

THE COUNTERCYCLICAL CAPITAL BUFFER RATE

Eesti Pank's assessment of the countercyclical capital buffer rate (Q4 2018)¹

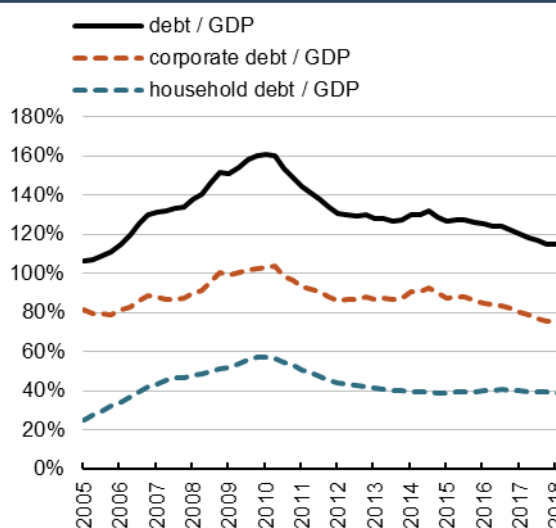
Eesti Pank decided on 10 December 2018 to keep the countercyclical capital buffer rate at 0%.

- The applicable countercyclical capital buffer rate: **0%**
- The standardised credit-to-GDP ratio: **116%**; its deviation from the long-term trend: **–15 percentage points**
- The countercyclical buffer guide: **0%**
- **Reasoning for the buffer rate:** although the yearly growth in non-financial sector debt has accelerated to close to the level of long-term nominal economic growth, this has not led to any substantial increase in indebtedness. This means there is currently no reason to raise the countercyclical capital buffer rate. The growth in total debt has come from borrowing by companies, which has increased in recent quarters. With investment levels low however, no major increase in the rate of growth of corporate debt is expected. The risk remains though that borrowing by the non-financial sector is increasing, raising the risks that come from the credit cycle. For this reason Eesti Pank monitors the growth in debt and indicators that affect it, and can if necessary raise the countercyclical capital buffer rate above 0%.

The decline in indebtedness in the non-financial sector ended in the first half of 2018. The credit-to GDP ratio fell to 115% at the end of 2017, which is its lowest level of the past 12 years (see Figure 1). The fall in recent years has been caused by a lack of borrowing by companies, but this year such borrowing started to increase again. As growth in the economy has remained strong at the same time, the debt level has not substantially increased. The Eesti Pank June forecast does not expect any significant rise in indebtedness in the next two years (see Figure 2).

The rate of growth of debt in the non-financial sector is comparable to the rate of long-term growth in the economy. The annual growth in housing loans accelerated to 5.7% by the end of the second quarter of 2018, which is less than the growth in nominal GDP. With the economy growing fast, there is a danger of the speed of growth in debt levels being underestimated. To reduce the effect of the economic cycle in the estimate, the growth in debt is compared to the long-term average growth in the economy (see Figure 3). The debt of the Estonian non-financial sector has grown more slowly in recent years than the eight year average for nominal GDP, though by the end of the second quarter of 2018 its rate of growth had approached that of GDP. The growth in bank loans and leases has for some time exceeded the long-term rate of GDP growth² and in the third quarter it picked up further to 6.6%.

Figure 1. Non-financial sector indebtedness

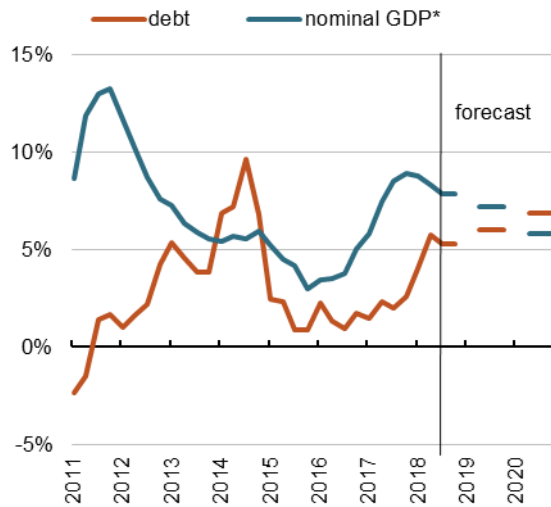


Sources: Statistics Estonia, Eesti Pank

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.

