THE COUNTERCYCLICAL CAPITAL BUFFER RATE

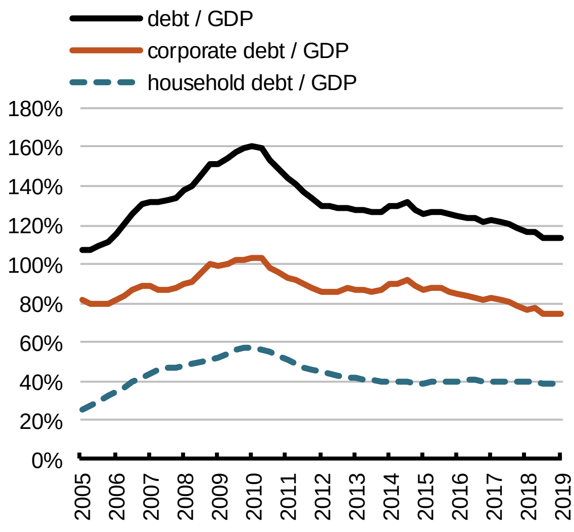
Eesti Pank's assessment of the countercyclical capital buffer rate (Q3 2019)[1]

Eesti Pank decided on 30 September 2019 to keep the countercyclical capital buffer rate at 0%.

- The applicable countercyclical capital buffer rate: **0%**
- The standardised credit-to-GDP ratio: **113%**; its deviation from the long-term trend: **–14 percentage points**
- The buffer guide: **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. Borrowing by companies has remained moderate given the growth in the economy, though household debt continues to grow quickly. However, activity in the real estate market has declined a little, and so the rate of growth in new housing loans has slowed. The banks have not eased their lending standards and loan margins have risen slightly. This development does not indicate imbalance in the credit market, though the relatively good state of the economy means 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 debt burden of the non-financial sector continued to shrink. The credit-to-GDP ratio fell to 113% by the end of the first quarter of 2019 (see Figure 1). The Eesti Pank June forecast 2019 does not expect any rise in the debt burden in the next two years.

Figure 1. Non-financial sector indebtedness



Sources: Statistics Estonia, Eesti Pank

The debt of the non-financial sector grew at the rate of 6% in the first quarter of 2019. Growth in the debt of both companies and households was slower than that in nominal GDP. Given the strong current GDP growth, it is important when assessing the sustainability of debt to compare the growth of debt with the long-term average GDP growth as well. 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 (see Figure 2). The growth in bank loans and leases was 6.4% in the fourth quarter.

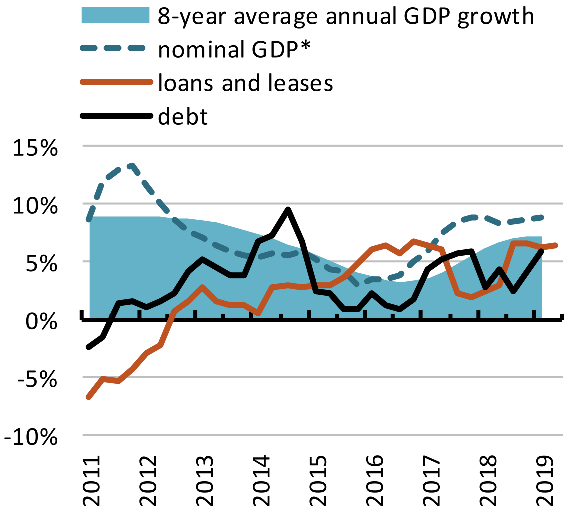
The standardised credit-to-GDP[2] gap calculated using the methodology of the Basel Committee on Banking Supervision was -14 percentage points at the end of the first quarter of 2019 (see Figure 3).

[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] 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.

The additional gap[3], which is also used by Eesti Pank, was -22 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 and include the major increase in the debt burden in the years 2005-2007 and the subsequent sharp drop caused by the economic crisis, 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.

