

## THE COUNTERCYCLICAL CAPITAL BUFFER RATE

Eesti Pank's assessment of the countercyclical capital buffer rate (Q2 2018)<sup>1</sup>

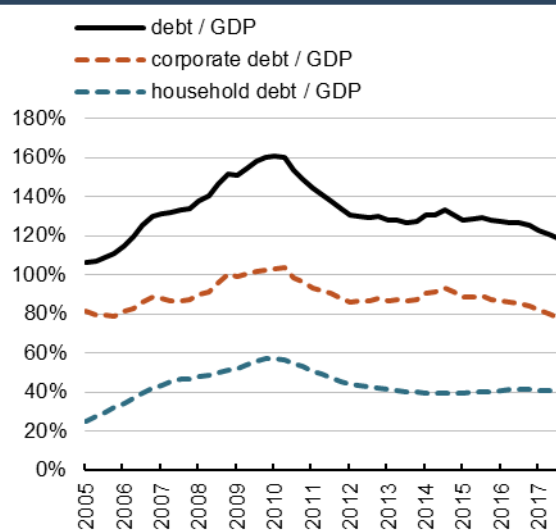
**Eesti Pank decided on 11 June 2018 to keep the countercyclical capital buffer rate at 0%.**

- The applicable countercyclical capital buffer rate: **0%**
- The standardised credit-to-GDP ratio: **117%**; its deviation from the long-term trend: **–18 percentage points**
- The buffer rate: **0%**
- **Reasoning for the buffer rate:** the growth in debt in the non-financial sector has remained slow, and indebtedness, which is the ratio of debt to GDP, has fallen in recent years, meaning there is no reason to raise the buffer rate at the moment. However, debt liabilities may grow faster in the future if the economy continues to grow fast and investment to increase. The risk remains that with wages continuing to rise fast and confidence remaining at a high level, enthusiastic borrowing by households could increase the indebtedness faster than forecast if real estate prices rise faster, and so could increase the cyclical risks. The corporate indebtedness could also start to grow strongly again with support from increasing economic activity and rising investment. For this reason Eesti Pank monitors the changes that could indicate a possible build-up of risks and can, if necessary, raise the countercyclical buffer rate above 0%.

**The indebtedness of the non-financial sector continued to decline in 2017.** This was because GDP growth accelerated to a nominal 9%, while the gross debt of the non-financial sector increased by only 1%. As a result, gross debt fell as a ratio to GDP to its lowest level of the past three years, falling from 130% to 117% (see Figure 1). The growth in debt has been modest mainly because of weak growth in corporate debt liabilities, while household debt has grown at a similar rate to GDP (see Figure 2).

**The Eesti Pank December forecast indicates that GDP will grow faster than debt in the non-financial sector this year again, though in subsequent years the growth in debt will accelerate to the level of nominal GDP growth** (see Figure 3). The forecast expects growth to pick up significantly in non-financial sector debt as continuing growth in the economy will also increase investment activity and in consequence increase the need for companies to access external funding.

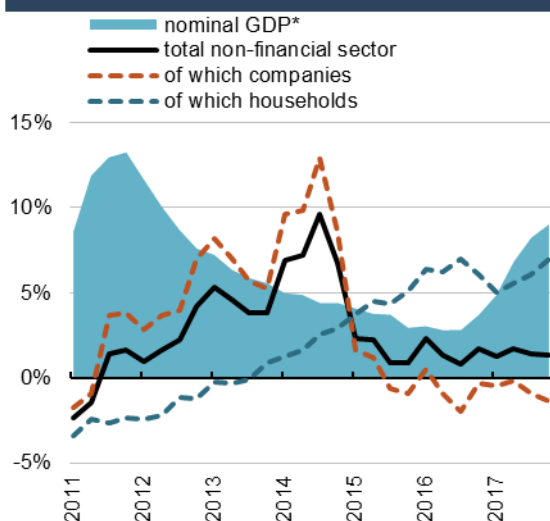
**Figure 1. Non-financial sector indebtedness**



Sources: Statistics Estonia, Eesti Pank

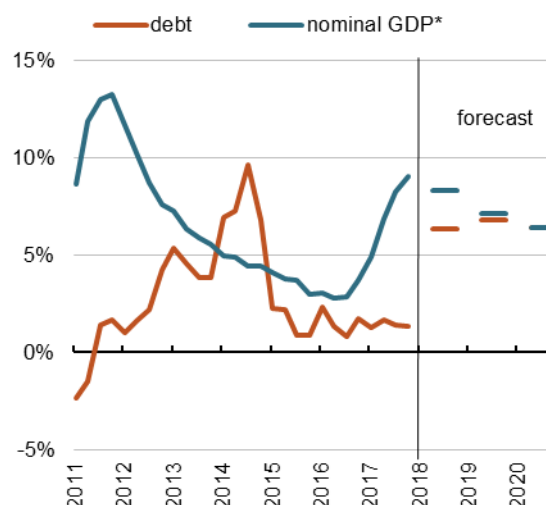
<sup>1</sup> The assessment methodology is described in more detail in the Eesti Pank document [“Countercyclical Capital Buffer. The principles and indicators for setting the buffer rate in Estonia”. October 2015.](#)

