

THE COUNTERCYCLICAL CAPITAL BUFFER RATE

EESTI PANK'S ASSESSMENT OF THE COUNTERCYCLICAL CAPITAL BUFFER RATE (Q4 2020)¹

Eesti Pank decided on 14 December 2020 to keep the countercyclical capital buffer rate at 0%.

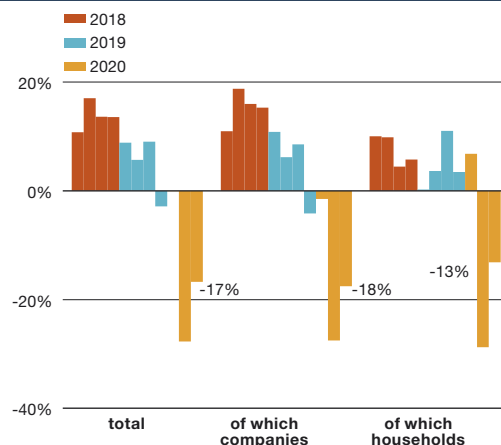
- **The applicable countercyclical capital buffer rate: 0%**
- **The standardised credit-to-GDP ratio: 110%**; its deviation from the long-term trend: **-11 percentage points**
- **The buffer rate: 0%**
- **Reasoning for the buffer rate:** the economic damage caused by the spread of the Covid-19 pandemic and the efforts to prevent it has caused uncertainty to increase, substantially reducing borrowing activity. Although the turnover of lending was larger in the third quarter than in the second, it still remained lower than before the outbreak of the pandemic. As the spread of the virus has increased again in Estonia, increasing uncertainty about the future, Eesti Pank currently considers it appropriate to keep the countercyclical capital buffer rate for the banks at 0%

The restrictions introduced around the world to counter the spread of the Covid-19 pandemic reduced economic activity and, with that, borrowing activity in Estonia. Although the restrictions started to be eased in Estonia in May and so borrowing activity started to improve, the volume of new loans taken has not yet recovered to its level of before the pandemic. Businesses borrowed 18% less from banks operating in Estonia in the third quarter than a year earlier, and households borrowed 13% less (see Figure 1).

The fall in borrowing by **businesses** was not as deep in the third quarter as it was in the second. The volume of long-term loans was 14% down on a year earlier, and the volume of short-term loans was down 18%.

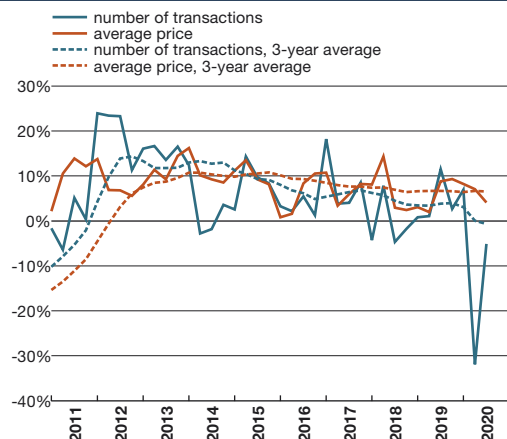
Borrowing by **households** picked up most in the third quarter in housing loans and car leases, though 9% less was taken in housing loans than a year earlier, and 15% less in car leases. Activity has also started to increase in the real estate market. There were almost one third fewer sales transactions in the second quarter than a year earlier, but in the third quarter the number of transactions was down only 5% over the year (see Figure 2). The crisis has not however had any major impact on housing prices. The average price in transactions for apartments in the third quarter was around 4% higher than a year earlier. The price growth in the third quarter was broadly based, as prices for new apartments were 7% higher and those for apartments in the secondary market were 4% higher.

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

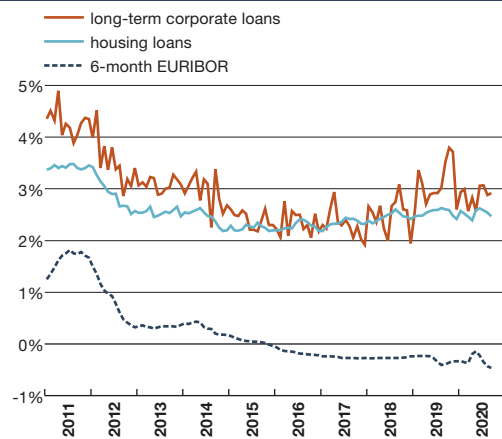


Source: Eesti Pank

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.

