

THE COUNTERCYCLICAL CAPITAL BUFFER RATE

Eesti Pank's assessment of the countercyclical capital buffer rate (Q2 2019)¹

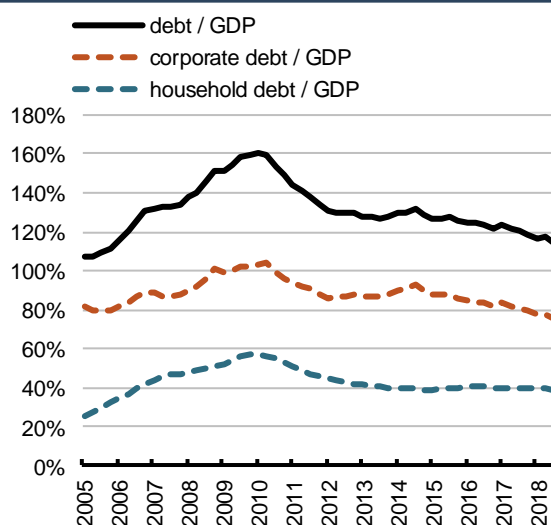
Eesti Pank decided on 12 June 2019 to keep the countercyclical capital buffer rate at 0%.

- The applicable countercyclical capital buffer rate: **0%**
- The standardised credit-to-GDP ratio: **112%**; its deviation from the long-term trend: **-17 percentage points**
- The buffer rate: **0%**
- **Reasoning for the buffer rate:** the rate of growth in debt in the non-financial sector remains below nominal economic growth for the current year and the long-term average nominal growth. The growth in corporate debt has remained modest. The growth in new loans to households slowed in the second half of 2018 and the residential real estate market continued to develop at a gentle pace. The growth in bank loans and leases has been supported by demand-side factors. The banks have not eased their lending standards and loan margins rose slightly in 2018. This development does not indicate any major imbalance in the credit market, though the relatively good state of the economy and low interest rates mean the risk remains of excessive borrowing that could increase the risks 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 level of non-financial sector indebtedness has not substantially changed. The credit-to-GDP ratio fell to 112% by the end of the fourth quarter of 2018 (see Figure 1). The Eesti Pank December forecast 2018 does not expect any significant rise in the debt burden in the next two years.

The debt of the non-financial sector increased by 2.9% in the fourth quarter of 2018. Growth in the debt of both companies and households was slower than nominal GDP growth. The danger of rapid growth in debt may be underestimated when the economy is growing fast though, and so the growth in debt is compared to the long-term average growth in the economy (see Figure 2). The debt of the Estonian non-financial sector has mostly grown more slowly in the past four years than the eight-year average for nominal GDP. The growth in bank loans and leases was 6.6% in the fourth quarter.

Figure 1. Non-financial sector indebtedness

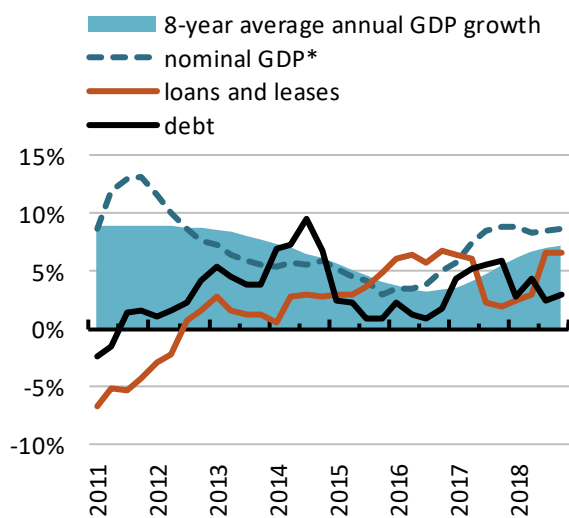


Sources: Statistics Estonia, Eesti Pank

¹The 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. http://www.eestipank.ee/sites/eestipank.ee/files/files/Finantsstabiilsus/ccb_est.pdf

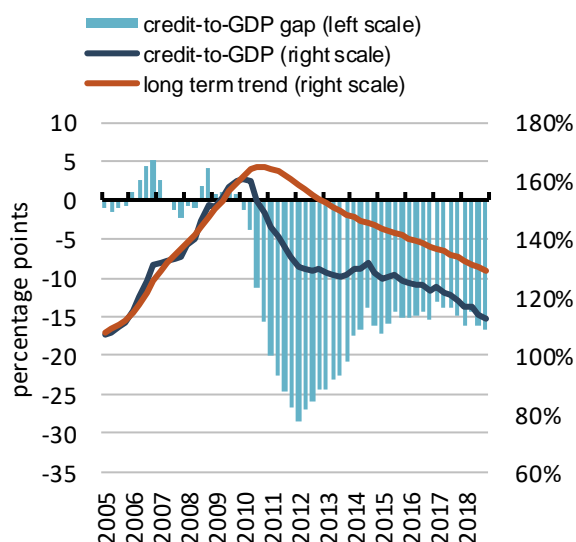
The standardised credit-to-GDP² gap calculated using the methodology of the Basel Committee on Banking Supervision was -17 percentage points at the end of the fourth quarter of 2018 (see Figure 3). The additional gap³, which is also used by Eesti Pank, was -23 percentage points. This means that the credit-to-GDP ratio is lower than the long-term trend, and so the imputed countercyclical buffer rate 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 2. Annual growth of loans and leases, debt and nominal GDP



