

## THE COUNTERCYCLICAL CAPITAL BUFFER RATE

Eesti Pank's assessment of the countercyclical capital buffer rate (Q3 2018)<sup>1</sup>

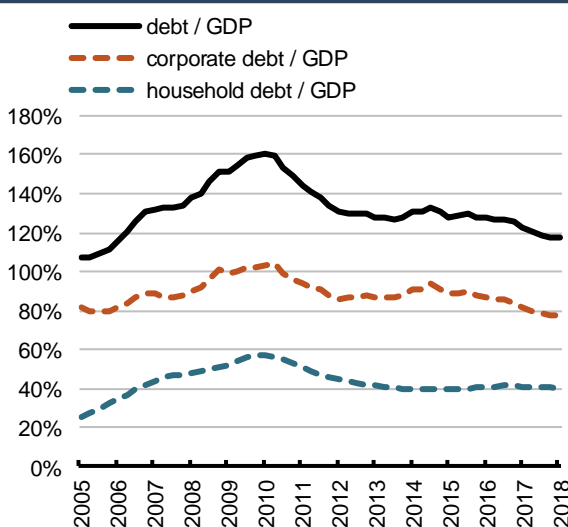
**Eesti Pank decided on 24 September 2018 to keep the countercyclical capital buffer rate at 0%.**

- The applicable countercyclical capital buffer rate: **0%**
- The standardised credit-to-GDP ratio: **115%**; its deviation from the long-term trend: **-17 percentage points**
- The buffer rate: **0%**
- Reasoning for the buffer rate: the growth in debt in the non-financial sector has remained small, and indebtedness, which is the ratio of debt to GDP, has fallen in recent years, and so 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, and they may grow faster than nominal GDP. There is equally the risk that with wages continuing to rise faster and confidence good, enthusiastic borrowing by households could increase the debt burden faster than forecast if real estate prices rise faster, and so could increase the cyclical risks. 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 declined in the first quarter of 2018.** This was because debt again grew more slowly than the economy in nominal terms. Debt liabilities were 4% larger in the first quarter of 2018 than in the first quarter of 2017, but nominal GDP grew by 9% over the year. As a result, gross debt fell as a ratio to GDP to 117% (see Figure 1). The growth in debt was restrained by the weak growth in corporate debt liabilities. Household debt has grown notably faster, but still more slowly than GDP (see Figure 2).

**The Eesti Pank June forecast expects debt to grow by less than nominal GDP this year and next, but to overtake it after that** (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.

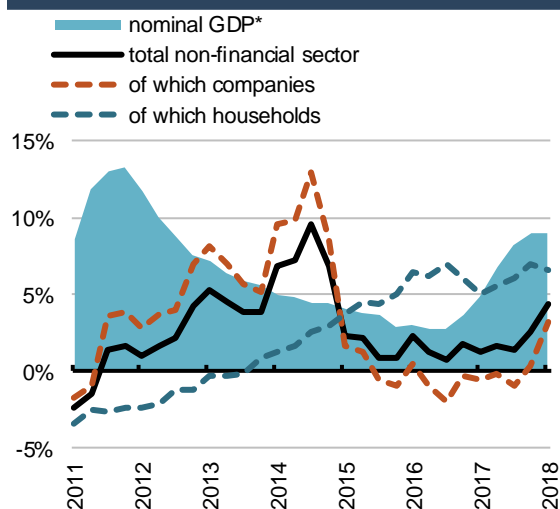
**Figure 1. Non-financial sector indebtedness**



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.

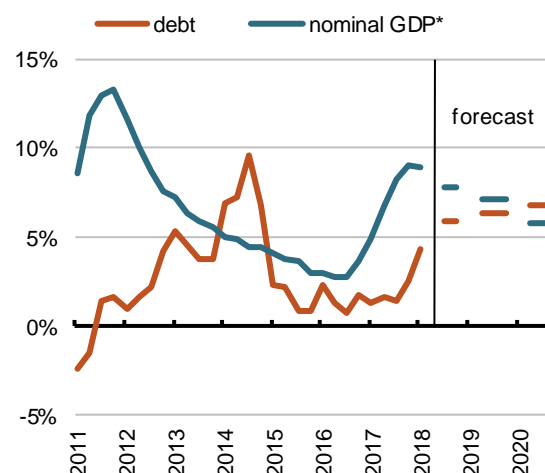
**Figure 2. Annual growth of non-financial sector debt and nominal GDP**



