

THE COUNTERCYCLICAL CAPITAL BUFFER RATE

EESTI PANK'S ASSESSMENT OF THE COUNTERCYCLICAL CAPITAL BUFFER RATE (Q2 2020)¹

Eesti Pank decided on 17 June 2020 to keep the countercyclical capital buffer rate at 0%.

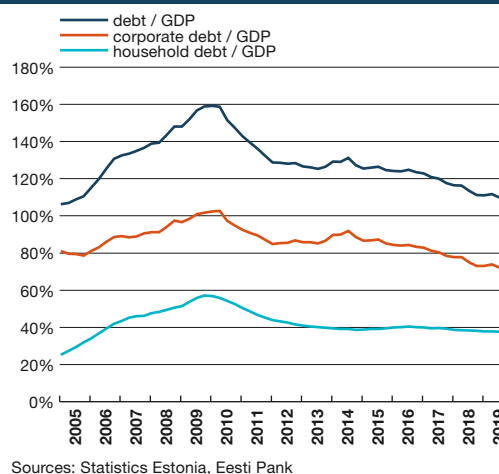
- The applicable countercyclical capital buffer rate: **0%**
- The standardised credit-to-GDP ratio: **108%**; its deviation from the long-term trend: **-15 percentage points**
- The buffer rate: **0%**
- **Reasoning for the buffer rate:** given the widespread negative impact the spread of the COVID-19 pandemic will have on the Estonian economy and banking sector, Eesti Pank thinks that it is appropriate to hold the countercyclical capital buffer for the banks at the rate of 0%. The sharp increase in uncertainty has reduced lending and borrowing and the reduced capacity of borrowers to pay makes it probable that loan losses will increase. Eesti Pank does not currently consider it likely that the buffer rate will be raised this year.

Before the economic impacts of the COVID-19 pandemic were felt, the indebtedness in Estonia was declining and the growth in debt was less than both current and long-term GDP growth. The credit-to-GDP ratio fell to 108% by the end of the fourth quarter of 2019 (see Figure 1). Yearly growth in non-financial sector debt reached 4.6% in the fourth quarter, with corporate debt increasing by 3.7% over the year and household debt by 6.3%.

The emergency situation that was declared from the middle of March reduced lending activity in Estonia substantially. Yearly growth in the portfolio of bank loans to the non-financial sector came down to 2.3% by the end of April² (see Figure 2). The decline in lending affected the corporate loan portfolio most, as it was 1.2% smaller in April than a year earlier³, and the portfolio of other loans to households, where yearly growth was down to 2.3% by the end of April having been 10% a year earlier. The yearly growth in the portfolio of housing loans to households slowed notably less, and was 6.7% at the end of April having been 7.2% a year earlier.

The drop in lending activity is most clearly evident in the reduced volume of new loans. Fewer new loans were issued in March, but the really sharp fall came in April. Businesses took some 30% less in loans in April than a year earlier, and households took 33% less. The biggest drop in turnover was in consumption loans. The turnover of new car leases was down 21% in March and as much as 66% in April. The turnover of overdrafts and credit cards was a third less in April than a year earlier.

Figure 1. Real sector indebtedness

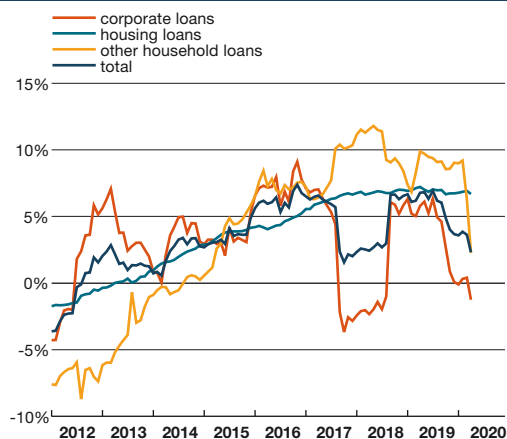


¹ The assessment methodology is described in more detail in the Eesti Pank document "Countercyclical Capital Buffer. The principles and indicators for setting the buffer rate in Estonia". October 2015.

² In autumn 2019 some of the loans of a branch of a foreign bank that had ceased activities in Estonia were transferred out of the Estonian banking sector. Without that the yearly growth in the loan portfolio would have been 4.2%.

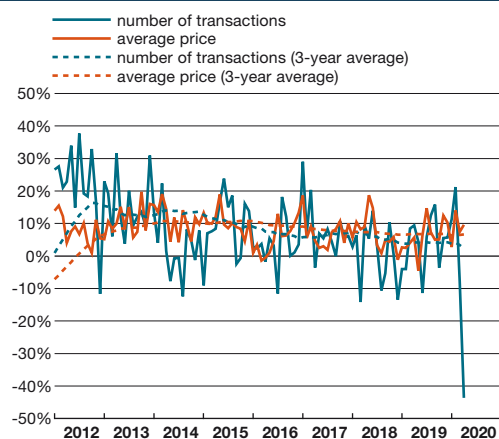
³ Without the removal of the loan portfolio from Estonia, the yearly growth in the corporate loan portfolio would have been 2.6%.

Figure 2. Annual growth of corporate and household loans



Source: Eesti Pank.

Figure 3. Annual growth of housing prices and number of transactions



Source: Estonian Land Board

Increased uncertainty is also apparent in the housing market, where the number of transactions dropped noticeably.

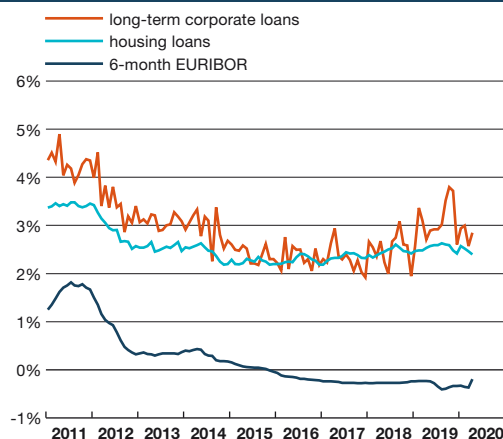
There were 8% fewer transactions with apartments in March than a year earlier, and 44% fewer in April (see Figure 3). The crisis has not particularly affected average prices for real estate though. The average price in transactions in April was around 10% higher than a year earlier. Rising real estate prices are again driven by the increase in prices for new apartments, which reached almost 14% over the year in April. Prices for older apartments built before 2016 were 3% lower in April than a year earlier.

Banks have become more conservative in issuing new loans and are choosing their clients carefully.

The Bank Lending Survey in March found banks tightening their lending standards and conditions in the first quarter. The average interest rates on new loans to companies and on housing loans to households have not risen though, and have even come down a little from the end of 2019 (see Figure 4). As new loans were issued during the crisis to clients with a strong financial position, the fall in the average interest rate does not indicate that interest margins have been reduced.

In summary, Eesti Pank does not currently consider it necessary to change the countercyclical buffer rate. The reason for this is that before the outbreak of the COVID-19 crisis the rate of growth in debt in the non-financial sector remained below that of nominal economic growth for the current year and the long-term average nominal growth. The economic damage caused by the spread of the pandemic and the efforts to prevent it has caused uncertainty to increase, substantially reducing borrowing activity. The reduced capacity of borrowers to pay makes it probable that loan losses will increase. In consequence Eesti Pank currently considers it appropriate to keep the countercyclical capital buffer rate for the banks at 0%. Looking forward, Eesti Pank does not currently consider it likely that the buffer rate will be raised this year.

Figure 4. Weighted average interest rates on housing loans and long-term corporate loans



Sources: European Central Bank, Eesti Pank