

THE COUNTERCYCLICAL CAPITAL BUFFER RATE

Eesti Pank's assessment of the countercyclical capital buffer rate (Q4 2016)

Eesti Pank decided on 5 December 2016 to keep the countercyclical capital buffer rate at 0%.

In accordance with Article 136(7) of Directive 2013/36/EU of the European Parliament and of the Council, Eesti Pank is notifying the ESRB of its decision on the buffer rate and publishing the decision and related information on its own website.

- The applicable countercyclical capital buffer rate: **0%**
- The standardised credit-to-GDP ratio: **130%**; its deviation from the long-term trend: **–12 percentage points**
- The buffer rate: **0%**
- Reasoning for the buffer rate: There has been no change in indebtedness in the real economy and it remains stable. The rate of growth of bank loans will come into line with that of GDP in the coming years, and there is nothing evident in the behaviour of the banks that would amplify lending activity. Credit growth in the non-financial sector is backed by rapid growth in deposits. However, low interest rates and relatively fast wage rises contain the risk that activity and prices could increase rapidly in the real estate market, leading to fast growth in debt levels for households and an increase in related risks. The corporate indebtedness could also start to grow again if investment increases. For this reason Eesti Pank constantly monitors the factors that could indicate a possible build-up of risks and can, if necessary, raise the countercyclical buffer rate above 0%.

Section 86⁴⁶ of the Credit Institutions Act states that Eesti Pank is responsible for setting the rate for the countercyclical capital buffer. The same section gives the general principles for assessing the buffer rate based on Article 136 of Directive 2013/36/EU of the European Parliament and of the Council and the requirements for announcements of information from Eesti Pank.

The buffer is set in order to protect the banking sector against losses that could be caused by cyclical systemic credit risks building up in the economy. Banks can use the additional capital buffers they have built up during the growth phase of the financial cycle to cover losses that may arise when the cycle turns down and to continue supplying credit to the real economy.

The basis for setting the countercyclical capital buffer rate is the assessment by Eesti Pank of the cyclical systemic credit risk in Estonia. The assessment combines a quantitative approach based on economic indicators with expert assessment¹. One of the main indicators that is regularly assessed is the credit-to-GDP gap and the buffer guide calculated from it, though the decision on the buffer rate also considers other indicators. The greatest weight in the assessment of the buffer rate is given to the indicators that best show the position of the credit cycle at that moment.

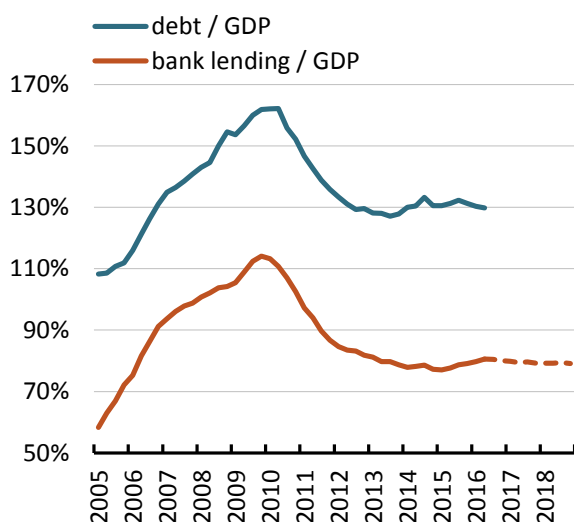
¹ The assessment methodology is described in more detail in the Eesti Pank document "[Countercyclical Capital Buffer. The principles and indicators for setting the buffer rate in Estonia](#)". October 2015.

