THE COUNTERCYCLICAL CAPITAL BUFFER RATE

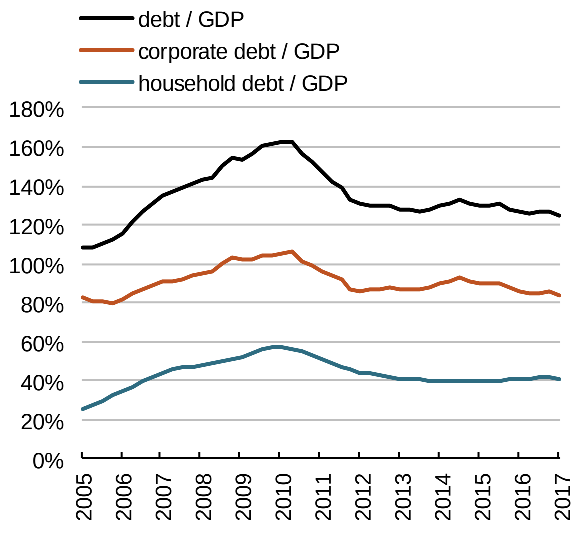
Eesti Pank's assessment of the countercyclical capital buffer rate (Q3 2017)[1]

Eesti Pank decided on 25 September 2017 to keep the countercyclical capital buffer rate at 0%.

- The applicable countercyclical capital buffer rate: **0%**
- The standardised credit-to-GDP ratio: **126%**; its deviation from the long-term trend: **–13 percentage points**
- The buffer rate: **0%**
- Reasoning for the buffer rate: there has been no increase in indebtedness in the real economy, which is the ratio of debt to GDP, in the past 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. However, households have started to borrow more as wages have risen rapidly and confidence has increased, and this could lead indebtedness to grow faster than forecast and so increase the related risks. The corporate indebtedness could also start to grow strongly again if investment increases. In consequence the current development of the loan market does not give any grounds for raising the capital buffer rate, but Eesti Pank constantly monitors the factors that could indicate a possible build-up of risks and can, if necessary, raise the countercyclical buffer rate above 0%.

There was a reduction in the indebtedness of the real economy in Estonia in the first quarter of 2017. The debt-to-GDP ratio fell to 126% at the end of the quarter, which is its lowest level of the past five years (see Figure 1). The reduction in the indebtedness was mainly due to modest growth in the debt liabilities of companies. Nominal GDP growth also picked up (see Figure 2), and this slowed the increase in the indebtedness of households. The notable increase in the rate of GDP growth continued in the second quarter, and with considering the increase in bank lending it suggests that the total indebtedness of the real sector probably did not increase in the second quarter either.

Figure 1. Real sector indebtedness



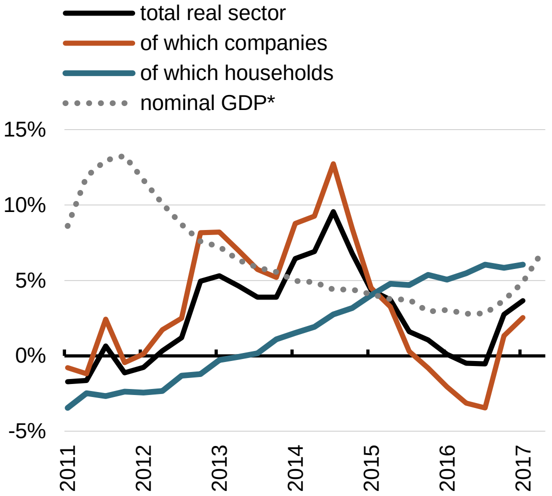
Sources: Statistics Estonia, Eesti Pank

The Eesti Pank June forecast expects that the total credit-to-GDP ratio of the non-financial sector will remain at its current level 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 the economy and investment grow, but the rate of growth will not exceed the forecast growth of 5-6% 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.

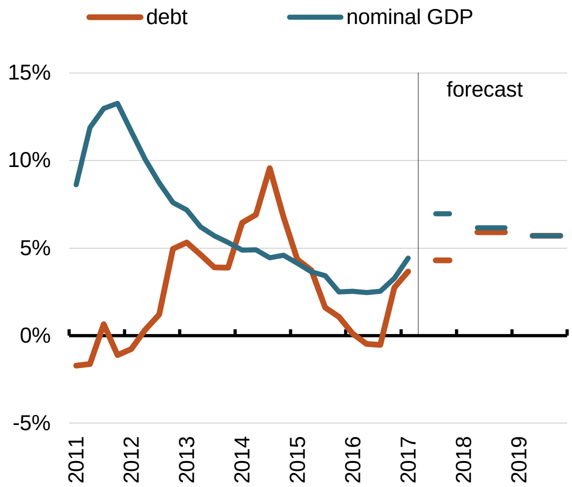
The standardised credit-to-GDP gap calculated using the methodology of the Basel Committee on Banking Supervision[2] was -13 percentage points at the end of the first quarter of 2017 and the additional gap[3], which is also used by Eesti Pank, was -22 percentage points at the end of the second quarter of 2017 (see Figure 4), 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
*4 quarter moving average annual GDP growth

