THE COUNTERCYCLICAL CAPITAL BUFFER RATE

Eesti Pank's assessment of the countercyclical capital buffer rate (Q4 2015)

The Executive Board of Eesti Pank decided on 30 November 2015 to set the countercyclical capital buffer rate at 0%. Credit institutions need to apply this rate in calculating their institution-specific buffer rate from 1 January 2016.

In accordance with Article 136(7) of EU Directive 2013/36/EU, Eesti Pank is notifying ESRB of its decision on the buffer rate and publishing the decision and related information on its own website.

- The applicable countercyclical capital buffer rate: **0%**
- The standardised credit-to-GDP ratio: **127%** and its deviation from the long-term trend: **–16 percentage points.**
- The buffer guide: **0%**
- Reasoning for the buffer rate: assessment of the credit cycle in Estonia shows that credit growth is currently in line with the general development of the economy and it is forecast to remain so, and there is no indication of excess credit risk accumulating. Credit growth in the non-financial sector is backed by moderate GDP growth and rapid growth in deposits, and the growth in housing loans is supported by sustained growth in incomes.

Section 86[46] of the Credit Institutions Act states that Eesti Pank is responsible for setting the rate for the countercyclical capital buffer. The same section gives the general principles for assessing the buffer rate based on Article 136 of EU Directive 2013/36/EU and the requirements for announcements of information from Eesti Pank.

The buffer is set in order to protect the banking sector against losses that could be caused by cyclical systemic credit risks building up in the economy. Banks can use the additional capital buffers they have built up during the growth phase of the financial cycle to cover losses that may arise when the cycle turns down and to continue supplying credit to the real economy.

The basis for setting the countercyclical capital buffer rate is the assessment by Eesti Pank of the cyclical systemic credit risk in Estonia. The assessment combines a quantitative approach based on economic indicators with expert judgement[1]. One of the main indicators that is regularly assessed is the credit-to-GDP gap and the buffer guide calculated from it, though this is not the only indicator used in the decision on the buffer rate. The greatest weight in the assessment of the buffer rate is given to the indicators that best show the current position of the credit cycle.

Indicators used in the assessment of the countercyclical capital buffer rate

- **Credit-to-GDP gap**

The credit-to-GDP ratio for the non-financial sector in Estonia was 127% in the second quarter of 2015. The debt of the non-financial sector increased at the same time by 3% over the year, which is somewhat slower than a year earlier. The credit-to-GDP ratio has not changed particularly in the past

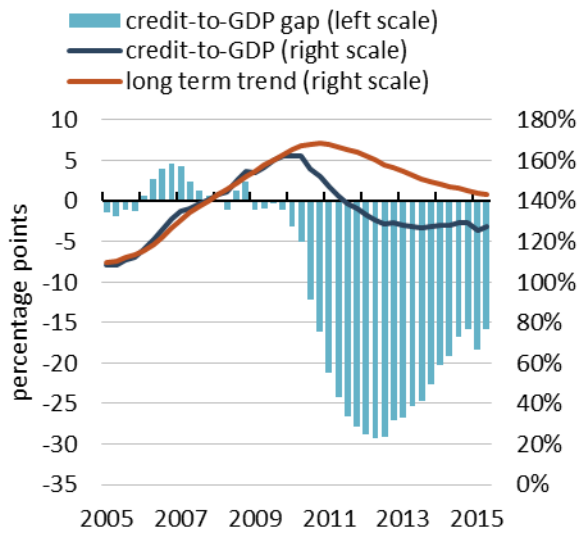
[1] The assessment methodology is described in more detail in the Eesti Pank document *Countercyclical Capital Buffer. The principles and indicators for setting the buffer rate in Estonia*. October 2015.

three years, and in the second quarter of 2015 it was about 33% below the peak it reached in the middle of 2010.

The standardised credit-to-GDP gap[2] **was –15.8 percentage points in the second quarter of 2015** (see Figure 1). The credit-to-GDP gap has been negative since 2009 but it was narrowing from 2013 until the last quarter of last year. The gap has stopped narrowing in recent quarters, mainly because credit to companies has been growing more slowly.