Indicators used in the assessment of the countercyclical capital buffer rate

• Credit-to-GDP

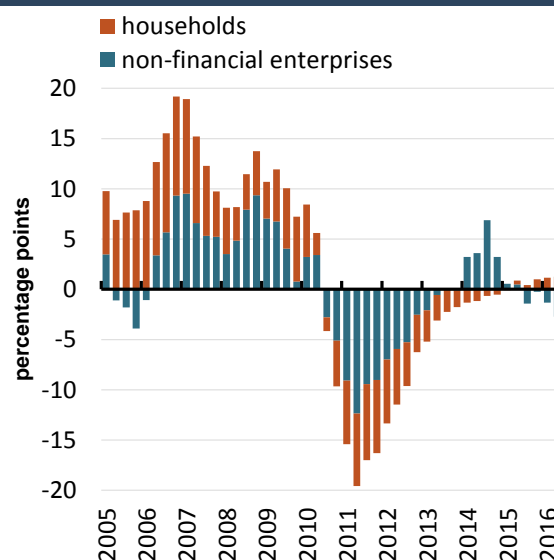
There was no change in the indebtedness of the real economy in Estonia in the second quarter of 2016. The credit-to-GDP ratio has remained almost unchanged since the start of 2014, and in the second quarter of 2016 it was 130% (see Figure 1). Corporate debt has declined slightly in the past year and the debt of households has increased stably as a ratio to GDP (see Figure 2). At the same time, household incomes have increased steadily as a share in the structure of GDP since 2015, which means that household debt has not increased relative to disposable income, but has remained at 72%.

Figure 1. Real sector indebtedness



Sources: Statistics Estonia, Eesti Pank

Figure 2. Yearly change of debt-to-GDP ratio



Sources: Statistics Estonia, Eesti Pank

• Credit-to-GDP gap

The standardised credit-to-GDP gap² was –12 percentage points in the second quarter of 2016 (see Figure 3). The credit-to-GDP gap has been negative since 2009 but it has been narrowing since 2013 because of the fall in the long-term trend, as the credit-to-GDP ratio has not changed.

The additional credit-to-GDP gap³, which is calculated from a narrower credit aggregate has remained negative, but it has narrowed. In the second quarter of 2016 the gap was –23 percentage points. The Eesti Pank June 2016 forecast expects the credit-to-GDP ratio to remain around 79% in

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 resources borrowed and bonds issued by the Estonian private sector both within Estonia and abroad. This is an unconsolidated indicator.

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.

the years ahead and the gap to continue to close. As the credit-to-GDP gap is negative, the buffer guide is 0%. Given the major increase and subsequent sharp fall in indebtedness in Estonia in 2005–2007 however, the gap calculated from the credit-to-GDP ratio and its long-term trend may not be the most appropriate indicator for assessing the need for the buffer. For this reason the assessment has to use other indicators that give an idea of the possible development of the credit cycle and debt.

- **Yearly growth in debt liabilities and loans**

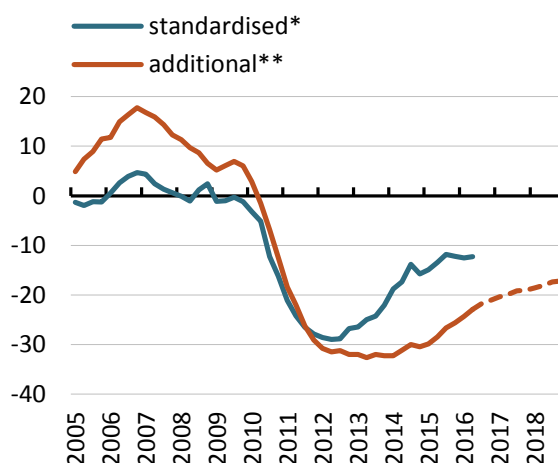
Debt liabilities in the non-financial sector grew more slowly than nominal GDP in the second quarter of 2016. Non-financial sector debt liabilities were up 1.4% over the year in the second quarter, while nominal GDP growth was 2.7% (see Figure 4). Household debt liabilities were up 5.8% over the year, while corporate debt liabilities were down 0.5%.

Only the credit aggregate of domestic bank loans and leases has increased faster than GDP in the past year. Yearly growth in the stock of bank loans and leases in the non-financial sector, was 6.4% in the second quarter of 2016 and 5.7% in the third quarter.

Yearly growth in bank loans to companies was 6.1% at the end of the third quarter, and the growth was quite broadly based across sectors. The different development paths of the bank loans of companies and their total debt liabilities indicate changes in the structure of corporate debt as companies have replaced some of their foreign loans with domestic bank loans. In consequence the impact of the temporarily faster growth in corporate bank loans can at present be considered neutral for the credit cycle.

