THE COUNTERCYCLICAL CAPITAL BUFFER RATE

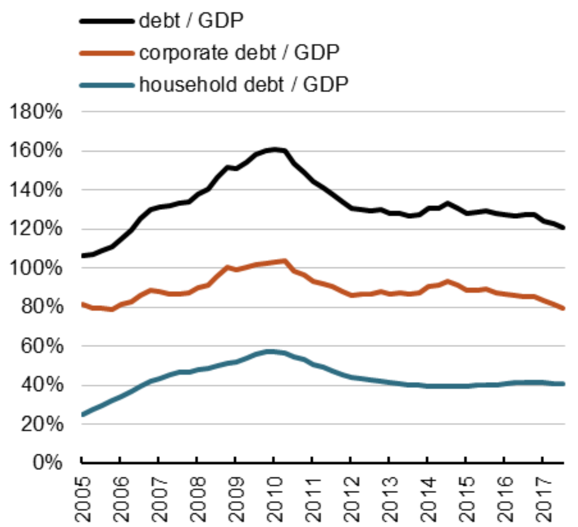
Eesti Pank's assessment of the countercyclical capital buffer rate (Q1 2018)[1]

Eesti Pank decided on 26 March 2018 to keep the countercyclical capital buffer rate at 0%.

- The applicable countercyclical capital buffer rate: **0%**
- The standardised credit-to-GDP ratio: **121%**; its deviation from the long-term trend: **–16 percentage points**
- The buffer rate: **0%**
- <u>Reasoning for the buffer rate</u>: there has been no increase in the past three years in indebtedness in the real economy, which is the ratio of debt to GDP, and it has even started to decrease in recent quarters because of rapid GDP growth. Debt liabilities will grow faster in the coming years if the economy continues to grow rapidly and investment increases, but the rate of growth is not forecast to exceed that of nominal GDP consistently or significantly. The banks have not loosened their lending standards and conditions and have not increased their leverage. However, households have started to borrow more as wages have risen rapidly and confidence has increased, and this could lead loan burdens to increase faster than forecast and so increase the related risks. Total corporate debt could also start to grow strongly again if investment increases. Although the current development of the loan market does not give grounds for raising the countercyclical buffer rate, Eesti Pank constantly monitors the developments that could indicate a possible build-up of risks and can, if necessary, raise the countercyclical buffer rate above 0%.

The debt burden of the non-financial sector in Estonia has gradually declined in recent years. Total debt as a ratio to GDP was 121% at the end of the third quarter of 2017 (see Figure 1). Yearly growth in the debt of the non-financial sector has been close to 2% in the past three years. Corporate debt liabilities have increased modestly, while the growth in the debt of households has remained moderate. An important development in recent quarters has been the notable acceleration of GDP growth (see Figure 2). In consequence the overall debt burden has shrunk.

Figure 1. Non-financial sector indebtedness

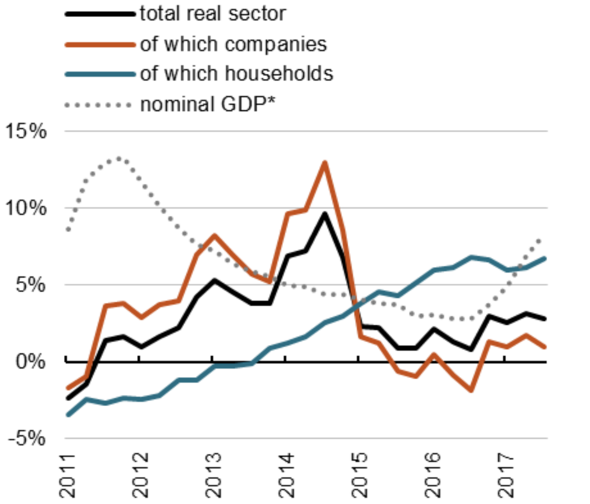


Sources: Statistics Estonia, Eesti Pank

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 in the coming years. The debt of the non-financial sector will grow faster in the coming years as the economy continues to grow and investment activity picks up, but the rate of growth will not exceed the forecast growth in nominal GDP in the years ahead (see Figure 3).

