

## THE COUNTERCYCLICAL CAPITAL BUFFER RATE

Eesti Pank's assessment of the countercyclical capital buffer rate (Q4 2017)<sup>1</sup>

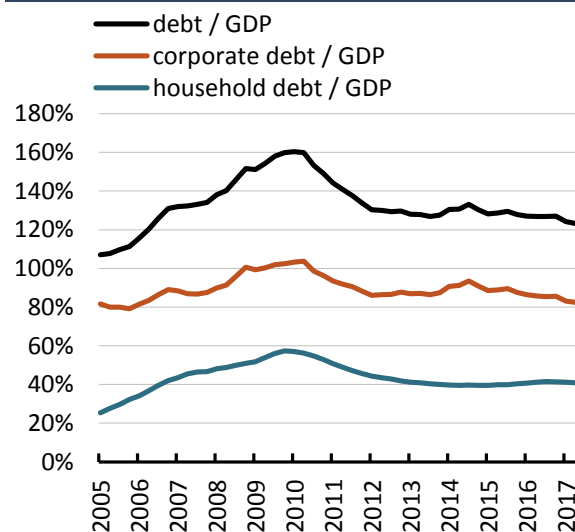
**Eesti Pank decided on 11 December 2017 to keep the countercyclical capital buffer rate at 0%.**

- The applicable countercyclical capital buffer rate: **0%**
- The standardised credit-to-GDP ratio: **123%**; its deviation from the long-term trend: **-14 percentage points**.
- The buffer guide: **0%**
- Reasoning for the buffer rate: there has been no increase in indebtedness in the real economy as shown by the debt-to-GDP ratio in the past three years. Debt liabilities will grow faster in the coming years as the economy grows, but the rate of growth is forecast not 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. At the same time, rapid wage growth and improved confidence have supported increased borrowing by households, which could lead to faster growth in indebtedness than forecast and an increase in the attendant risks. The corporate indebtedness could also start to grow again if investment increases. Although current developments in the loan market do not suggest that an immediate rise in the countercyclical buffer rate is warranted, 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 indebtedness of the non-financial sector in Estonia declined in the first half of 2017.** The credit-to-GDP ratio was down to 123% at the end of the second quarter, which is its lowest level for five years (see Figure 1). Indebtedness was mainly reduced because of the low growth in corporate debt. On top of this, nominal GDP growth was faster (see Figure 2), which braked the increase in household indebtedness.

**The Eesti Pank June forecast expects that the total debt-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 consistently exceed the rate of 5-6% forecast for nominal GDP (see Figure 3).

**Figure 1. Real sector indebtedness**



Sources: Statistics Estonia, Eesti Pank

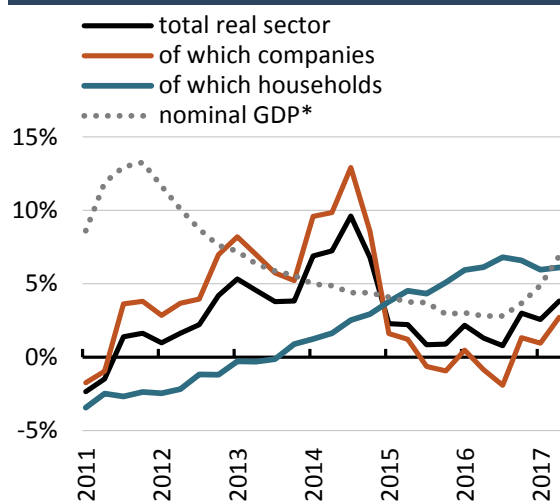
The standardised credit-to-GDP gap calculated using the methodology of the Basel Committee on Banking Supervision<sup>2</sup> was -14 percentage points at the end of the second quarter of 2017 and the

<sup>1</sup> 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.](#)

<sup>2</sup> 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 non-financial sector both within Estonia and abroad. This is an unconsolidated indicator.

additional gap<sup>3</sup>, which is also used by Eesti Pank, was –22 percentage points (see Figure 4), so the buffer guide was 0%. The gap will remain negative in the years of the forecast, 2017-2019.

