

THE COUNTERCYCLICAL CAPITAL BUFFER RATE

EESTI PANK'S ASSESSMENT OF THE COUNTERCYCLICAL CAPITAL BUFFER RATE (Q3 2020)¹

Eesti Pank decided on 21 September 2020 to keep the countercyclical capital buffer rate at 0%.

- The applicable countercyclical capital buffer rate: **0%**
- The standardised credit-to-GDP ratio: **109%**; its deviation from the long-term trend: **-13 percentage points**
- The buffer rate: **0%**
- **Reasoning for the buffer rate:** the economic damage caused by the spread of the Covid-19 pandemic and the efforts to prevent it has caused uncertainty to increase, substantially reducing borrowing activity. In consequence Eesti Pank considers it appropriate to keep the countercyclical capital buffer rate for the banks at 0% and considers it unlikely that it will be decided to raise the buffer rate during this year.

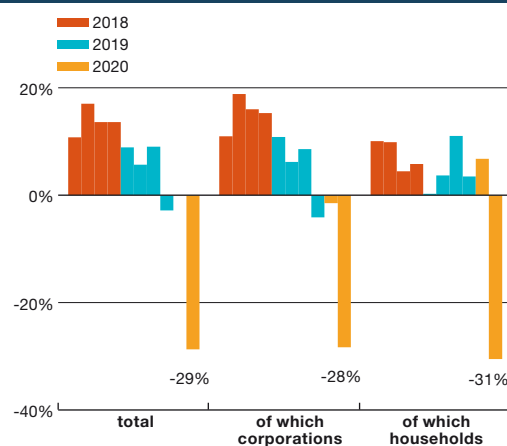
The restrictions introduced around the world to counter the spread of the Covid-19 pandemic have substantially reduced economic activity and, with that, borrowing activity in Estonia.

Businesses borrowed 28% less from banks operating in Estonia than a year earlier, and households borrowed 31% less (see Figure 1). There was a sharp drop in the turnover of car leases, which were down 52% on the year for companies and 47% for households.

The drop in loans and leases issued to **companies** was smaller for short-term loans, as expected, at 20% over the year in the second quarter, while only half as much was issued in long-term loans as a year earlier. The reduction in lending volumes was mainly due to the sharp drop in demand for loans, but lenders were also being more careful than previously.

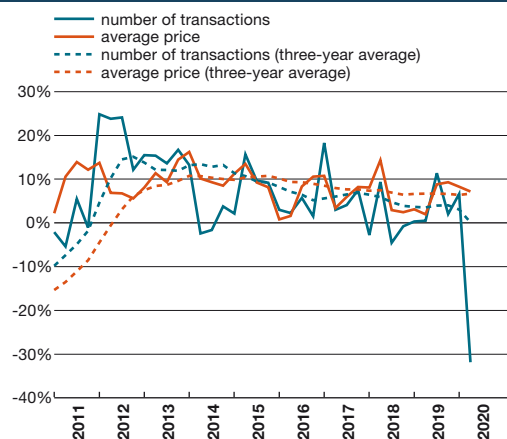
The drop in the turnover of loans to **households** in the second quarter was larger for consumption loans at 34% over the year, while the volume of new housing loans was 27% smaller than a year earlier. The more modest turnover of new housing loans reflects a drop in activity in the housing market. There were almost one third fewer sales transactions in the second quarter than in the second quarter of last year (see Figure 2). The crisis has not particularly affected average prices for housing though. The average price in transactions for apartments in the second quarter was around 7% higher than a year earlier. The growth

Figure 1. Annual growth rate of new corporate and household lending by quarters



Source: Eesti Pank

Figure 2. Annual growth of housing prices and number of transactions



Source: Estonian Land Board

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.

was held higher by an increase in the share of total transactions that were for new apartments, and by a rise in the price of new apartments that reached 7% over the year. Apartment prices in the secondary market fell by around 1% over the year however.

On top of the fall in demand for loans, the banks have become more conservative in issuing new loans and are choosing their clients carefully. The Bank Lending Survey in March and June found banks tightening both their lending standards and conditions in both the first and second quarters. The average interest rates on new loans to companies and on housing loans to households have not changed particularly since the start of the year though (see Figure 3).

Reduced lending activity meant that yearly growth in the portfolio of bank loans to the non-financial sector came down to 1% by the end of June (see Figure 4). The fall in the consolidated indicator was affected more by the reduction in the corporate loan portfolio of 3% over the year², while the growth in other household loans slowed to almost 0% from 10% a year before. The yearly growth in the stock of housing loans to households slowed notably less, and was 6% at the end of June having been 7% a year earlier.