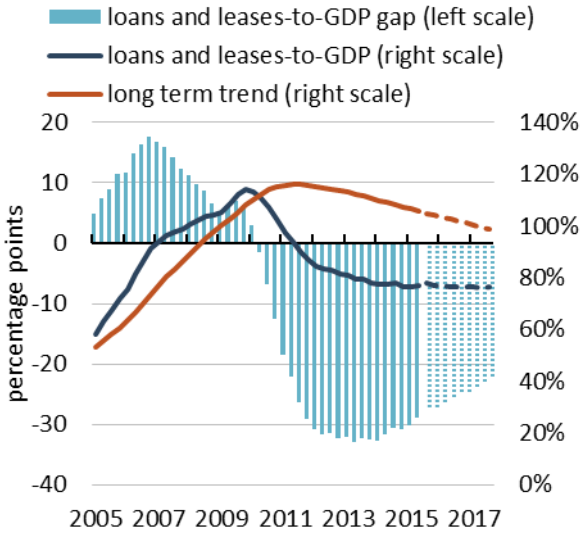
The additional credit-to-GDP gap, which is calculated from narrower credit aggregates[3] has also been consistently negative. As the credit volume of the banking sector has increased, the gap shrank to –28.9 percentage points in the second quarter of 2015 and –27 in the third quarter[4] (see Figure 1b). The Eesti Pank June forecast expects the credit-to-GDP ratio to remain around 76% in the years ahead and the negative gap to close, as the long-term trend of the ratio remains downwards. If the gap is negative, the buffer guide is 0%.

Figure 1. Standardised credit-to-GDP gap



Sources: Statistics Estonia, Eesti Pank

Figure 1b. Additional credit-to-GDP gap



Sources: Statistics Estonia, Eesti Pank

- **Annual growth in credit volumes**

Moderate economic growth in Estonia, where nominal annual GDP growth was 2.9% in the second quarter of 2015, and favourable interest rates on loans saw credit volumes continue to increase in

[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.

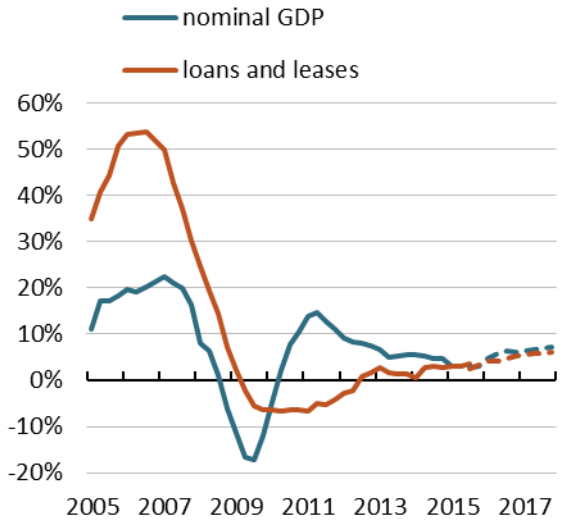
[3] The additional credit-to-GDP ratio is calculated using a narrow aggregate of credit that covers domestic loans and leases issued by banks operating in Estonia.

[4] The calculation is made from the Eesti Pank GDP forecast for the third quarter.

the third quarter of 2015 (see Figure 2). **Annual growth in the loan and lease portfolio of the banks was 3.7% in September**.

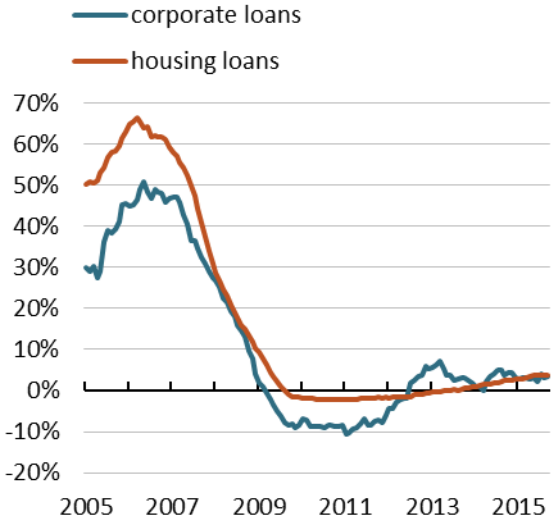
Growth in borrowing by households has been built on continuing strong growth in wages. The stock of housing loans was 3.9% larger in the third quarter of 2015 than a year earlier (see Figure 3). Credit to companies has grown at quite an uneven rate across quarters in recent years. The stock of loans and leases to companies was 2.7% larger in the second quarter than a year previously, meaning the growth rate was slightly lower than that of loans to households. It picked up to 3.6% in the third quarter however.

Figure 2. Annual growth of loans and leases and nominal GDP



Sources: Statistics Estonia, Eesti Pank

Figure 3. Annual growth of corporate loans and housing loans



Source: Eesti Pank

At the same time that credit volumes were increasing, the deposits of the non-financial sector have continued to grow quite fast, standing 9.8% higher in the third quarter of 2015 than a year earlier. Increased lending activity meant that the loan-to-deposit ratio no longer fell in the third quarter, and in September it rose to 103%.