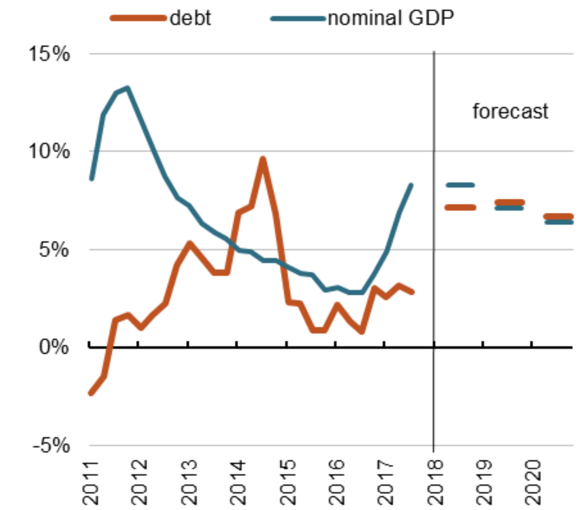
[1] The assessment methodology is described in more detail in the Eesti Pank document "Countercyclical Capital Buffer. The principles and indicators for setting the buffer rate in Estonia". October 2015.

Figure 2. Annual growth of non-financial sector debt and nominal GDP



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

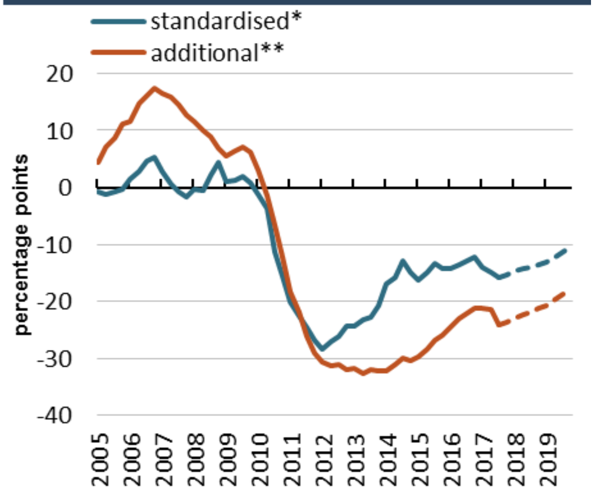
Figure 3. Forecast for annual growth of non-financial sector debt and nominal GDP



Sources: Eesti Pank, Statistics Estonia

The standardised credit-to-GDP gap[2] calculated using the methodology of the Basel Committee on Banking Supervision was -16 percentage points at the end of 2017 and the additional gap[3], which is also used by Eesti Pank, was -24 percentage points (see Figure 4). This means that both indicators show the credit-to-GDP ratio to be lower than the long-term trend, and so the benchmark buffer rate remains at 0%. In the years of the forecast 2018-2020 the credit-to-GDP gap will remain clearly negative.

Figure 4. Credit-to-GDP gap



* based on total debt data
** based on data for domestic bank loans and leases
Sources: Statistics Estonia, Eesti Pank