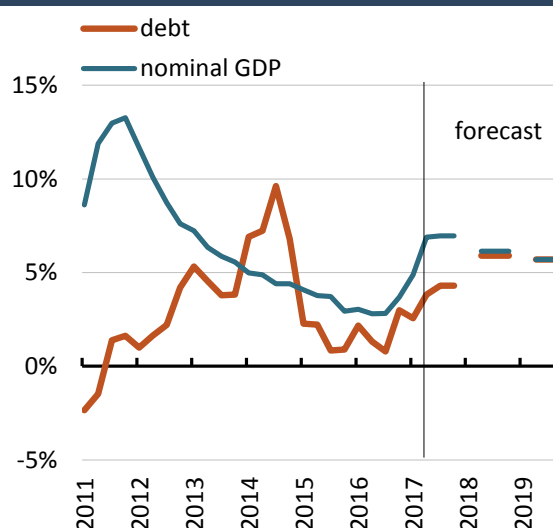
**Figure 2. Annual growth of real sector debt and nominal GDP**



Sources: Eesti Pank, Statistics Estonia

\*4 quarter moving average GDP annual growth

**Figure 3. Forecast of annual growth of real sector debt and nominal GDP**

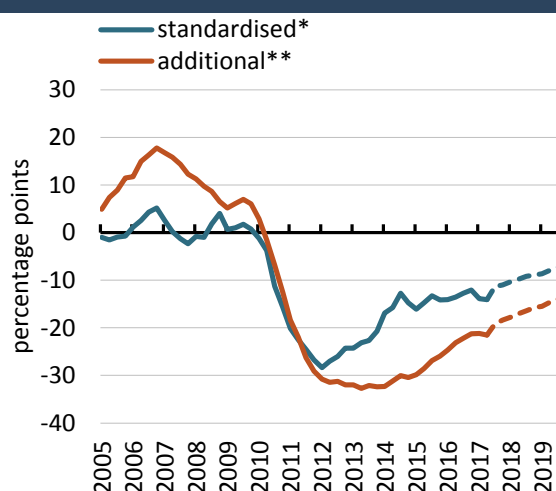


Sources: Eesti Pank, Statistics Estonia

**Corporate debt was up 2.7% on a year earlier at the end of the second quarter.**

The structure of debt liabilities has been affected in recent years by the different investment needs of different sectors and the sources of funding preferred by different companies. The sharp increase of recent years in borrowing from banks operating in Estonia has slowed a little this year, and the rate of yearly growth in the stock of loans and leases came down from 8% a year earlier to 6% at the end of the second quarter, and growth remained moderate in the third quarter too. The stock of foreign corporate debt liabilities has been largely unchanged for the past two years, but it is likely to increase in future as the reduction in the very volatile short-term debt liabilities of less than one year to maturity will end soon, while long-term debt liabilities of over one year will continue to grow. Inter-company lending has also stabilised after its decline in 2016 (see Figure 5).

**Figure 4. Credit-to-GDP gap**



\* based on total debt data

\*\* based on domestic bank loans and leases data

Sources: Statistics Estonia, Eesti Pank

Despite the divergence in the sources of funding, the forecast general growth in economic activity and investment gives grounds to assume that total corporate debt will grow at a faster rate in future. The Eesti Pank June forecast expects corporate borrowing will start to increase in the years ahead because of increased investment.

<sup>3</sup> 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.

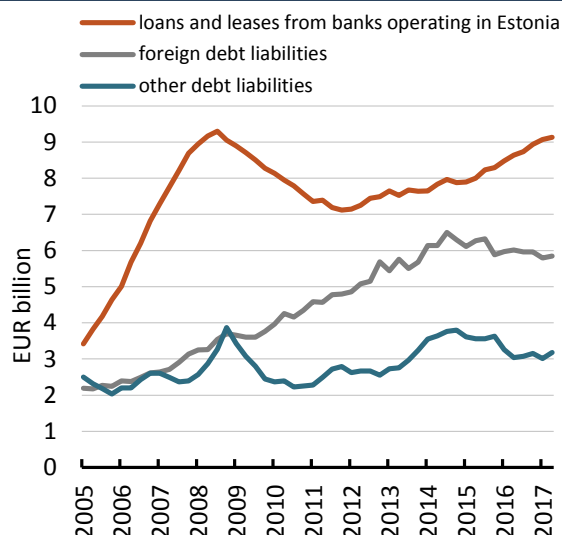
### Borrowing by households has remained strong.

The yearly growth in debt liabilities picked up to more than 6% by the end of the second quarter of 2017 as housing loans, car leases and other consumption loans all increased (see Figure 6). Growth in borrowing by households has so far been supported by rising wages, low unemployment and favourable interest rates on loans. The increasing labour shortages that are accompanying the growth in the economy will maintain upwards pressure on wages, though inflation will rein in the growth in real wages. This means that continued acceleration in the growth in borrowing could increase the risks of payment difficulties.

