

THE COUNTERCYCLICAL CAPITAL BUFFER RATE

EESTI PANK'S ASSESSMENT OF THE COUNTERCYCLICAL CAPITAL BUFFER RATE (Q3 2022)

The Eesti Pank assessment in September 2022 is that the growth in credit has increased the risks from the financial cycle and it may be necessary quite soon to raise the countercyclical capital buffer rate in response to those risks. The countercyclical capital buffer rate has two parts: the base rate, which is the base requirement that does not change under ordinary circumstances, and the cyclical component, which is related to high credit growth. Eesti Pank set the base rate of the countercyclical capital buffer at 1% in November 2021 and the banks have to comply with that from 7 December 2022. Eesti Pank has not so far changed the cyclical component.

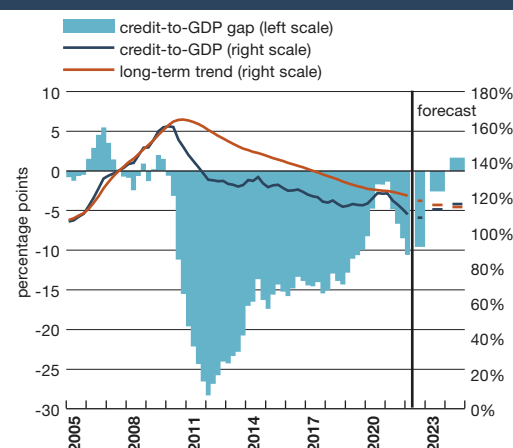
- The applicable countercyclical capital buffer rate: **1%**, of which the cyclical component is 0%, from 7 December 2022
- The standardised credit-to-GDP ratio: **110%**; its deviation from the long-term trend: **-11 percentage points**
- The buffer guide: **0%**
- **The reasoning for the buffer rate.** Several indicators point to an increase in risks from the financial cycle. Growth in borrowing from banks has been fast for both housing loans and corporate loans, and real estate prices are also rising fast. However the indebtedness of the non-financial sector has not increased, but has continued to decline and the rate of growth in debt does not yet exceed that in nominal GDP. It is expected though that debt will continue to grow fast and the slower growth in the economy could start to increase indebtedness. For this reason Eesti Pank considers it possible that it may be necessary in the near future to raise the countercyclical capital buffer rate requirement above its current base level of 1% to counter the increased cyclical risks.

The indebtedness of the non-financial sector continued to decline in the first quarter of 2022.

Strong nominal growth in the economy has helped the Estonian non-financial sector reduce its debt burden. Indebtedness came down to 110% by the end of the first quarter of 2022. It is still expected looking forward though that the slower growth in nominal GDP will see indebtedness stop declining and that it will start to increase again in the coming years (see Figure 1), and that the risks from the financial cycle will consequently increase together with it.

The standardised credit-to-GDP¹ gap calculated using the methodology of the Basel Committee on Banking Supervision was -10 percentage points at the end of the first quarter of 2022. The additional gap², which is

Figure 1. Standardised credit-to-GDP gap



Sources: Statistics Estonia, Eesti Pank

1 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 non-financial sector and bonds issued both within Estonia and abroad. This is an unconsolidated indicator.

2 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.

also used by Eesti Pank, was -17 percentage points. The negative credit-to-GDP gap means that the credit-to-GDP ratio is currently lower than the long-term trend, and so the buffer guide is at 0%. The Eesti Pank September forecast predicts that moving forward the credit-to-GDP gap will gradually narrow over the coming three years, and will become positive by the end of 2024.

The yearly growth in the debt of the non-financial sector accelerated a little in the first quarter of 2022.

The debt of the non-financial sector increased by 6.3% over the year in the first quarter, leaving it below the yearly growth of 18% in nominal GDP. Given the rapid growth in debt however, it is important when assessing the sustainability of debt to compare the growth of debt with the long-term average growth in the economy. In assessing the countercyclical capital buffer requirement, Eesti Pank uses average nominal GDP growth over the past eight years as long-term GDP growth, which helps smooth the short-term volatility in the rate of growth. The eight-year average nominal GDP growth in the first quarter of 2022 was almost 6.4%, meaning that the growth in debt in the first quarter of 2022 remained lower than that in GDP. The Eesti Pank September forecast expects that growth in debt will continue to accelerate in the foreseeable term and that by the end of this year it will start to exceed the long-term growth in nominal GDP, while the growth in debt may exceed that in current nominal GDP by the end of 2023 (see Figure 2). Growth in debt remaining faster than long-term growth in nominal GDP for several consecutive quarters would indicate an increase in the risks coming from the financial cycle, and so it may prove necessary to increase the countercyclical capital buffer rate to cover those risks.

Bank loans to companies and housing loans to households are both growing faster than non-financial sector debt overall. Corporate debt was 5% larger in the first quarter than a year earlier and household debt was up 9%, while corporate bank loans were up 7% over the year in the first quarter and housing loans were up 10%. Bank loans continued to grow rapidly in the second quarter of 2022. This also means that both corporate bank loans and housing loans to households are increasing as a share of the debt of the non-financial sector (see Figure 3). Bank loans are growing much faster than long-term GDP at a time when competition is tight in the banking market, and so there is a risk of vulnerabilities in the banking sector increasing.