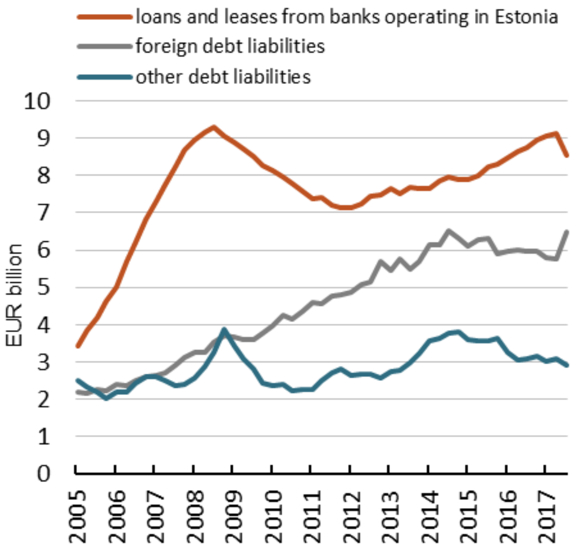
Corporate debt increased by 0.9% over the year to the end of the third quarter of 2017. Although the volume of investment increased, it was funded a lot through own funds and the need for external capital was consequently smaller. Another major factor was the reduction in short-term corporate debt liabilities, which is not because of a lack of need for funds, but rather reflects the cash flow management of foreign-owned companies. At the same time, long-term debt liabilities grew by more than 5%. With levels of economic activity remaining high and investment forecast to increase, it may be assumed that corporate debt liabilities will continue to increase rapidly. The Eesti Pank December forecast expects the growth in corporate debt liabilities to be close to 6% a year in the coming years.

[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 loans to the real sector and bonds issued 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.

The structure of corporate debt liabilities has been affected in recent years by the different investment requirements of different sectors, and the preferences of companies for sources of funds (see Figure 5). In connection with this, borrowing from banks operating in Estonia has grown quickly. The volume of corporate debt liabilities abroad has remained stable though, especially because of a reduction in short-term debt liabilities. Long-term debt has increased at the same time and looking forward, total foreign debt liabilities could start to grow again. In the third quarter of 2017 one bank moved part of its loans to the portfolio of its foreign parent bank, increasing foreign debt liabilities and reducing loans from banks operating in Estonia by the same amount.

Figure 5. Corporate debt

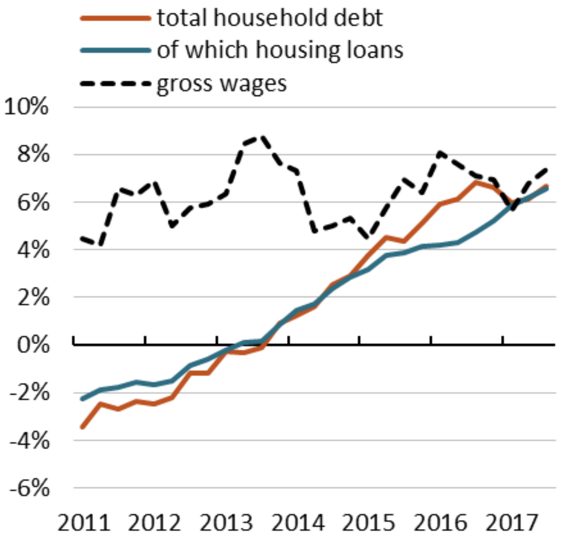


Source: Eesti Pank

Household borrowing has remained strong. The yearly rate of growth in debt liabilities was 6.7% at the end of the third quarter of 2017 (see Figure 6). There was growth in housing loans, car leases and other consumer loans. Growth in borrowing by households has been supported by rising wages, low unemployment and favourable interest rates on loans. The increasing demand for labour that has accompanied the growth in the economy means that wage pressures will continue, but inflation has slowed the growth in real wages. This may mean that faster growth in borrowing could increase the risks around the ability of borrowers to pay their loans.

