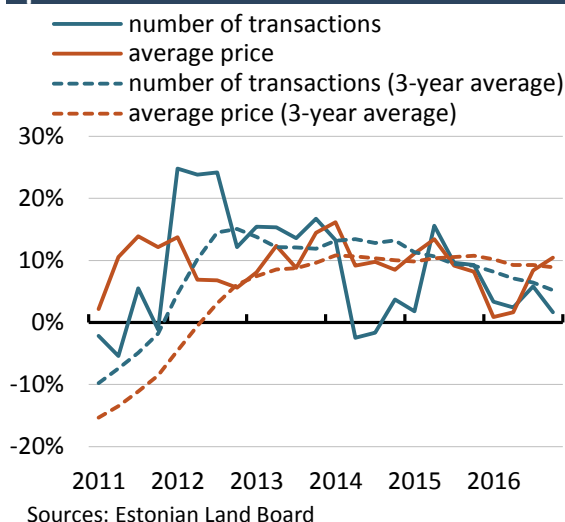
Source: Eesti Pank

The annual growth in housing loans accelerated to 5.2% in the fourth quarter. Growth in the volume of loans was affected primarily by more rapidly rising prices for residential property in the final months of the year. The average value of apartment transactions in Estonia was up more than 10% on a year earlier in the fourth quarter, leaving it a little

higher than the average of the past three years (see Figure 8). The rise in real estate prices has been supported by the continuing strong growth in household incomes and savings, which has boosted demand for residential property as interest rates are low.

If prices for residential property continue to rise fast, it may cause credit growth to accelerate. Households continued to use their own resources to a considerable extent for buying residential property, though at the end of 2016 there was a slight increase in the share of borrowed money used for financing real estate transactions. The conditions for housing loans have not been eased however, and the interest margin over the six-month EURIBOR was at the same level of 2.2% at the end of 2016 as a year earlier.

Figure 8. Annual growth of housing prices and number of transactions



In summary, Eesti Pank does not currently consider it necessary to raise the countercyclical buffer rate above 0%. The main argument for this is that the indebtedness of the non-financial sector as shown by the credit-to-GDP ratio has not increased in recent years and is predicted by the Eesti Pank December forecast to remain at around 130% for the next three years. The yearly rate of growth of debt will rise and debt will grow at the same rate as nominal GDP in the next few years. The growth in debt will be supported by increased corporate investment and the disappearance of the impact of changes in recent years in foreign borrowing.

The main risk in the near term is a faster loan growth if rising prices in the real estate market for residential property should lead the share of credit financing to increase. The risk of rapid credit growth has not substantially increased since the last assessment, although prices for apartments and housing loans did start to rise faster at the end of 2016. This was supported by rising household incomes, while the lending conditions of the banks were not eased. To dampen the risks from housing loans, Eesti Pank introduced requirements for new housing loans from 1 March 2015⁴.

The capitalisation of the banks is currently strong and this is further underpinned by the capital buffer requirements introduced for macroprudential purposes. If the risk of rapid credit growth increases, Eesti Pank can raise the rate of the countercyclical capital buffer. Larger capital buffers help banks cover their possible loan losses if rapid loan growth is followed by repayment problems for borrowers.

⁴ A limit of 85% on the loan-to-value (LTV) ratio; a limit of 50% on the debt service-to-income (DSTI) ratio; a limit of 30 years as the maximum maturity for housing loans.