Sources: Eesti Pank, Statistics Estonia

\*Four-quarter moving average yearly GDP growth

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



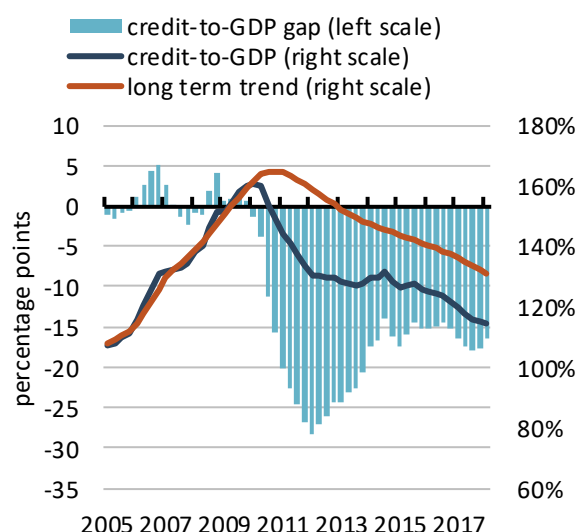
Sources: Eesti Pank, Statistics Estonia

\*Four-quarter moving average yearly GDP growth

The standardised credit-to-GDP<sup>2</sup> gap calculated using the methodology of the Basel Committee on Banking Supervision was -17 percentage points at the end of 2018 (see Figure 4). The additional gap<sup>3</sup>, which is also used by Eesti Pank, was -23 percentage points at the end of the second quarter of 2018. 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 started to grow again at the end of 2017 having been stationary for around three years, and in the first quarter of 2018 that yearly growth reached 3% (see Figure 5). Although the yearly growth accelerated in the first quarter, the favourable economic climate meant that it still remained quite modest. This was because investment was weak, which particularly holds back stronger growth in long-term debt liabilities. However, the decline in borrowing from foreign associated companies in short-term loan liabilities has stopped and increased investment is expected

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



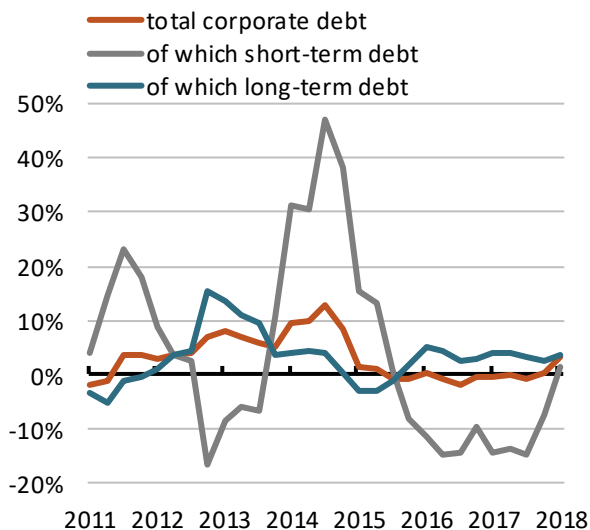
Sources: Statistics Estonia, Eesti Pank

<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.

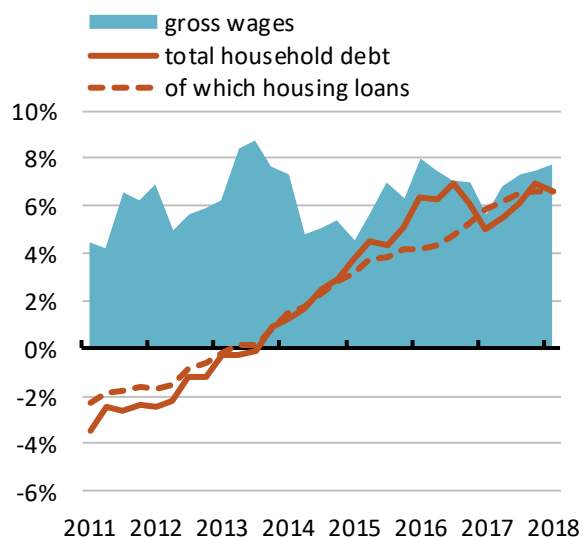
to lift the rate of growth in gross corporate debt in future. The Eesti Pank June forecast expects the growth in corporate debt liabilities to increase to 6% in the coming years.