Although borrowing has declined notably because of the crisis, the even steeper drop in GDP at the same time means that the indicator for indebtedness has risen. Growth in the debt of the non-financial sector slowed in the first quarter of 2020 to 3.6%, while GDP growth also slowed. As GDP growth slowed by more however, the debt-to-GDP ratio saw a marginal rise of 0.2 percentage point to 109% (see Figure 5).

It is quite usual for the indebtedness indicator to rise when there is a sharp drop in the economy³, and so a notable rise in the ratio may be expected as early as the second quarter, and the rise will probably continue until the start of next year. As there are statistical and technical reasons for this growth in indebtedness, indebtedness will return to its level of before the crisis once the period of volatility has ended.

For these reasons the rise in the debt-to-GDP ratio is not the best indicator to use for

Figure 3. Weighted average interest rates on housing loans and long-term corporate loans

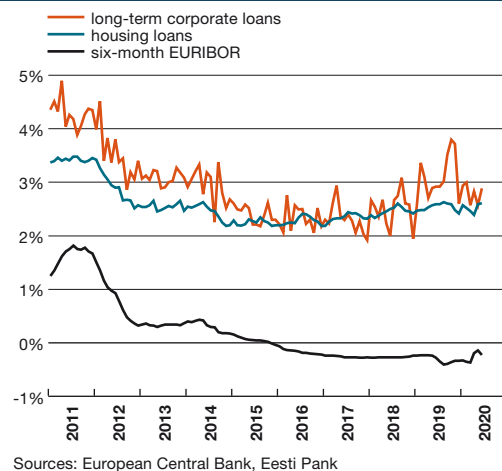
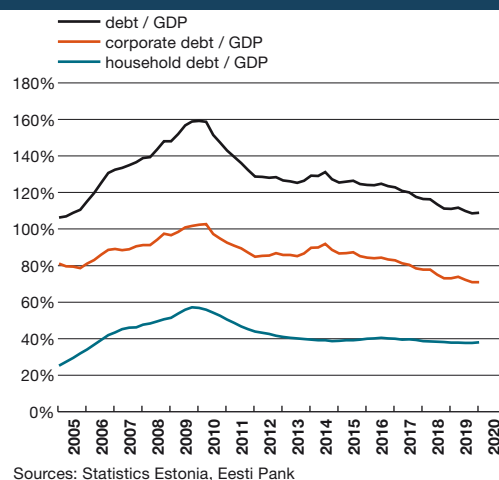


Figure 4. Annual growth of corporate and household loans



Figure 5. Real sector indebtedness



² The reduction in the loan portfolio was affected by one bank moving part of its portfolio out of Estonia in the final quarter of 2019.

³ A similar dynamic was apparent in the economic crisis of 2008-2009 for example.

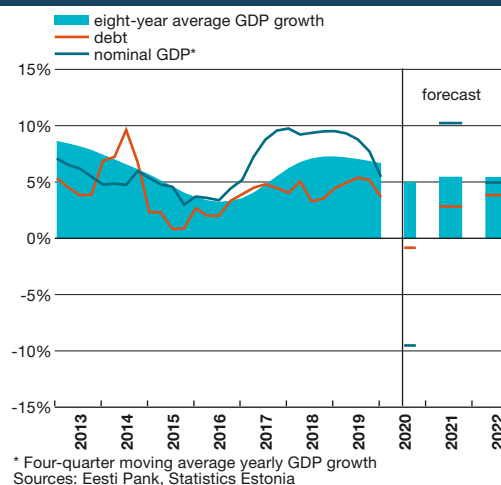
assessing the credit cycle in the current environment. A more stable comparison base for estimating the speed of growth in debt is the eight-year average nominal growth in GDP of 5-6%, which is still faster than the growth in debt given current estimates of the growth in lending (see Figure 6).

The solvency of borrowers has deteriorated because of the coronavirus crisis, but the banks are well capitalised. The reduction in incomes caused by the efforts to stop the Covid-19 pandemic has been partially compensated for by state support measures for businesses and households. Equally, the payment holidays that banks have granted to their clients mean that the reduced ability to pay has not yet been reflected significantly in the indicators for overdue loans⁴.

Borrowers being less able to repay their loans means a reduction in their capacity to borrow and makes loan losses more likely. Under these circumstances it is not currently reasonable to require the banks to create additional capital buffers that could increase limits on the credit supply as a countercyclical measure. The resilience of the banks to future loan losses is supported by the current capital buffers that have been built up under the micro-prudential and macroprudential requirements of earlier years. At the end of June the average capital adequacy ratio of the banks was 27%, and the lowest indicator for any bank was 17%.

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 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. In consequence Eesti Pank considers it appropriate to keep the countercyclical capital buffer rate for the banks at 0% and considers it unlikely that it will be decided to raise the buffer rate during this year.

Figure 6. Forecast for annual growth of non-financial sector debt and nominal GDP



4 The banks have however already increased their write-downs of loans.