

THE COUNTERCYCLICAL CAPITAL BUFFER RATE

Eesti Pank's assessment of the countercyclical capital buffer rate (Q2 2017)¹

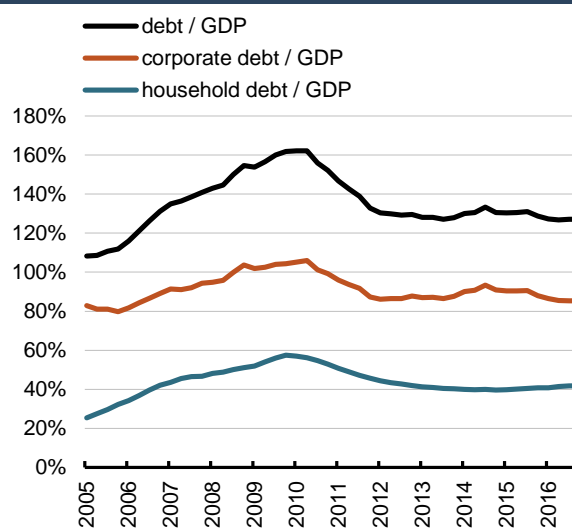
Eesti Pank decided on 6 June 2017 to keep the countercyclical capital buffer rate at 0%.

- The applicable countercyclical capital buffer rate: **0%**
- The standardised credit-to-GDP ratio: **127%**; its deviation from the long-term trend: **-12 percentage points**
- The buffer rate: **0%**
- Reasoning for the buffer rate: there has been no increase in indebtedness in the real economy and it will remain stable for the near future. Debt liabilities will grow faster in the coming years as the economy grows, but the rate of growth will not 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 significantly. Even so, low interest rates and relatively fast wage rises contain the risk that trading activity and prices could increase at a faster rate in the real estate market, leading to growth in debt levels and an increase in related risks. The corporate debt burden could also start to grow again if investment and confidence increase. For this reason Eesti Pank monitors the indicators that could show a possible build-up of risks and can, if necessary, raise the countercyclical buffer rate above 0%.

The debt burden of Estonian companies and households shrank slightly in 2016 as debt liabilities grew more slowly than nominal GDP. Corporate debt declined slightly as a ratio to GDP over the year, while the debt of households increased (see Figure 1). The share of household income in the structure of GDP has been increasing since 2015 though, 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 in the years ahead, and the credit-to-GDP gap will remain negative. The debt of the non-financial sector will grow faster in the coming years as economic activity and investment grow, but the rate of growth will not exceed that of nominal GDP consistently or significantly (see Figure 2). The standardised credit-to-GDP gap calculated using the methodology of the Basel Committee on Banking Supervision² was -12 percentage points at the end

Figure 1. Real sector indebtedness



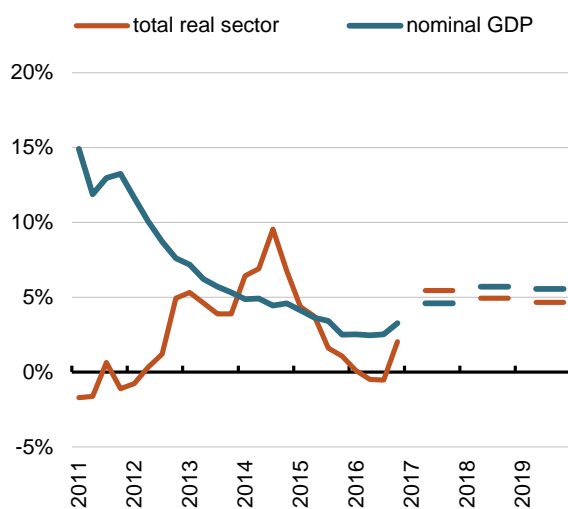
Sources: Statistics Estonia, Eesti Pank

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.