**Figure 5. Annual growth of corporate short-term and long-term debt**



Source: Eesti Pank

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

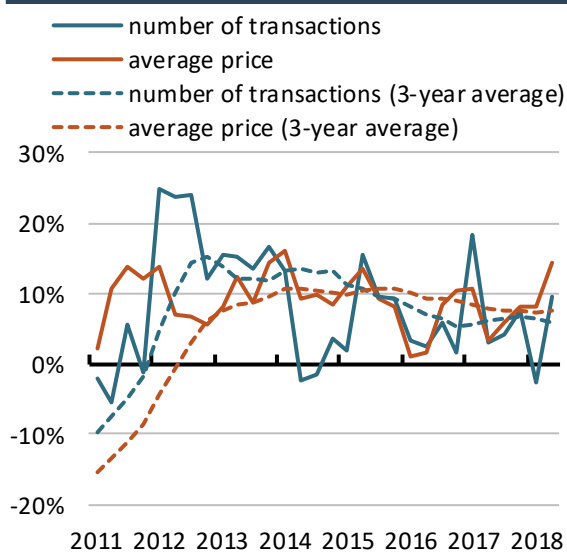


Sources: Eesti Pank, Statistics Estonia

**Borrowing activity by households remains strong.** The growth in gross household debt reached almost 7% in the first quarter of 2018. Demand has been strong for housing loans, car leases and other consumption loans, and 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 reached almost 7% in the second quarter of 2018. The driver of this was again the active real estate market, where prices have risen rapidly (see Figure 7). However, there has been no increase in the share of borrowed money used for purchasing housing and buyers are using their own funds relatively more than during the period of rapid economic growth in the previous decade, which reflects a somewhat more cautious approach by market participants. To dampen the risks from housing loans, Eesti Pank has set three restrictions for new housing loans that limit the 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.

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



Source: Estonian Land Board

The lending standards and conditions of the banks have mostly remained more or less the same, with only a slight rise in the margins on housing loans to households (see Figure 8). The average interest rate on new housing loans has risen a little since the start of 2018 and in July it reached 2.5%. This is its highest rate of the past four years, but it still looks low in a longer perspective. The average interest rate on new long-term corporate loans has been quite volatile though, and depends largely on which companies are signing loan contracts for which projects in a given period.

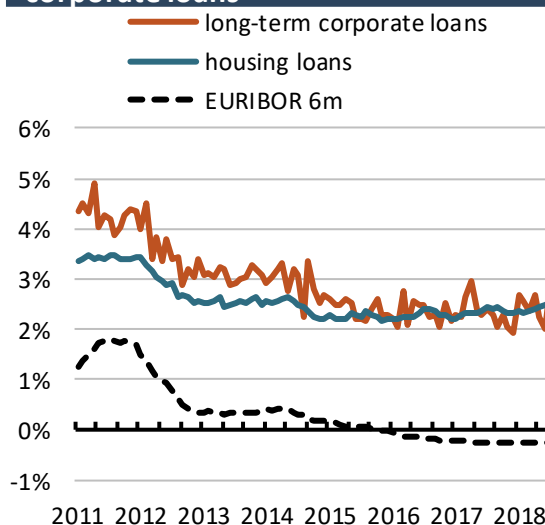
**The supply of loans from the banks is supported by strong growth in deposits and by high levels of capitalisation, which have been helped by good profitability.**

Deposits from the non-financial sector have grown very rapidly in recent years, and the rate of growth was around 10% in July 2018. The ratio of resident loans to deposits was 114%, which indicates that banks were funding loans to a large extent with deposits.

**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 been modest, and indebtedness, which is the ratio of debt to GDP, 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, and they may grow faster than nominal GDP. There is equally the risk that with wages continuing to rise faster and confidence good, enthusiastic borrowing by households could increase the debt burden faster than forecast if real estate prices rise faster, and so could increase the cyclical risks. **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