### The annual growth in the stock of housing loans

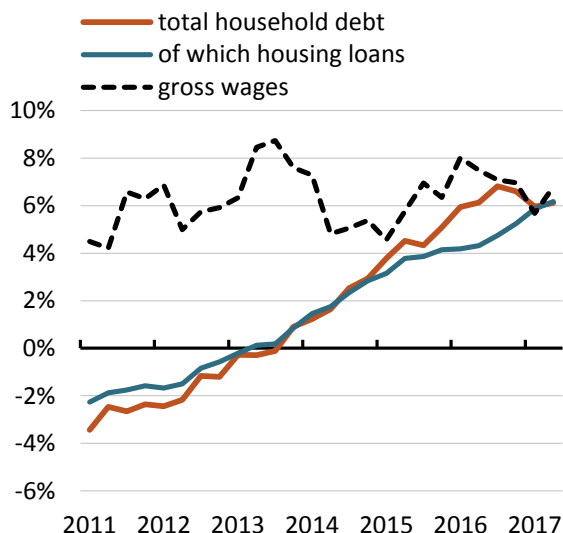
**accelerated to 6.5% by the end of the third quarter of 2017.** The low reference base means the yearly growth in new housing loans has been fast this year, but it slowed in the third quarter and at 14% it was below the average of the past three years. A rise in the number of contracts has made a relatively large contribution to the growth in housing loans this year. The rise in real estate prices, which affects the size of the average loan, has slowed a little in the second half of 2017. The yearly growth in the average price of apartments was 6% in the third quarter (see Figure 7). Although loans are being used a little more to finance real estate transactions this year, households are still using more of their own funds to buy residential property than they were in the previous business cycle.

Figure 5. Corporate debt



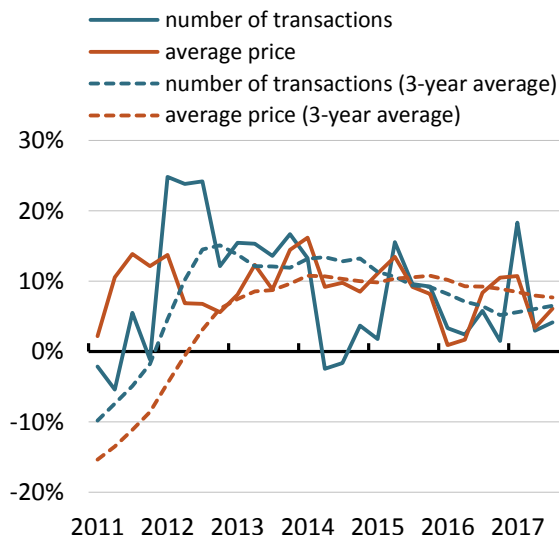
Source: Eesti Pank

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



Source: Eesti Pank

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



Source: Estonian Land Board

**The lending standards and conditions of the banks have not been eased.** Strong demand for loans has allowed the banks to raise their loan margins on housing loans to some degree. This meant the average interest rate on housing loans rose a little in the third quarter to 2.4%, which was some 0.2 percentage point higher than at the start of the year (see Figure 8). The other conditions for housing loans, meaning the ratios for loan value to collateral and loan repayments to income, and the

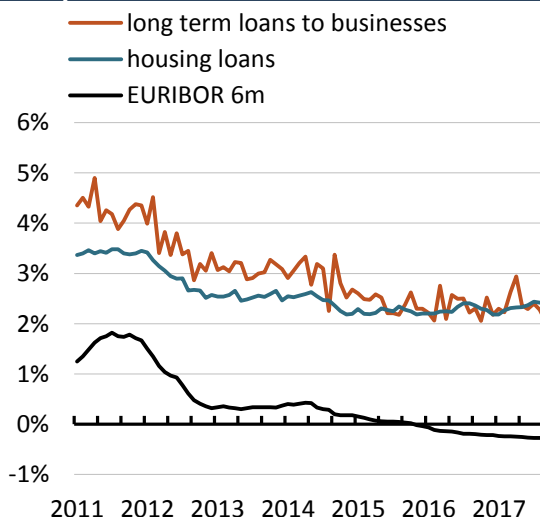
maximum maturity of loans, have not notably changed over the year. Tighter competition between the banks has led the average interest margin on long-term corporate loans to fall a little in recent years and it is now equal to the margin on housing loans.

**The supply of lending from banks is supported by strong growth in deposits and the leverage of the banks has not increased.** Deposits from the non-financial sector have grown very fast in recent years, and the growth rate at the end of September was almost 11%. The ratio of resident loans to deposits has been essentially unchanged at 122% for the past three years, meaning the banks have not been put under pressure to increase the share of market-based financing in order to boost the credit supply. The capitalisation of the banks has remained high, and has been aided by high levels of profitability.

**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 as shown by the credit-to-GDP ratio has not increased in the past three years and is predicted by the Eesti Pank June 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 is forecast not 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.

At the same time, rapid wage growth and improved confidence have supported increased borrowing by households, which could lead to faster growth in indebtedness than forecast and an increase in the attendant risks. The corporate indebtedness could also start to grow again if investment increases. Current developments in the loan market do not demand an immediate rise in the countercyclical buffer rate, but 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%.

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



Source: Eesti Pank