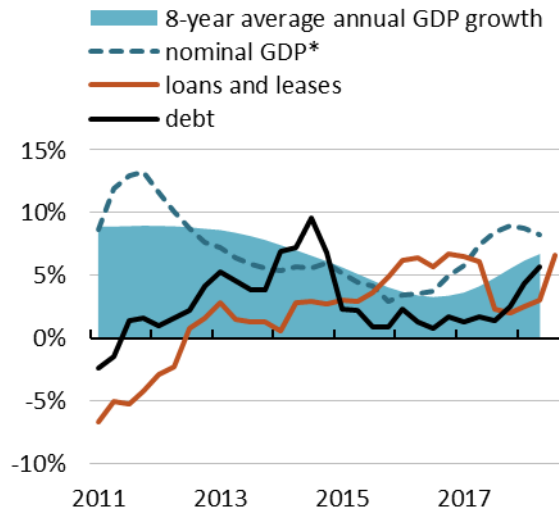
² Excluding the partial transfer of the loan portfolio of one bank to its parent bank in autumn 2017.

Figure 2. Forecast for annual growth of non-financial sector debt and nominal GDP



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

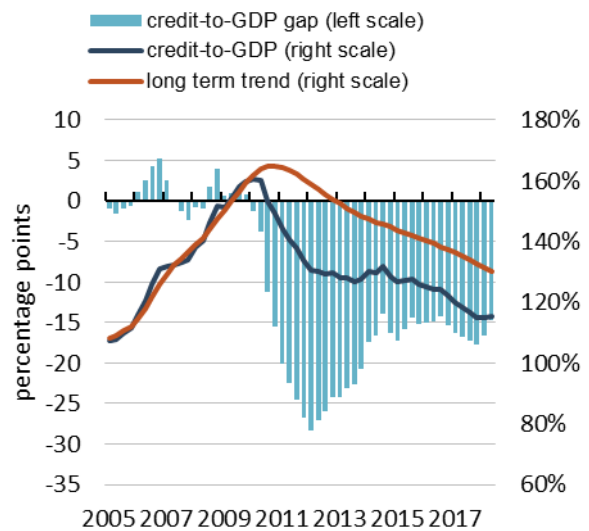
Figure 3. Annual growth of loans and leases, debt and nominal GDP



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

The standardised credit-to-GDP³ gap calculated using the methodology of the Basel Committee on Banking Supervision was -15 percentage points at the end of the second quarter of 2018 (see Figure 4). The additional gap⁴, which is also used by Eesti Pank, was -23 percentage points. This means that the credit-to-GDP ratio is lower than the long-term trend, and so the countercyclical buffer guide remains at 0%. As the time series for Estonia are short, the Basel methodology does not give a reliable estimate of the credit cycle. This means that other indicators showing the development of indebtedness need to be analysed in depth to reach an estimate of the need for the countercyclical buffer.

Figure 4. Standardised credit-to-GDP gap



Sources: Statistics Estonia, Eesti Pank

³ 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.

⁴ 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.

Demand from companies for loans has so far been modest given the rapid growth in the economy. Levels of investment have been low and the ability of companies to finance their own activities and investments from own funds has improved. In consequence the level of corporate debt has remained fairly unchanged for the past three years, and yearly growth picked up in it only this year to 5.1%. The Eesti Pank June forecast expects that companies will start to invest more in the years ahead, but as investment as a share of the economy is low by the levels of previous decades, this will not lead to any significant growth in corporate debt.

Corporate debt liabilities have seen the fastest growth in recent years in borrowing from banks operating in Estonia, and this growth was 6% in the third quarter (see Figure 5). Loans have increased their share of sources of financing for companies as access to loans in Estonia has been relatively good. The main borrowers have been companies that usually fund themselves primarily from banks operating in Estonia. Furthermore, borrowing from foreign associated companies in short-term loan liabilities has stopped declining and in consequence gross corporate debt will grow a little faster in future.

Demand from households for loans remains strong. It is supported by the continuing rapid growth in incomes and improved confidence, favourable interest rates, low unemployment, and an active housing market. Growth has been fast for housing loans, consumption loans and car leases. The growth in household debt has not accelerated in recent quarters but has remained at close to 7% (see Figure 6). However, fewer new loans have been added in recent months than earlier. 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 was around 7% in the third quarter of 2018. The driver of this was again the active real estate market, where prices have risen relatively rapidly (see Figure 7). There has been no increase in the share of borrowed money used for purchasing housing and purchasers are using their own funds relatively more than during the period