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

Source: Estonian Land Board

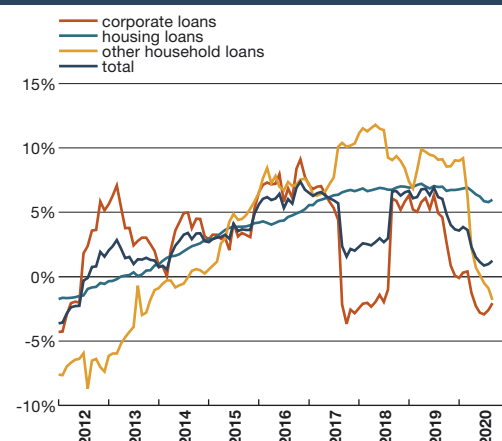
Figure 3. Weighted average interest rates on housing loans and long-term corporate loans

Sources: European Central Bank, Eesti Pank

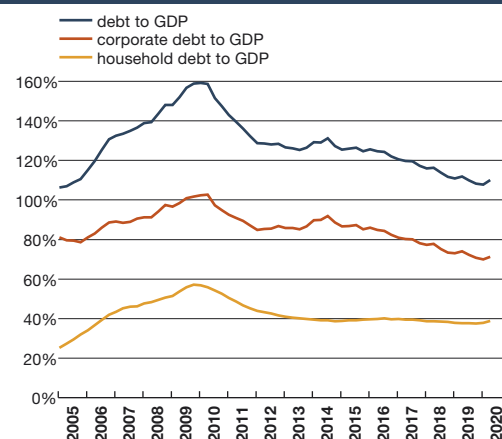
The interest rates on new loans were not substantially different from what they were at the end of 2019 (see Figure 3). The Bank Lending Survey found banks tightening both their lending standards and conditions in the first half of 2020, but standards were not tightened any further in the third quarter.

As new loans are taken more actively, the yearly growth in the portfolio of bank loans to the non-financial sector stopped slowing in the third quarter of 2020 (see Figure 4). The yearly growth in September was 1.2%. The portfolio of housing loans had grown by 6% over the year at the end of the third quarter. The portfolios of corporate loans and other household loans had shrunk over the year at the end of September though by 2%.

A faster fall in nominal GDP than in borrowing as a consequence of the crisis meant equally though that the indicator for indebtedness rose in the second quarter. The debt-to-GDP ratio was 110% in the second quarter of 2020 (see Figure 5), having risen by almost 2 percentage points over the quarter. It is quite usual for the indebtedness indicator to rise when there is a sharp drop in the economy². Such a rise is only temporary though, and indebtedness will return to its pre-crisis level as growth in the economy recovers. This means the rise in the debt-to-GDP ratio is not the best indicator to use for assessing the credit cycle in the current environment. A more stable comparison base for estimating the speed of growth in

Figure 4. Annual growth of corporate and household loans

Source: Eesti Pank

Figure 5. Non-financial sector indebtedness

Sources: Statistics Estonia, Eesti Pank

² A similar dynamic was apparent in the economic crisis of 2008-2009 for example.

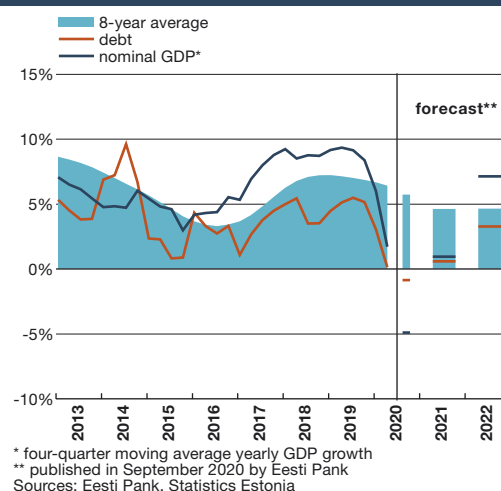
debt is the eight-year average nominal growth in GDP of 5-6%, which is still faster than the growth in debt given current estimates of the growth in lending (see Figure 6).

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 loans³. Borrowers being less able to repay their loans means a reduction in their capacity to borrow and makes loan losses more likely. The resilience of the banks to future loan losses is supported by the current capital buffers that have been built up under the microprudential and macroprudential requirements of earlier years. At the end of September the average capital adequacy ratio of the banks was 27%, and the lowest indicator for any bank was 17%.

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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. Although there was more borrowing activity in the third quarter than in the second, it still remained below where it was before the outbreak of the pandemic. As the spread of the virus has increased again in Estonia, increasing uncertainty about the future, Eesti Pank currently considers it appropriate to keep the countercyclical capital buffer rate for the banks at 0%.

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



³ The banks have however already increased their write-downs of loans.