The yearly growth in housing loans to households was a little higher in the third quarter than in the previous quarter at 4.8%. Growth in housing loans has been affected by rising prices for residential property. The loan market has not however given a boost to the growth in the real estate market, as the share of credit used in purchasing real estate has not increased.

Figure 3. Credit-to-GDP gap

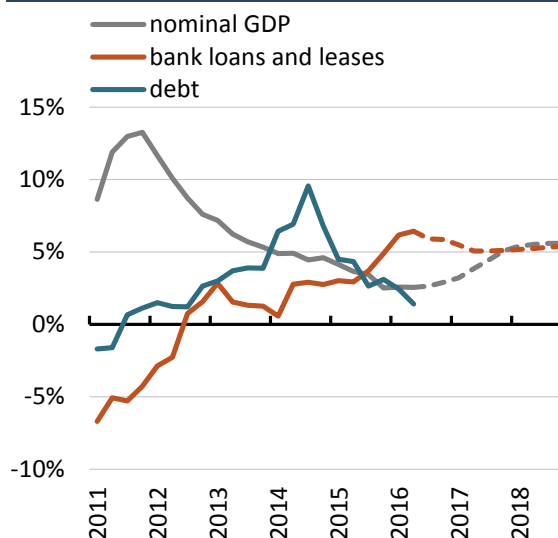


* based on total debt data

** based on domestic bank loans and leases data

Sources: Statistics Estonia, Eesti Pank

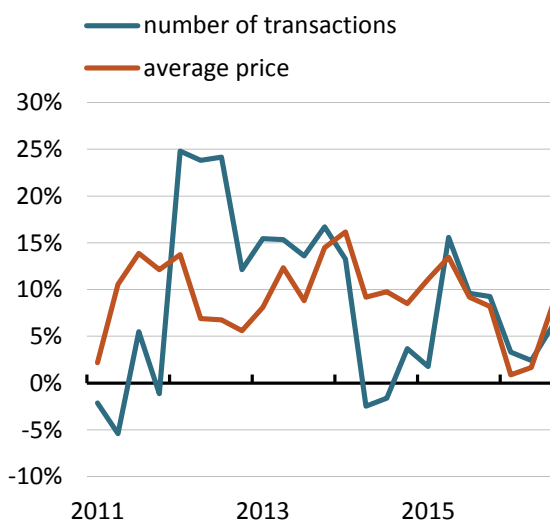
Figure 4. Yearly growth of debt, bank lending and nominal GDP



Sources: Statistics Estonia, Eesti Pank

Growth in prices for housing increased a little in the third quarter of 2016 (see Figure 5), and this was supported primarily by strong growth in incomes and savings. The prices of apartments sold in Tallinn and in Estonia as a whole were on average 8% higher in the third quarter of 2016 than a year earlier, which is a similar rate of growth to that of wages, as the average wage rose by 7.5% in the second quarter. There was a slight increase in transactions in the third quarter in Estonia overall, and at the end of the quarter the growth rate stood at 6%. The rate of yearly growth in other household loans was little different in the third quarter to what it was in the previous one and was 7% at the end of the quarter.

Figure 5. Annual growth of housing prices and number of transactions



Source: Estonian Land Board

The June forecast from Eesti Pank found that the volume of credit growing faster than nominal GDP is a temporary effect, and the ratio of domestic bank loans to GDP will remain below 80% for the next two years. Credit growth and nominal GDP growth will fall into step during the forecast horizon. The indicators for indebtedness and changes in it do not currently indicate excessively fast development of the credit cycle. However, low interest rates and relatively fast wage rises contain the risk that activity and prices could increase rapidly in the real estate market, leading to growth in debt levels for households and an increase in related risks. The corporate indebtedness could also start to grow again if investment increases. For this reason Eesti Pank constantly monitors the factors that could indicate a possible build-up of risks and can, if necessary, raise the countercyclical buffer rate above 0%.

To dampen the risks from housing loans, Eesti Pank introduced requirements for new housing loans from 1 March 2015 that limited 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.