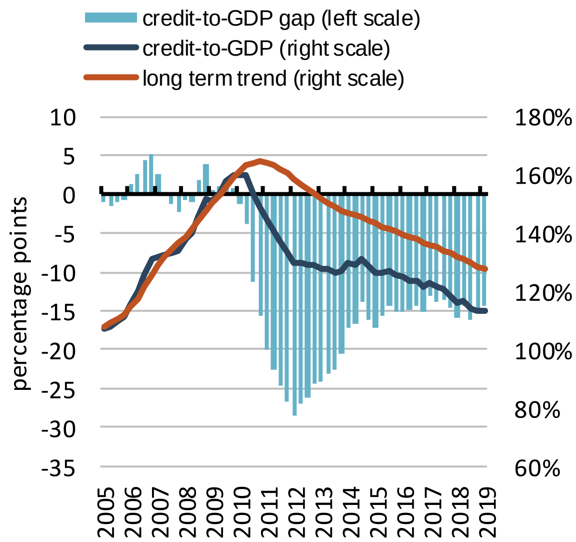
Figure 2. Annual growth of loans and leases, debt and nominal GDP



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

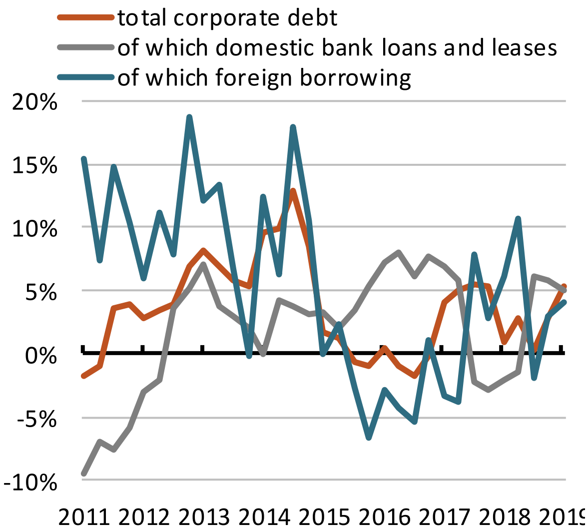
The growth in corporate debt was 5.3% in the first quarter of 2019 (see Figure 4). Corporate investment's share in the economy has been small in recent years, and so borrowing has been only moderate. The ability of companies to finance their own activities and investments from their own funds has also improved. The Eesti Pank June forecast 2019 expects that companies will 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, and the yearly growth in debt will be around 5% over the next two years.

Figure 3. Standardised credit-to-GDP gap



Sources: Statistics Estonia, Eesti Pank

Figure 4. Annual growth of domestic and foreign corporate debt



Source: Eesti Pank

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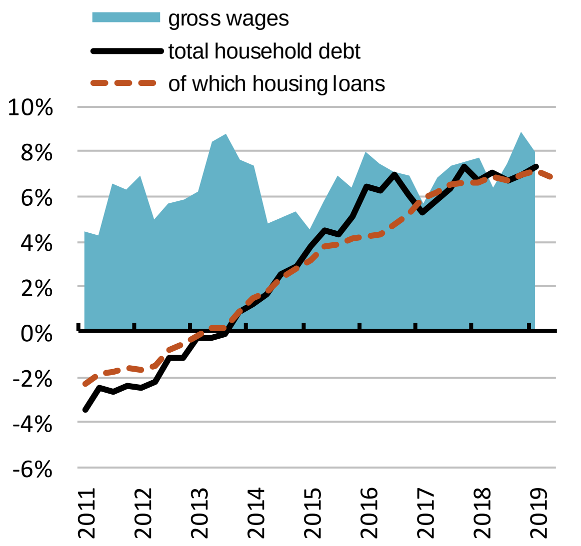
[3] The additional credit-to-GDP ratio is calculated using a narrow aggregate of credit that covers domestic loans and leases issued by banks operating in Estonia.