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

Figure 3. Standardised credit-to-GDP gap



Sources: Statistics Estonia, Eesti Pank

The growth in corporate debt did not change significantly in the fourth quarter of 2018. As the ability of companies to finance their activities and investments with own funds has improved, corporate borrowing has remained relatively modest compared to the growth in the economy. The yearly growth in gross corporate debt was at almost 1% by the end of the fourth quarter of 2018 (see Figure 4). The Eesti Pank December forecast expects that companies will invest more in the years ahead, but investment as a share of the economy will remain low by the levels of previous decades. This means that any growth in investment will not lead to a substantial increase in corporate debt, and yearly growth in debt will be 6-7% in the coming two years.

²In 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.

³The 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.

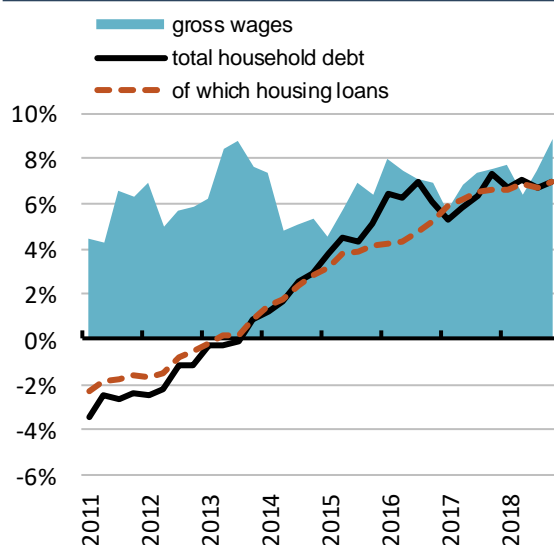
Growth in borrowing by companies from banks operating in Estonia reached 6% in the fourth quarter. Bank loans have increased their share of sources of financing for companies as access to loans in Estonia has been relatively good. The main borrowers have been companies that usually fund themselves primarily from banks operating in Estonia.

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 5). The strong demand for labour means that wage pressures remain and the growth in borrowing could accelerate further in future.

The largest share of household debt liabilities is made up of housing loans, and the yearly growth in the stock of such loans was 7% in the fourth quarter of 2018. This was driven until the second half of 2018 by a relatively active real estate market, where prices rose quickly (see Figure 6). However, real estate prices have risen at a slower rate since the second half of 2018 and the rate of rise has been below its three-year average. In consequence the upward pressure from housing loans has declined a little. As the rate of rise in real estate prices has slowed, so has the rate of growth in new housing loans. In 2017 the yearly growth in new housing loans was 16%, but by the end of 2018 this had slowed to 9%. To dampen the risks from housing loans, Eesti Pank has set three restrictions for new housing loans that limit 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.

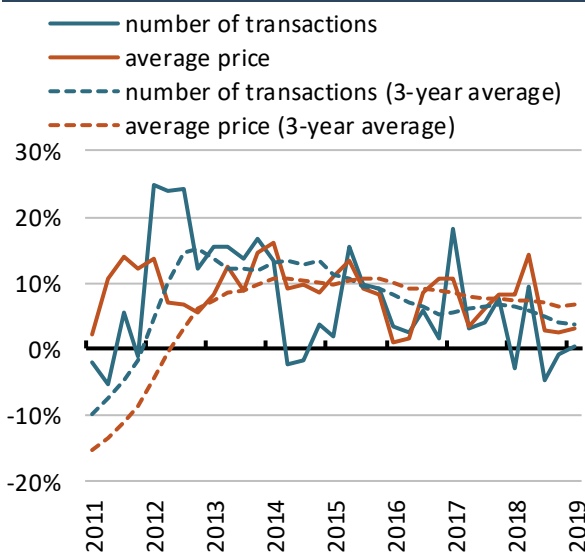
The lending standards of the banks and their lending conditions have not been loosened. The bank lending survey shows that banks have even tightened their lending conditions slightly in the past two years. Higher margins on both long-term corporate loans and residential loans to households have

Figure 5. Annual growth of household debt and the average gross wage



Sources: Eesti Pank, Statistics Estonia

Figure 6. Annual growth of housing prices and number of transactions



Source: Estonian Land Board

raised interest rates a little (see Figure 7), which suggests that the banks are not being aggressive about issuing loans.

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%. The reason for this is that the rate of growth in debt in the non-financial sector remains below nominal economic growth for the current year and the long-term average nominal growth. The growth in corporate debt has remained modest. The growth in new loans to households slowed in the second half of 2018 and the residential real estate market continued to develop at a gentle pace. The growth in bank loans and leases has been supported by demand-side factors. The banks have not eased their lending standards and loan margins rose slightly in 2018. This development does not indicate any major imbalance in the credit market, though the relatively good state of the economy and low interest rates mean the risk remains of excessive borrowing that could increase the risks 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. Weighted average interest rates on housing loans and long-term corporate loans