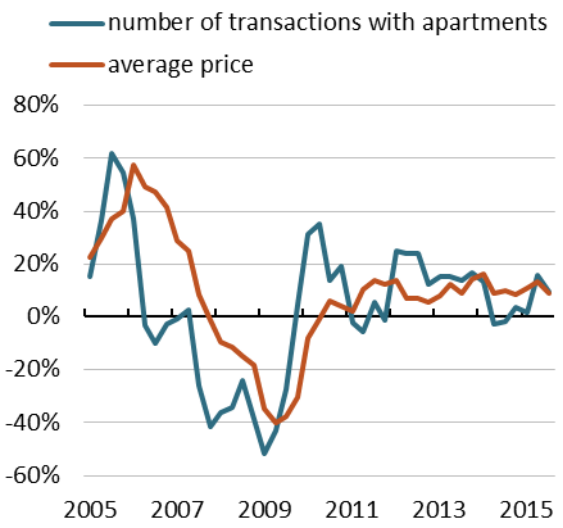
The June forecast 2015 by Eesti Pank expects growth in the loan and lease portfolio of the non-financial sector to accelerate somewhat in the next couple of years too, though it will remain close to GDP growth. Credit growth is currently in line with the general development of the economy and is forecast to remain so, and there is no indication of excess credit risk accumulating.

- **The ratio of average apartment prices and average gross monthly wages**

As housing loans make up a relatively large part of the loan and lease portfolio of the banks, at 39% in the third quarter of 2015, it is important to assess developments in the real estate market separately. Apartment prices in Estonia have risen stably following the correction that came after the rapid rise in 2005–2007. Prices have almost climbed back up to the levels they reached during the boom in big towns like Tallinn and Tartu.

The average square metre price of apartments rose 6% in Tallinn in the third quarter of 2015 and 7% in the rest of Estonia. Activity in the market has increased most in Tallinn, where 41% of all transactions in the third quarter were made. The change in the price of apartments in Tallinn is also driven by the completion of new developments that are of better quality than the other apartments on the market and sell at a higher price premium. The share of transactions in Tallinn that were made with new apartments increased, leading the average price of apartments in Estonia to rise. That price was up 9% over the year in the third quarter (see Figure 4).

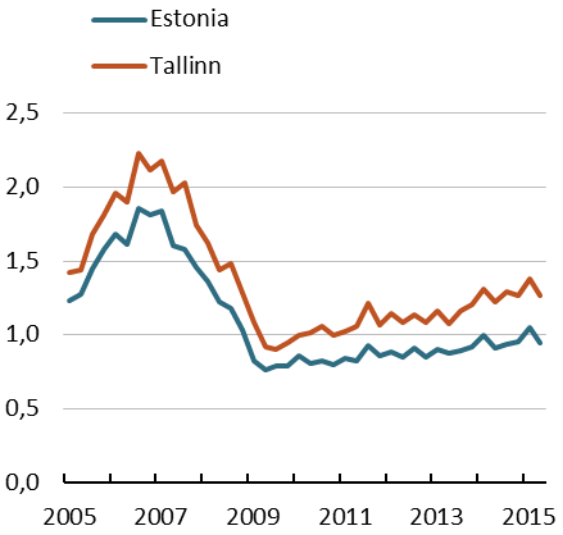
Figure 4. Annual growth of housing prices and number of transactions



Sources: Estonian Land Board

Unlike during the previous period of very rapidly rising prices in 2005–2007, the current rise in prices is more in line with the rise in incomes. **The ratio of square metre prices for apartments to gross monthly wages stood at 0.94 for Estonia in the second quarter of 2015** and at 1.3 in Tallinn (see Figure 5). These figures are well below the peaks of 2006-2007, when they hit 1.8 for Estonia and 2.2 in Tallinn. This suggests that although the average price of apartments is starting to climb to close to record highs, apartments are still relatively affordable for someone receiving the average wage.

Figure 5. Ratio of square metre price for apartments to monthly gross wage



Sources: Estonian Land Board, Statistics Estonia

Moving forward, the risk remains that if incomes continue to rise rapidly and interest rates remain low, demand could increase for real estate and housing loans. To dampen the risks from housing loans, Eesti Pank introduced requirements for new housing loans from 1 March 2015 that limited their loan-to-value (LTV) ratio, the debt service-to-income (DSTI) ratio of borrowers, and the maximum maturity of the loans.