**Figure 2. Annual growth of non-financial sector debt and nominal GDP**



\*Four-quarter moving average yearly GDP growth  
Sources: Eesti Pank, Statistics Estonia

**Figure 3. Forecast for annual growth of non-financial sector debt and nominal GDP**

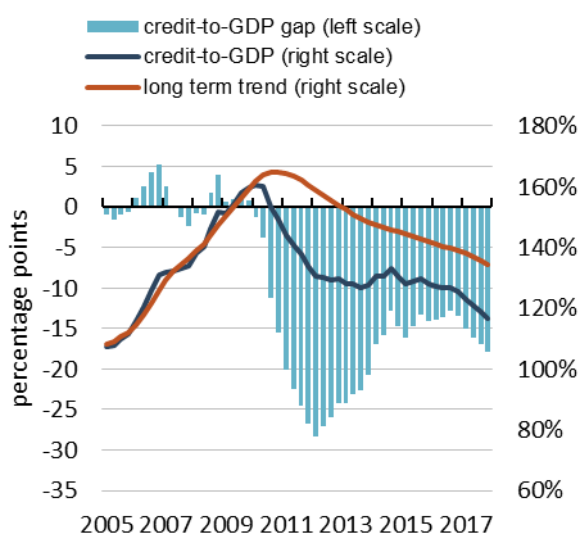


\*Four-quarter moving average yearly GDP growth  
Sources: Eesti Pank, Statistics Estonia

The standardised credit-to-GDP gap<sup>2</sup> calculated using the methodology of the Basel Committee on Banking Supervision was -18 percentage points at the end of 2017 (see Figure 4). The additional gap<sup>3</sup>, which is also used by Eesti Pank, was -24 percentage points. This means that both indicators show the credit-to-GDP ratio to be lower than the long-term trend, and so the benchmark buffer rate remains at 0%. As the Basel Committee methodology is not appropriate for use with the Estonian time series, additional indicators showing the development of indebtedness are important for analysing the need for the countercyclical buffer.

**Corporate debt fell last year by 1.4%.** Despite increasing a little, investment remains at a low level. Furthermore, demand for debt capital is weak because the ability of companies to finance investments using their own funds has improved. Gross debt fell because the use of short-term debt liabilities declined in the corporate sector. This was not because of a lack of need for funds, but rather reflects the cash flow management of foreign-owned companies. Long-term debt liabilities equally grew slowly, increasing by 2% over the year. With levels of economic activity remaining high and investment forecast to increase, it may be assumed that corporate debt liabilities will continue

**Figure 4. Standardised credit-to-GDP gap**



Sources: Statistics Estonia, Eesti Pank

<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 loans to the non-financial sector and bonds issued both within Estonia and abroad. This is an unconsolidated indicator.

<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.

to increase more rapidly going forward. The Eesti Pank December forecast expects the growth in corporate debt liabilities to be close to 6% a year in the coming years.

The structure of corporate debt liabilities has changed, as banks operating in Estonia have been preferred as a source of funds more in recent years than previously (see Figure 5). The share of corporate debt liabilities abroad has fallen gradually, especially because of a reduction in short-term debt liabilities. At the end of 2017 one bank moved part of its loans to the portfolio of its foreign parent bank, increasing foreign debt liabilities and reducing loans from banks operating in Estonia by the same amount.

#### Borrowing by households remained strong last year.

The growth in gross household debt reached 7%. Demand has been strong for housing loans, car leases and other consumption loans. This has been supported by rising wages, low unemployment and favourable interest rates on loans. Although the growth in debt liabilities is fast,