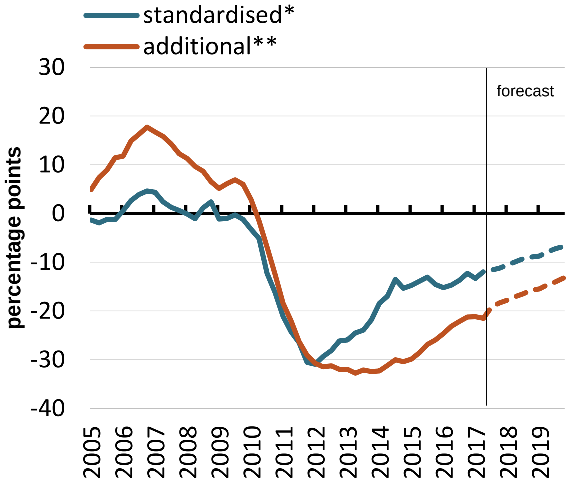
Figure 3. Annual growth of real sector debt and nominal GDP



Sources: Eesti Pank, Statistics Estonia

The growth in corporate debt, which was 2.5% over the year in the first quarter, has been slowed by the low level of investments. The structure of debt liabilities has been affected in recent years by the investment demand of different sectors, and the preferences of companies for sources of funding. There has been significant growth in recent years in borrowing from banks operating in Estonia but this has slowed a little this year, as the yearly growth in the stock of loans and leases slowed by the end of the second quarter to 6% from 8% a year ago. The stock of corporate debt liabilities from abroad, which had been at about the same level for a year and a half, started to increase slightly in

Figure 4. Credit-to-GDP gap



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

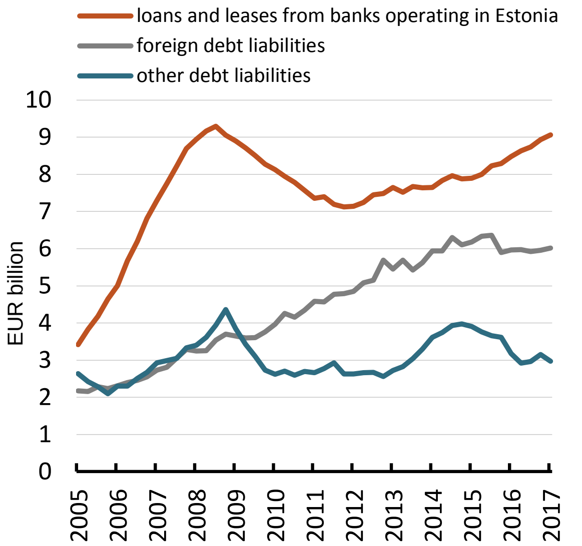
[2] In calculating the standardised credit-to-GDP ratio, Eesti Pank uses the quarterly statistics of the financial account from the system of national accounts for finding the debt level. This covers loans to the real sector and bonds issued both within Estonia and abroad. This is an unconsolidated indicator.

[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 first months of 2017 (see Figure 5). The decline in funding through holding companies has stabilised since the end of 2016. Despite the different dynamics of the different sources of funding, the forecasted increase in overall economic activity and investments gives grounds to expectations that total corporate debt will start to increase faster in future. The Eesti Pank June forecast expects that investment growth will accelerate this year and this will increase borrowing by companies.

Household borrowing has remained strong. The yearly growth in debt liabilities picked up to more than 6% by the end of the first quarter of 2017 as housing loans, car leases and other consumption loans all increased, and this rapid growth continued in the second quarter. Growth in borrowing by households has so far 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 will slow the growth in real wages. This may mean that faster growth in borrowing could threaten the ability of borrowers to repay their loans (see Figure 6).

