

THE COUNTERCYCLICAL CAPITAL BUFFER RATE

Eesti Pank's assessment of the countercyclical capital buffer rate (Q4 2019)¹

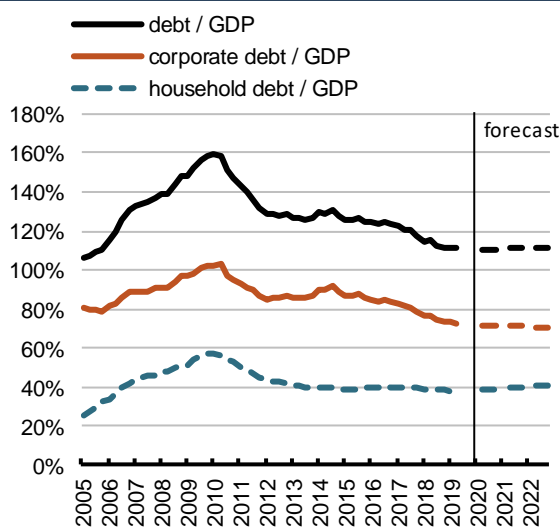
Eesti Pank decided on 16 December 2019 to keep the countercyclical capital buffer rate at 0%.

- The applicable countercyclical capital buffer rate: **0%**
- The standardised credit-to-GDP ratio: **111%**; 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. Borrowing by companies has remained moderate given the growth in the economy, though household debt continues to grow quite quickly. The banks have not eased their lending standards and loan margins have risen. Although developments so far do not indicate imbalance in the credit market, the risk remains that growth in debt could in future become faster than current growth in the economy, and so the risks from the credit cycle would be increased. At the same time it is not expected the growth in debt will exceed the long-term average growth in the economy. 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 111% by the end of the second quarter of 2019 (see Figure 1). The Eesti Pank December 2019 forecast for three years ahead gives grounds to expect that the debt burden will stop shrinking.

The debt of the non-financial sector grew at the rate of 5% in the second quarter of 2019. Growth in the debt of both companies and households was slower than that in nominal GDP growth. The growth in bank loans and leases was 6% in the third quarter. Given the rapid growth in debt, it is important when assessing the sustainability of debt to compare the growth of debt with the long-term average growth in the economy as well. The debt of the Estonian non-financial sector has grown more slowly in the past four years than the eight-year average for nominal GDP (see Figure 2). It is expected though that the growth in nominal GDP will slow over the coming three years. Under these circumstances both debt and bank loans and leases could start to grow faster than current

Figure 1. Non-financial sector indebtedness



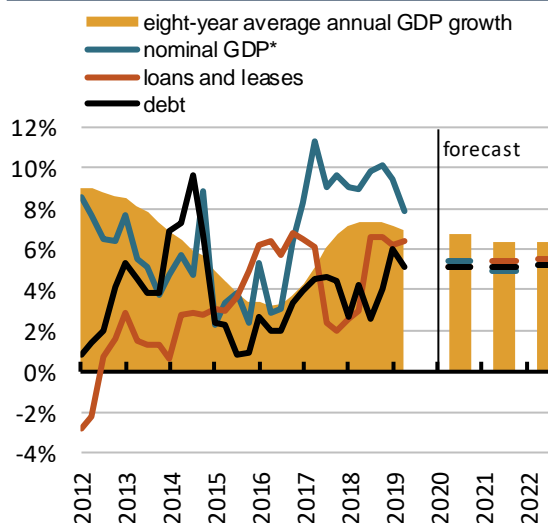
Sources: Statistics Estonia, Eesti Pank

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

nominal GDP. At the same time though, growth in both debt and bank loans will remain lower than the long-term average growth in the economy.

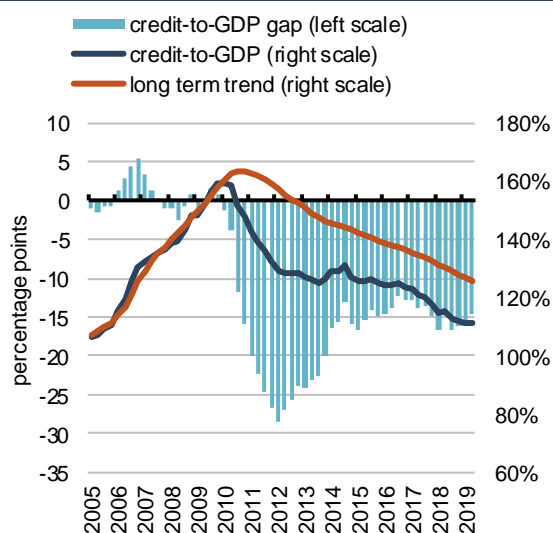
The standardised credit-to-GDP² gap calculated using the methodology of the Basel Committee on Banking Supervision was -17 percentage points at the end of the second quarter of 2019 (see Figure 3). The additional gap³, which is also used by Eesti Pank, was -21 percentage points. This means that the credit-to-GDP 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. Yearly growth of loans and leases, debt and nominal GDP