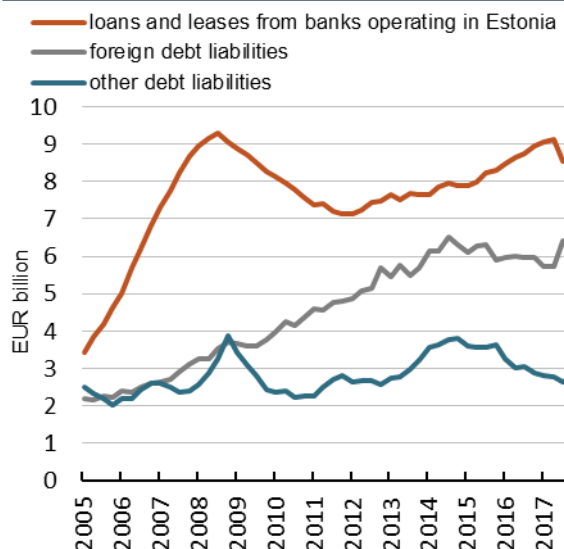
it has not yet surpassed the rate of growth in wages (see Figure 6). The strong demand for labour means that wage pressures remain and the growth in demand for loans could accelerate further in future. This in turn would increase the risks to the capacity of households to service their loans.

The largest share of household debt liabilities are housing loans, and the yearly growth in the stock of such loans increased constantly last year (see Figure 6). During the year, 16% more was issued in new housing loans than a year earlier. The driver of this was again the active real estate market, where both prices and numbers of transactions have increased rapidly (see Figure 7). Although there was a slight increase last year in the use of borrowed money to fund real estate transactions, households are still using more of their own funds for buying residential property than was the case during the rapid growth in the economy a decade ago.

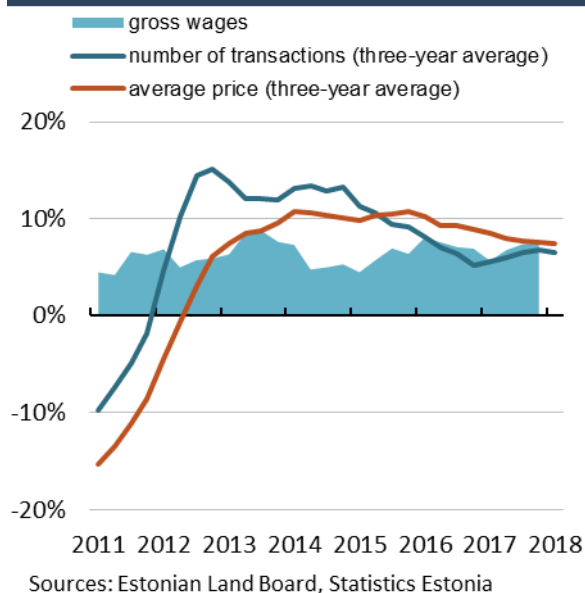
**Figure 6. Annual growth of household debt and the average gross wage**



**Figure 5. Corporate debt**



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



**The lending standards of the banks and their lending conditions have not notably changed.**

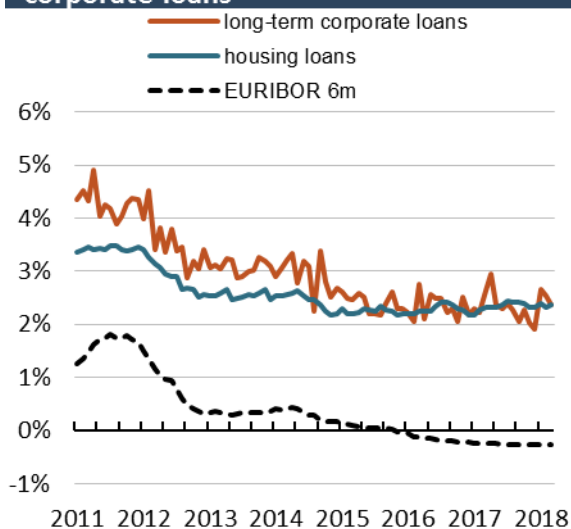
The average interest rate on both housing loans and long-term corporate loans was 2.4% in March (see Figure 8). The other conditions for housing loans, which are the loan-to-value ratio, the debt service-to-income ratio and maturity, have not particularly changed.

**The supply of loans from the banks is supported by strong growth in deposits and by high levels of capitalisation, which have been helped by good profitability.** Deposits from the non-financial sector have grown very rapidly in recent years, and the rate of growth was around 10% over the year in March. The ratio of resident loans to deposits was 119%, which indicates that banks were funding loans to a large extent with the deposits they had taken in.

**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 growth in debt in the non-financial sector has remained slow, and indebtedness has fallen in recent years. Furthermore, the banks have not loosened their lending standards and conditions.

However, debt liabilities may grow faster in the future if the economy continues to grow fast and investment to increase. The risk remains that with wages continuing to rise fast and confidence remaining at a high level, enthusiastic borrowing by households could increase the indebtedness faster than forecast if real estate prices rise faster, and so could increase the cyclical risks. The corporate indebtedness could also start to grow strongly again with support from increasing economic activity and rising investment. **For this reason Eesti Pank monitors the changes 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**



Source: Eesti Pank