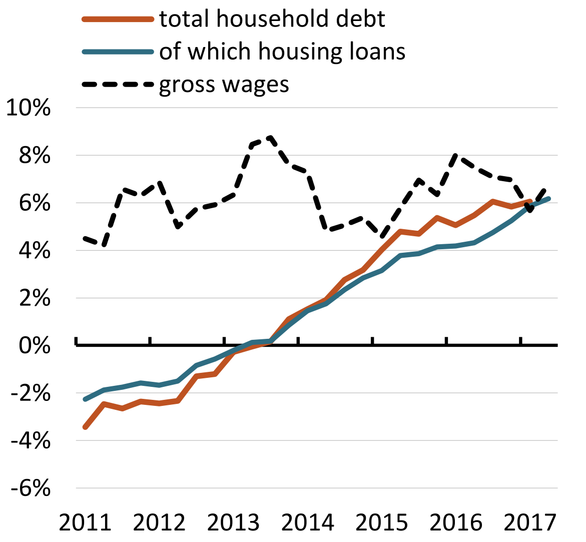
Figure 5. Corporate debt



Source: Eesti Pank

The annual growth in housing loans accelerated to 6% by the end of the second quarter of 2017. The growth in housing loans has been affected relatively substantially this year by the rise in the number of loan contracts. At the same time the rise in real estate prices, which affects the size of the average loan, slowed in the second quarter of 2017 to 4% (see Figure 7). Although there has been a slight increase this year in the share of real estate transactions that are funded with borrowed money, households are still using more of their own funds for buying residential property than was the case during the last business cycle.

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

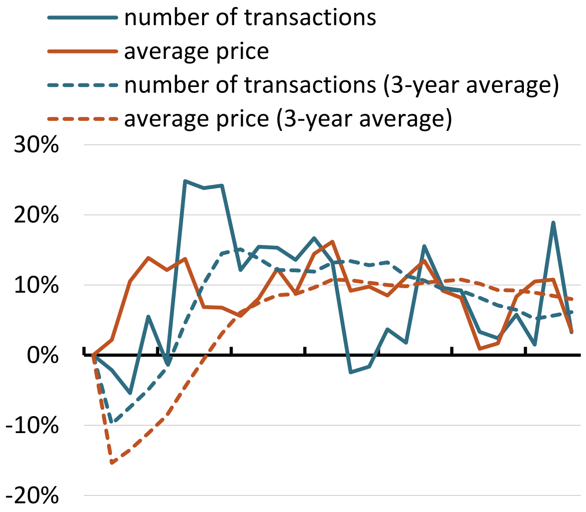


Source: Eesti Pank

The lending standards of the banks and their lending conditions have not been loosened. Increased demand for credit has allowed banks to increase their loan margins slightly on housing loans. This meant that the average interest rate on housing loans rose in the second quarter to 2.4%, which is around 0.2 percentage point more than at the start of the year (see Figure 8). The other conditions for housing loans, which are the LTV, DSTI and maturity, have not become looser however[4]. Competition between the bigger banks has meant the average margin on long-term corporate loans has fallen slightly in recent years, and has been similar to the margin on housing loans.

The supply of loans from the banks is supported by strong growth in deposits, and the banks have not increased their financial leverage. Deposits from the real sector have grown very rapidly in recent years, and the rate of growth passed 11% in July. The ratio of resident loans to deposits has not changed significantly in the past three years and has been at 122%, meaning the increase in the loan supply has not put pressure on the banks to increase the share of market-based funding. The capitalisation of the banks remains strong, and this has supported profitability.

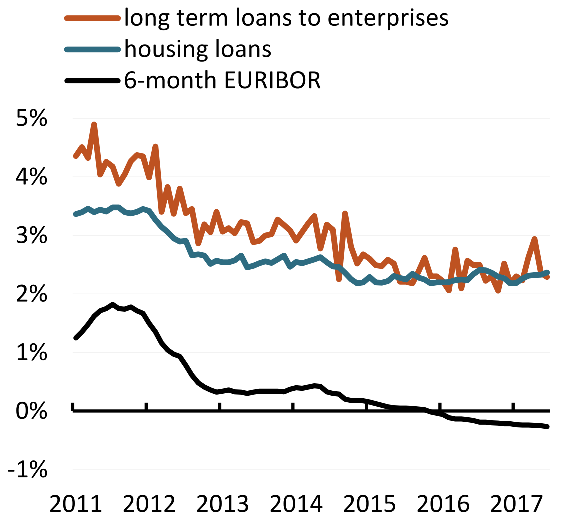
Figure 7. Annual growth of housing prices and number of transactions



Source: Estonian Land Board

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 has not increased in recent years and is predicted by the Eesti Pank June 2017 forecast to remain at around the same level for the next two 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. Furthermore, the banks have not loosened their lending standards and conditions and have not increased their leverage. However, low interest rates and possible rapid 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 indebtedness could also start to grow again if investment and confidence increase. For this reason Eesti Pank constantly monitors the factors that could indicate a possible build-up of risks and can, if necessary, raise the countercyclical buffer rate above 0%.

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



[4] To dampen the risks from housing loans, Eesti Pank introduced restrictions for new housing loans from 1 March 2015 that limited 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.