Figure 5. Corporate debt

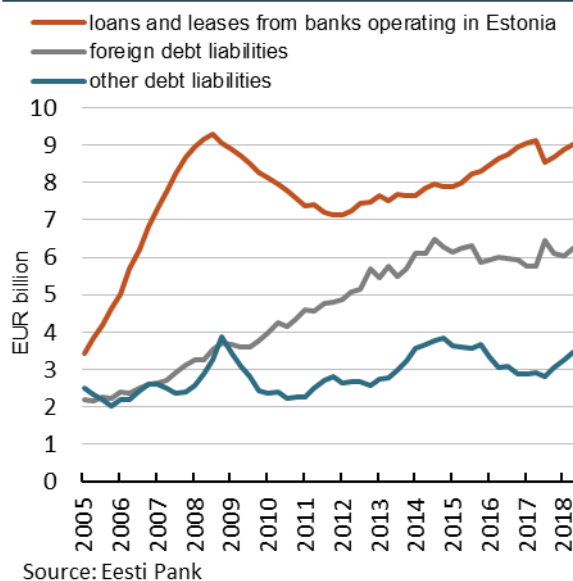
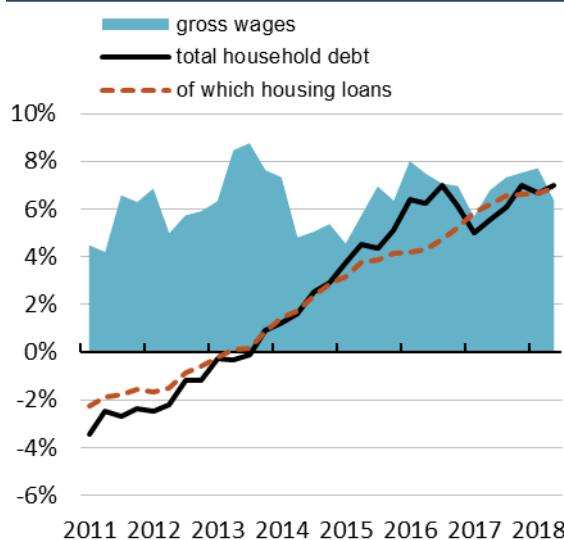


Figure 6. Annual growth of household debt and the average gross wage



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.

The lending standards of the banks and their lending conditions have not been loosened. The average interest rate on new housing loans has risen a little since the start of 2018 as the margin has risen, and in September it was at 2.5% (see Figure 8). The Bank Lending Survey also shows that the banks have not loosened their lending standards or conditions for companies or households in the past year.

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. The yearly growth in deposits of the non-financial sector has been very fast of late, and in September it was at 9%. 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 consequence, Eesti Pank does not currently consider it necessary to change the countercyclical buffer rate, though if debt grows faster in future it could consider raising the rate above 0%. This conclusion is reached because although the yearly growth in non-financial

sector debt has accelerated to close to the level of long-term nominal economic growth, this has not led to any substantial increase in indebtedness. The growth in total debt has come from borrowing by companies, which has increased in recent quarters. With investment levels low however, no major increase in the rate of growth of corporate debt is expected. With support from demand-side factors, bank loans have grown at almost the same rate as nominal GDP. The banks have not loosened their lending standards and conditions and have not increased their leverage. The risk remains though of borrowing increasing, raising the risks that come from the credit cycle. For this reason Eesti Pank monitors the growth in debt and indicators that affect it, and can if necessary raise the countercyclical capital buffer rate above 0%.

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

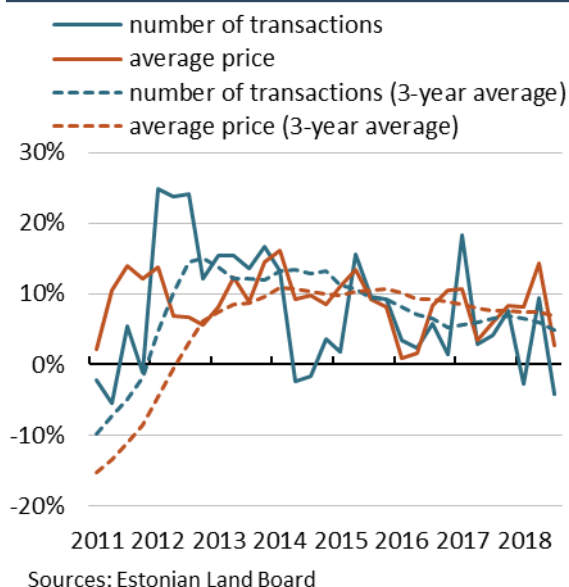


Figure 8. Weighted average interest rates on housing loans and long-term corporate loans

