THE COUNTERCYCLICAL CAPITAL BUFFER RATE

Eesti Pank's assessment of the countercyclical capital buffer rate (Q3 2016)

Eesti Pank decided on 5 September 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 guide: **0%**
- Reasoning for the buffer rate: credit growth is currently in line with the general development of the economy and is forecast to remain so, and there is no indication of excess credit risk accumulating. Credit growth in the non-financial sector is backed by moderate GDP growth and rapid growth in deposits, and the growth in housing loans is supported by sustained growth in incomes.

Section 86^{46} 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 assessment[1]. 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.

Indicators used in the assessment of the countercyclical capital buffer rate

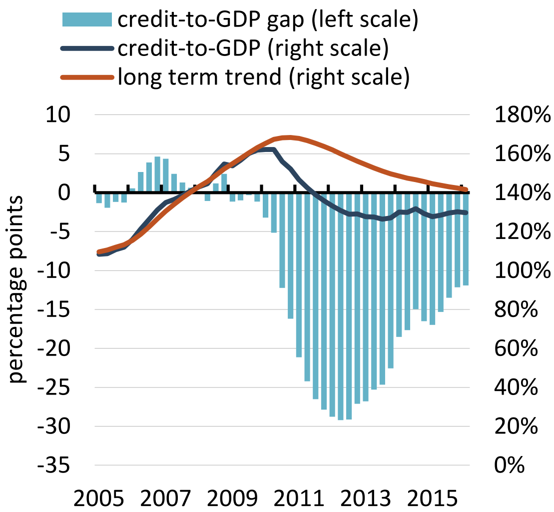
- **Credit-to-GDP gap**

The credit-to-GDP ratio for the non-financial sector in Estonia was 130% in the first quarter of 2016. The credit-to-GDP ratio has not changed particularly in the past three years, and remains about 32 percentage points below the peak it reached in the middle of 2010.

[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.

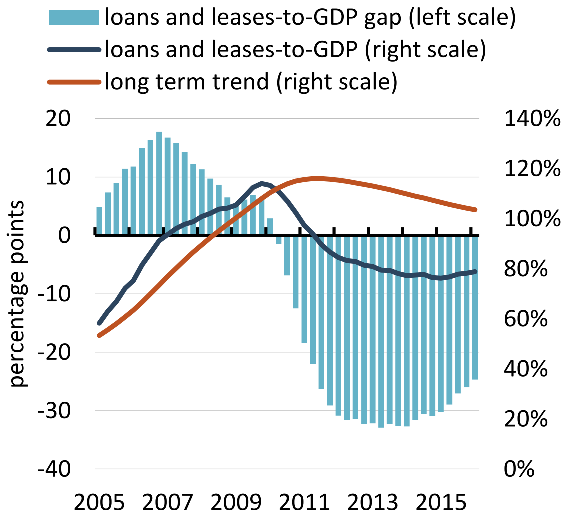
The standardised credit-to-GDP gap[2] was –12 percentage points in the first quarter of 2016 (see Figure 1). The credit-to-GDP gap has been negative since 2009 but it has been narrowing since 2013 because of the fall in the long-term trend, as the credit-to-GDP ratio has not changed.

Figure 1. Standardised credit-to-GDP gap



Sources: Statistics Estonia, Eesti Pank

Figure 1b. Additional credit-to-GDP gap



Sources: Statistics Estonia, Eesti Pank

The additional credit-to-GDP gap, which is calculated from a narrower credit aggregate[3] has remained negative, but it has narrowed. In the first quarter of 2016 the gap was –25 percentage points (see Figure 1b). The Eesti Pank forecast released in June expects the credit-to-GDP ratio to remain around 79% in the years ahead and the negative gap to continue to close, mainly because the long-term trend remains downwards. As the credit-to-GDP gap is negative, the base indicator for the countercyclical buffer is imputed to be 0% and it is principally additional indicators that are used for assessing the need for the buffer.

- **Annual growth in credit volumes**

In the first quarter of 2016 the debt liabilities of the non-financial sector were 4.3% larger than a year earlier, which was a somewhat larger increase than the 3% growth in nominal GDP. Household debt liabilities were 5.6% larger in the first quarter than a year previously, and corporate debt liabilities were up 3.7%. Corporate debt grew with support from bank lending, while borrowing from abroad declined at the same time.

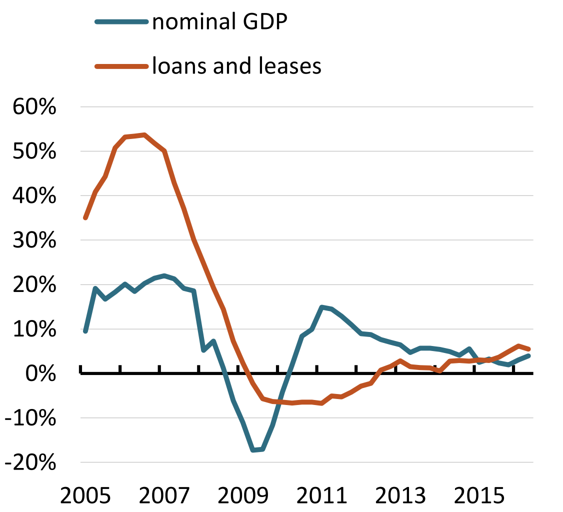
Yearly growth in the narrower credit aggregate, which shows the stock of bank loans and leases in the non-financial sector, was 6.4% in the second quarter of 2016 (see Figure 2). The fastest growth was in loans to companies, which were up 8% over the year at the end of the second quarter, and

[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.