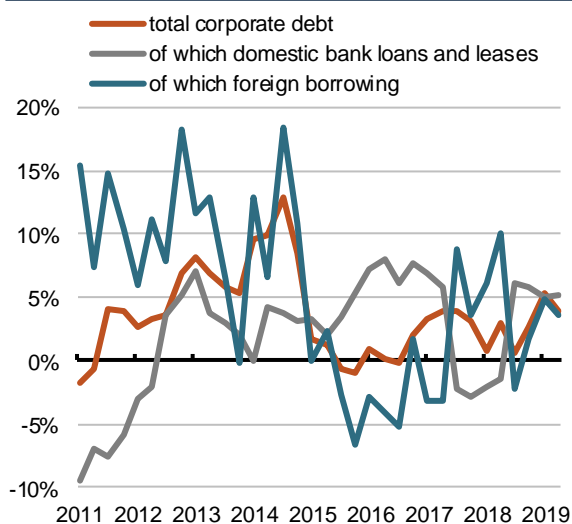
*Four-quarter moving average yearly GDP growth
Sources: Statistics Estonia, Eesti Pank

Figure 3. Standardised credit-to-GDP gap



Sources: Statistics Estonia, Eesti Pank

Figure 4. Annual growth of domestic and foreign corporate debt



Source: Eesti Pank

The growth in corporate debt was 4% in the second quarter of 2019, which was lower than that in nominal GDP. Lending by banks operating in Estonia has accounted for the largest part of lending to

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.

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.

companies. The yearly growth in loans and leases from banks was 5% in the second quarter, which was faster than the total growth in debt and in borrowing from abroad (see Figure 4). The most recent data do not indicate any increase in the growth in corporate debt, as the growth in the amount taken in loans and leases from banks was 4.6% in the third quarter. The Eesti Pank December forecast expects that corporate debt will grow a little faster by the end of 2019 because of the reference base effect, but then that growth will start to slow. It is expected that corporate debt will grow more slowly than the economy as a whole throughout the forecast horizon of 2020-2022.

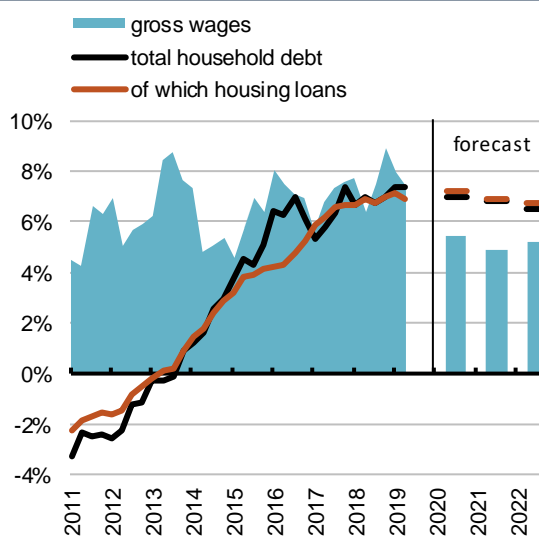
There was no notable change in the growth in household debt from the first quarter to the second quarter, as it stood at 7.4%, which is also slower than the growth in nominal GDP. The largest share of household debt liabilities are housing loans, and the yearly growth in the stock of such loans was around 7% in the third quarter of 2019 (see Figure 5). This is more or less the same as the growth in gross wages in the second quarter. However, the Eesti Pank December forecast expects that in future the slower growth in gross wages will reduce the level of activity in housing loans. This in turn will affect the stock of housing loans with a lag, and so the growth in them will slow to some degree. As the growth in nominal GDP will slow by more though, it is expected that the growth in the stock of housing loans will in future start to exceed both current and long-term nominal growth in the economy.

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. It has also applied a risk weighting floor since 30 September 2019 of 15% for mortgages for banks using the internal ratings-based approach.

The loan margins of the banks have increased.

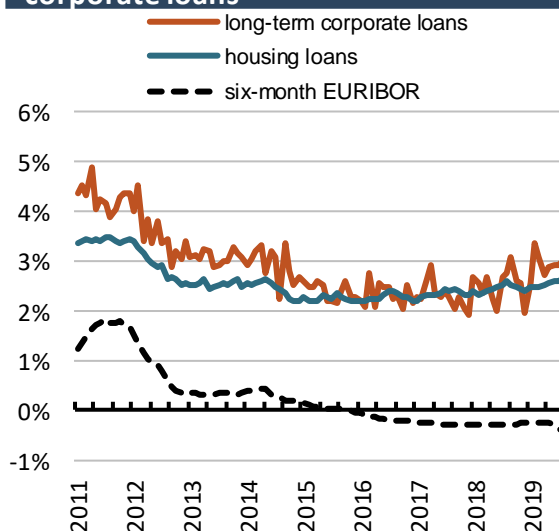
Interest rates on both long-term corporate loans and housing loans to households are a little higher than they were at the start of 2019 (see Figure 6). Bank lending surveys do not indicate any easing of lending standards, which suggests that the banks are not being aggressive about issuing loans.

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



Sources: Eesti Pank, Statistics Estonia

Figure 6. Weighted average interest rates on housing loans and long-term corporate loans



Source: Eesti Pank

In summary, Eesti Pank does not currently consider it necessary to change the countercyclical buffer rate. The reason for this is that the rate of growth in debt in the non-financial sector remains below that of nominal economic growth for the current year and long-term average nominal growth. Borrowing by companies has remained moderate given the growth in the economy, though household debt continues to grow relatively quickly. The banks have not eased their lending standards and loan margins have risen. Although developments so far do not indicate imbalance in the credit market, the risk remains that growth in debt could in future become faster than current growth in the economy, and so the risks from the credit cycle would be increased. At the same time it should not be expected that the growth in debt will exceed the long-term average growth in the economy. Eesti Pank monitors the growth in debt and indicators that affect it, and can if necessary raise the countercyclical capital buffer rate above 0%.