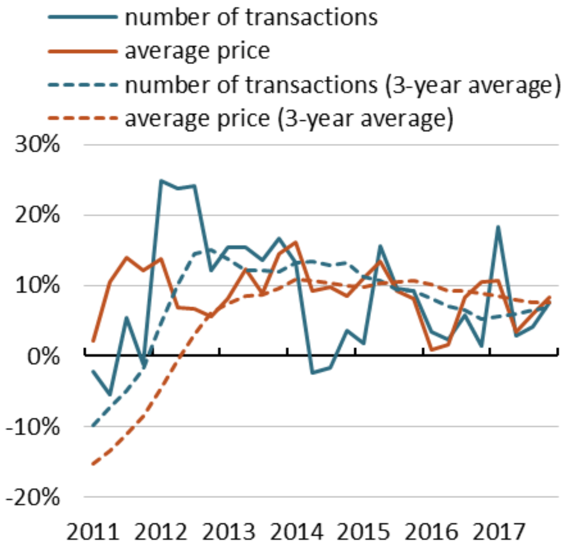
The yearly growth in the stock of housing loans has accelerated gradually and it reached 6.6% by the end of 2017 (see Figure 6). Last year, 16% more was taken out in new housing loans than a year earlier. The growth was due to increases in the number of real estate transactions and in prices, and the growth rates for both reached 8% in the fourth quarter (see Figure 7). Although there was a slight

Figure 6. Annual growth of household debt and the average gross wage



Sources: Eesti Pank, Statistics Estonia

Figure 7. Annual growth of housing prices and number of transactions

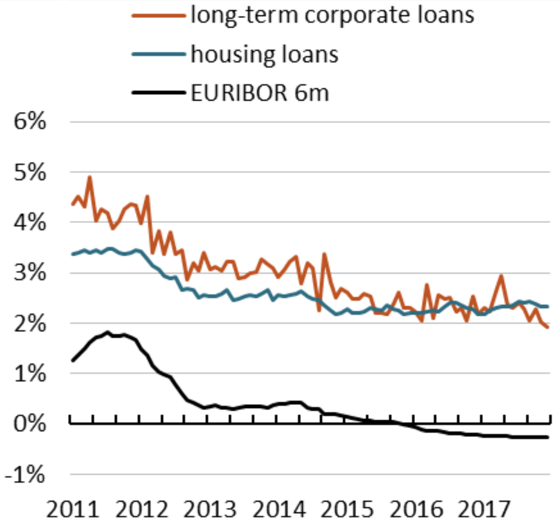


Source: Estonian Land Board

increase last year in the use of borrowed money to fund real estate transactions, households are still using more of their own funds for buying residential property than was the case during the last business cycle.

The lending standards and lending conditions of the banks have not been loosened. The average interest rate was 2.3% in December, which is a little higher than a year earlier. The other conditions for housing loans, which are the loan-to-value ratio, the debt service-to-income ratio and maturity, have not become looser however. There is relatively tight competition between the banks in the corporate loan market and the average interest rate on new long-term corporate loans fell below 2% in December (see Figure 8).

Figure 8. Weighted average interest rates on housing loans and long-term corporate loans



Source: Eesti Pank

The supply of loans from the banks is supported by strong growth in deposits and by high levels of capitalisation, which have been helped by good profitability. Deposits from the real sector have grown very rapidly in recent years, and the rate of growth was 9% at the end of the year. The ratio of resident loans to deposits was 117%, which indicates that banks were funding loans to a large extent with the deposits they had taken in. This means increasing demand for loans can currently be funded by additional deposits and repayment of loans and the banks do not need to get any additional funds from the financial markets.

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 debt burden of the non-financial sector as shown by the credit-to-GDP ratio has not increased in the past three years and is predicted by the Eesti Pank December 2017 forecast to remain at around the same level for the next two years. Debt liabilities will grow faster in the coming years if the economy continues to grow rapidly and investment increases, but the rate of growth is not forecast to exceed that of nominal GDP consistently or significantly. Furthermore, the banks have not loosened their lending standards and conditions and have not increased their leverage.

However, households have started to borrow more as wages have risen rapidly and confidence has increased, and this could lead loan burdens to increase faster than forecast and so increase the related risks. The corporate debt burden could also start to grow strongly again with support from increasing economic activity and rising investment. **In consequence the current development of the loan market does not give grounds for raising the capital buffer rate, but Eesti Pank constantly monitors the developments that could indicate a possible build-up of risks and can, if necessary, raise the countercyclical buffer rate above 0%.**