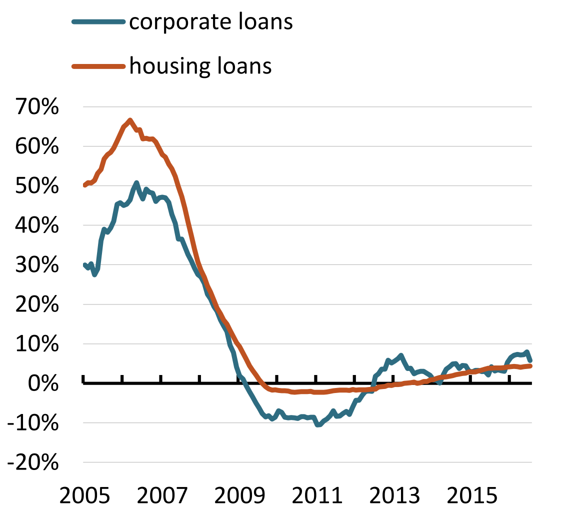
which were mainly supported by growth in long-term loans. Corporate loan growth has been relatively broadly based with companies from most sectors contributing to it. The loan portfolio for industrial companies showed the fastest growth over the year in the second quarter. Yearly growth in housing loans to households in the second quarter remained at the 4.3% as the average level in the preceding three months. The rate of yearly growth in other household loans was a little slower in the second quarter than in the previous one and was 7% at the end of the quarter.

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



Sources: Statistics Estonia, Eesti Pank

Figure 3. Annual growth of corporate loans and housing loans



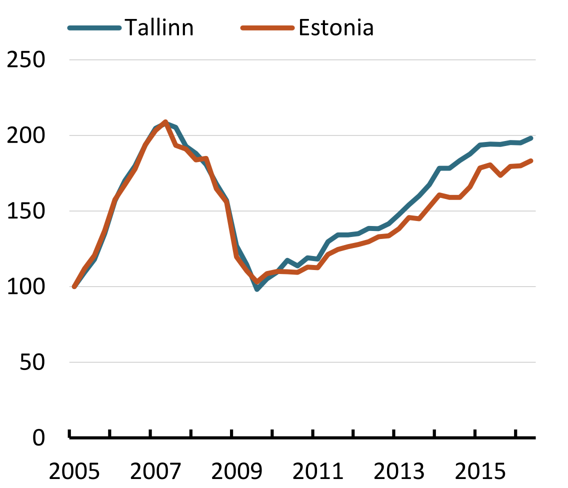
Source: Eesti Pank

The June forecast from Eesti Pank found that the volume of credit growing faster than nominal growth in the economy is a temporary effect, and the ratio of domestic bank loans to GDP will remain below 80% for the next two years. It may be assumed that if the Estonian income level is to harmonise with the euro area average in the longer term, financial deepening will continue. The indicators do not currently point to excessively fast development of the credit cycle even though the speed of credit growth has picked up a little.

- **Growth in housing prices**

Growth in real estate prices remained slow in the second quarter of 2016 in Tallinn and in Estonia as a whole (see Figure 4). The prices of apartments sold in Tallinn were on average 1.9% higher in the second quarter than a year previously, and in Estonia as a whole they were 1.5% higher. Transaction activity fell further in the second quarter. Yearly growth in the number of transactions in the whole of Estonia slowed to 2.3% in the second quarter, while 1.3% fewer transactions were made in Tallinn than a year before.

Figure 4. House price index, 2005 q1=100



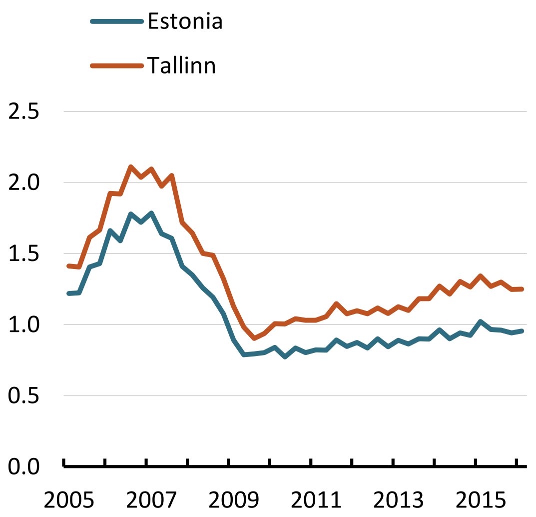
Sources: Estonian Land Board, Eesti Pank's calculations

The ratio of square metre prices for apartments to gross monthly wages stood at close to 1 for Estonia in the first quarter of 2016 and did not change particularly from the first half of 2015. The figure for Tallinn remained at 1.25 (see Figure 5).

Moving forward, some risk remains of demand increasing for real estate and housing loans if household incomes continue to rise and interest rates stay low.

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.

Figure 5. Ratio of square metre price for apartments to monthly gross wage



Sources: Estonian Land Board, Statistics Estonia