Growth in borrowing by companies from banks operating in Estonia reached 5% in the second quarter of 2019. Bank loans have increased their share of sources of financing for companies as access to loans in Estonia has been relatively good.

Demand from households for loans remains strong. It is supported by the continuing rapid growth in incomes, improved confidence and low unemployment. Growth has been fast for housing loans, consumption loans and car leases. However, the growth in household debt has not accelerated in recent quarters but has remained at close to 7% (see Figure 5).

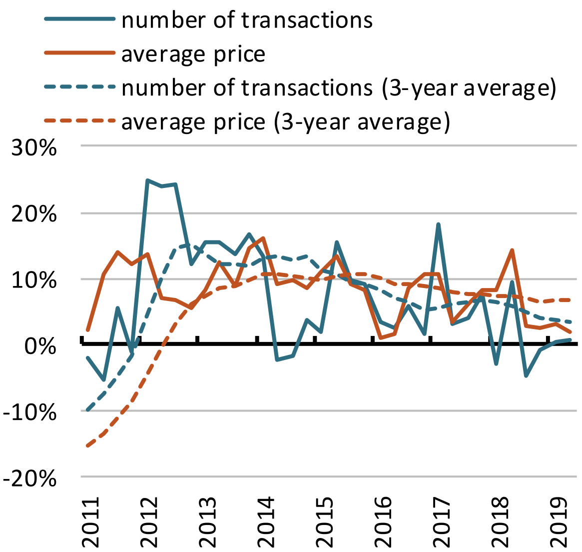
The largest share of household debt liabilities is made up of housing loans, and the yearly growth in the stock of such loans was 7% in the second quarter of 2019. This was driven until the first half of 2018 by a relatively active real estate market, where prices rose quickly (see Figure 6). However, activity in the real estate market has been declining since the second half of 2018, and together with this the rate of growth in new housing loans has also slowed. In 2017 the yearly growth in new housing loans was 16%, but by the end of the second quarter of 2019 this had slowed to 8%. 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. In addition, Eesti Pank has set the risk weight floor of 15% for retail exposures secured by real estate for banks that have adopted the Internal Ratings Based Approach (applies since September 30th 2019).

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

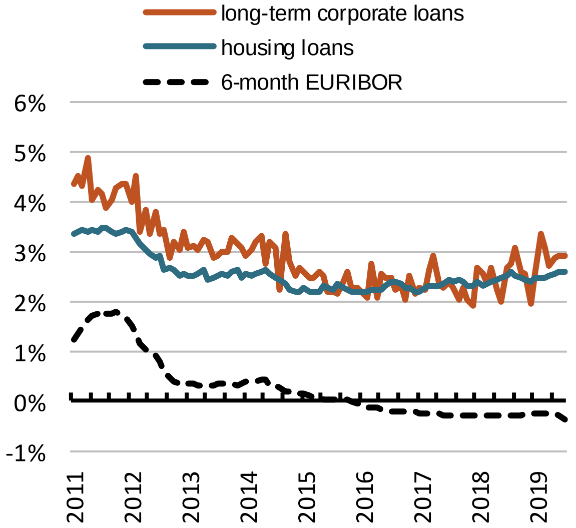


Source: Estonian Land Board

The loan margins of the banks have increased. The results of the bank lending survey do not show any loosening of lending standards. Higher margins on both long-term corporate loans and residential loans to households have raised interest rates (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 for debt in the non-financial sector remains below that of nominal economic growth for the current year and the long-term average nominal growth. Borrowing by companies has remained moderate given the growth in the economy, though household debt continues to grow quickly. However, activity in the real estate market has declined a little, and so the rate of growth in new housing loans has slowed. The banks have not eased their lending standards and loan margins have risen slightly. This development does not indicate imbalance in the credit market, though the relatively good state of the economy means 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



Source: Eesti Pank