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

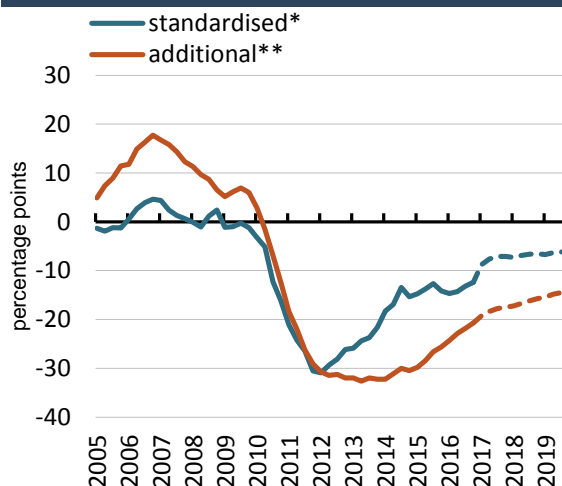
of 2016 and the additional gap³, which is also used by Eesti Pank, was -21 percentage points (see Figure 3), so the buffer guide was 0%. The gap will remain negative in the years of the forecast, 2017-2019.

Figure 2. Annual growth of real sector debt and nominal GDP



Sources: Eesti Pank, Statistics Estonia

Figure 3. Credit-to-GDP gap



* based on total debt data

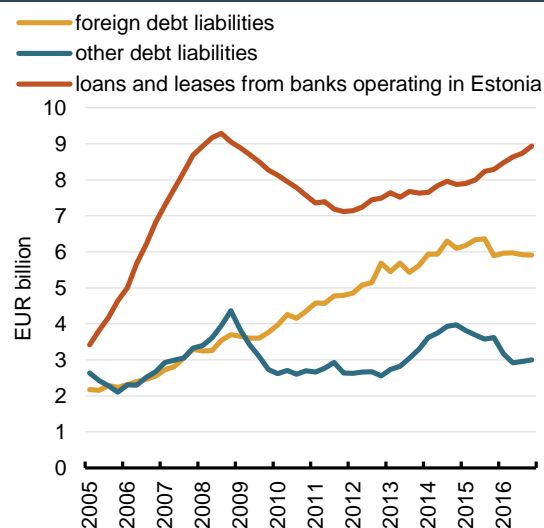
** based on domestic bank loans and leases data

Sources: Statistics Estonia, Eesti Pank

To get a better picture of the changes in the credit cycle and the behaviour of participants in the credit market, the credit-to-GDP gap of the non-financial sector has to be considered alongside other indicators that allow the need for the buffer in the coming years to be assessed. It is particularly important to analyse alternative indicators in Estonia's case, given the wide amplitude of the previous credit cycle and the short time series.

Growth in corporate debt has been slowed by the low level of investment, while the corporate debt structure has changed and lending by banks operating in Estonia has increased quickly. There was an increase of 8% in 2016 in the stock of loans and leases taken from banks operating in Estonia, but by the end of March

Figure 4. Corporate debt



Sources: Eesti Pank

2017 this growth had slowed to 7%. However,

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.

borrowing from abroad by companies remained at the same level throughout the whole year and other borrowing by companies contracted substantially (see Figure 4). This meant that corporate debt liabilities increased by only 0.3% during the whole of 2016.

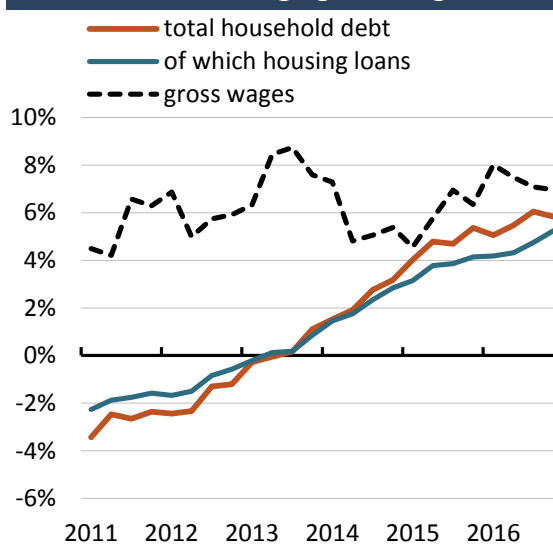
This rapid growth in bank loans from domestic banks in recent years reflects the increased borrowing by companies in sectors like real estate that are mainly financed by domestic banks. The growth has also been supported by the relatively favourable lending conditions and by the replacement of foreign loans with domestic ones. Foreign borrowing has mainly declined because of reduced investment 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. Other corporate liabilities were reduced in 2016 primarily because of a fall in lending by holding companies⁴ to non-financial companies. There was also a decline in 2016 in lending between companies in the non-financial sector.