The lending conditions of the banks did not particularly change in the second quarter of 2022.

The bank lending survey in the second quarter of 2022 did not show any clear overall trend in loan conditions, as conditions tightened somewhat for companies while those for loans to households were eased. The loan margins did not particularly change in the second quarter either. The margins on new housing loans started to narrow in July, but the rise in the six-month Euribor meant that the total interest rate on loans still rose (see Figure 4).

Figure 2. Forecast for annual growth of non-financial sector debt and nominal GDP

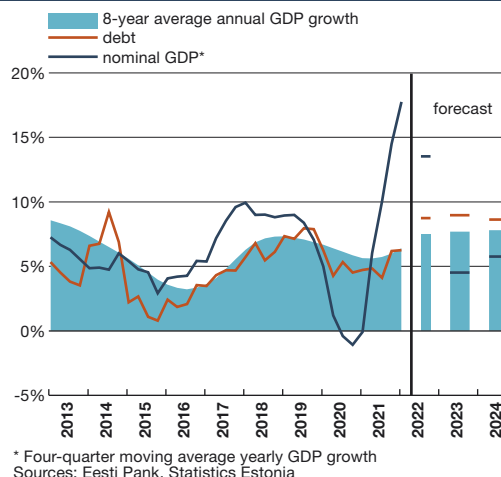
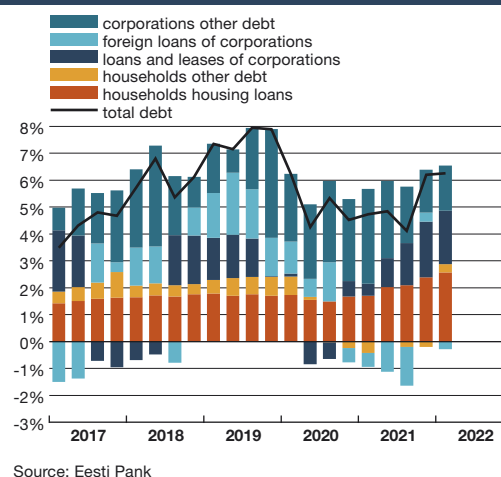


Figure 3. Contributions to yearly growth in the debt of the non-financial sector



Real estate prices continued to rise rapidly in the second quarter.

Housing loans account for the largest share of household debt liabilities, and so growth in the debt of households is greatly affected by developments in the real estate market. Rising real estate prices are significant for the financial cycle because they could be mutually reinforcing with rapid growth in lending. More expensive residential property first increases the need for loans, and then the faster the real estate prices rise, the faster the value of collateral rises, and so the more that households are able to borrow to purchase residential property as their incomes rise. This then in turn boosts the growth in borrowing. The yearly growth in the average price of apartments in Estonia was shown by data from Statistics Estonia to have risen to 27% in the second quarter (see Figure 5). Yearly growth in the prices of apartments was last so fast 15 years ago. To dampen the risks from housing loans, Eesti Pank has set three restrictions for new housing loans that limit their loan-to-value (LTV) ratio to 85%, the debt service-to-income (DSTI) ratio of borrowers to 50%, and the maximum maturity of the loans to 30 years. It has also applied a risk weighting floor since 30 September 2019 of 15% for mortgages for banks using the internal ratings approach.

In summary, Eesti Pank is leaving the countercyclical capital buffer rate unchanged in the third quarter of 2022, keeping it at the base rate decided earlier of 1%. As the risks from the financial cycle will probably continue to increase

however, it may be found necessary in the coming quarters to raise the buffer rate to cover those risks. Several indicators point to an increase in risks from the financial cycle. Growth in borrowing from banks has been fast for both corporate loans and housing loans to households, while real estate prices are rising fast. However, the indebtedness of the non-financial sector has not increased, and growth in debt does not yet exceed that in long-term nominal GDP. It is expected though that debt will continue to grow fast and the slower growth in the economy could soon see indebtedness start to increase again. For this reason Eesti Pank considers it possible that it may be necessary in the near future to raise the requirement of the countercyclical capital buffer rate to above its base level to counter the increased cyclical risks.

Figure 4. Weighted average interest rates on housing loans and long-term corporate loans

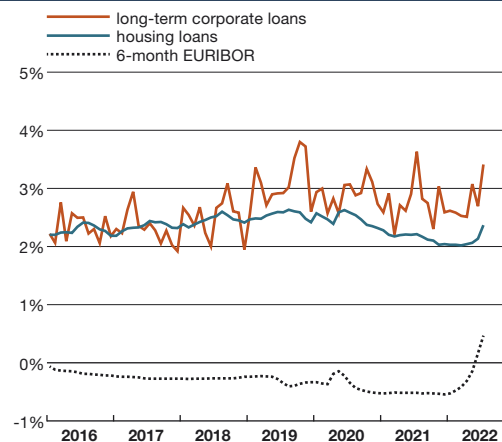


Figure 5. Change in the average price of apartments, Q1 2006=100, and yearly growth rate