The loan liabilities of households increased in 2016 at the same rate as incomes, but a little more slowly than savings. The yearly growth in household debt liabilities picked up to almost 6% by the end of 2016 as housing loans, car leases and other consumption loans all increased (see Figure 5). Growth in borrowing by households has been supported by rising wages, low unemployment and favourable interest rates on loans.

The annual growth in housing loans accelerated to 6% by the end of the first quarter of 2017. Both the average value of housing loans and the number of contracts have risen since the last quarter of 2016. This indicates increased growth in demand for housing loans and in real estate prices. The average value of apartment transactions in Estonia was up around 11% on a year earlier in the first quarter of 2017, leaving it a little higher than the average of the past three years (see Figure 6). The rapid rise in prices in the past two years has been driven to a large extent by an increase in the share of transactions that are for new apartments, and by an increase within the structure of transactions in the share of transactions that are in Tallinn, where prices

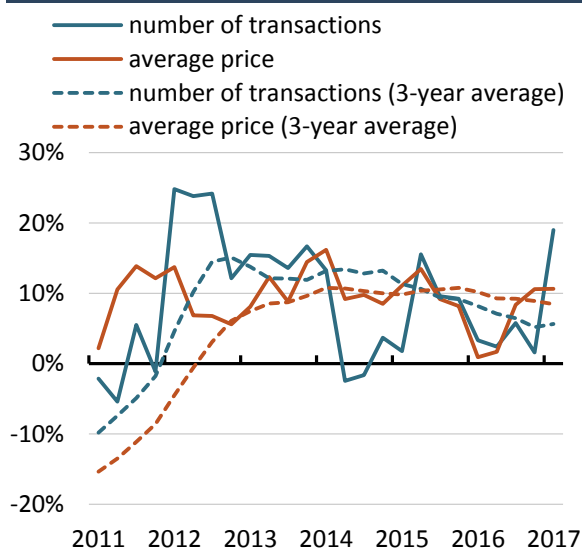
⁴ Classified under the financial sector.

Figure 5. Annual growth of household debt and the average gross wage



Source: Eesti Pank

Figure 6. Annual growth of housing prices and number of transactions



Sources: Estonian Land Board

are relatively high. Without this effect, the yearly growth in prices would have been 5-6%.

If prices for residential property continue to rise fast, it may cause credit growth to accelerate. The rise in real estate prices has itself been supported by the continuing strong growth in household incomes and savings, which has boosted demand for residential property as interest rates are low. 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 become looser however.

To dampen the risks from housing loans, Eesti Pank introduced requirements for new housing loans from 1 March 2015⁵.

Several indicators for the external balance of the economy have improved. The current account surplus for 2016 was the largest since independence was regained. Estonian residents invested more funds abroad than they took from there, so Estonia was a net lender. The net international investment position, which is the difference between external assets and external liabilities, climbed in consequence to -37% of GDP. The gross external debt shrank and remains smaller than debt assets.

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 recent years and is predicted by the Eesti Pank December forecast to remain at around the same level for the next three years. Debt liabilities will grow faster in the coming years as the economy grows, but the rate of growth will not 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 significantly.

At the same time, low interest rates and relatively fast wage rises contain the risk that trading activity and prices could increase at a faster rate in the real estate market, leading to growth in debt levels and an increase in related risks. The corporate debt burden could also start to grow again if confidence improves and investment increases. For this reason Eesti Pank constantly monitors the indicators that could show a possible build-up of risks and can, if necessary, raise the countercyclical buffer rate above 0%.

⁵ 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.