

COUNTERCYCLICAL CAPITAL BUFFER RATE

EESTI PANK'S ASSESSMENT OF THE COUNTERCYCLICAL CAPITAL BUFFER RATE (Q2 2021)¹

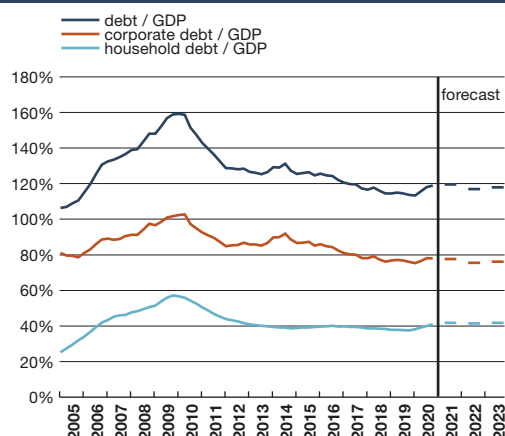
Eesti Pank's assessment in June 2021 is that the systemic risks coming from the credit cycle are not currently large, and so it is justified to keep the countercyclical capital buffer rate at 0%.

- The applicable countercyclical capital buffer rate: **0%**
- The standardised credit-to-GDP ratio: **119%**; its deviation from the long-term trend: **-3 percentage points**
- The buffer guide: **0%**
- **Reasoning for the buffer rate:** the growth in debt in the non-financial sector remains below long-term average nominal GDP growth. As the risk of rapid growth in borrowing is low at present, Eesti Pank currently considers it appropriate to keep the countercyclical capital buffer rate for the banks at 0%

The indebtedness of the non-financial sector continued to grow at the end of 2020 because of the decline in nominal GDP. The credit-to-GDP ratio increased to 119% by the end of the fourth quarter of 2020 (see Figure 1). Indebtedness grew mainly because the debt of the non-financial sector continued to grow, albeit at a slower rate, while nominal GDP fell as a result of the pandemic. It is quite usual for indebtedness to rise when there is a sharp drop in the economy². It is highly probable that the growth in indebtedness will fade as growth returns to the economy, and it is estimated that the indebtedness will decline to 118% by the end of 2023.

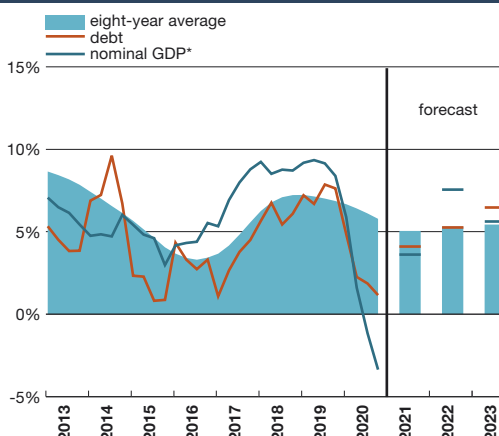
Growth in the debt of the non-financial sector slowed to 1.2% at the end of 2020 (see Figure 2), which is still below the long-term average nominal economic growth of 6%. Looking forward, the Eesti Pank March forecast does not suggest that the growth in the non-financial sector debt over

Figure 1. Real sector indebtedness



Sources: Statistics Estonia, Eesti Pank

Figure 2. Forecast for annual growth of non-financial sector debt and nominal GDP



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

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

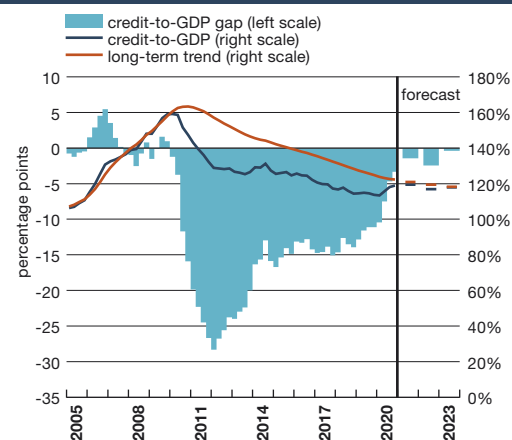
the next two years will surpass the GDP growth of the current year or the average of the previous eight years. The slower growth in non-financial sector debt has been particularly apparent at companies, where debt was almost 1% lower in the fourth quarter of 2020 than a year earlier. The debt of households has continued to grow at 5% for the past three quarters though. There has been particular growth in housing loans, which account for the largest part of household debt. Demand for housing loans recovered rapidly after a temporary period of uncertainty in spring 2020, and the rate of yearly growth in the portfolio rose back to 7% by the end of the first quarter of 2021. 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.

The standardised credit-to-GDP³ gap calculated using the methodology of the Basel Committee on Banking Supervision was -3 percentage points at the end of the fourth quarter of 2020 (see Figure 3). The additional gap⁴, which is also used by Eesti Pank, was -14 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%. Although the credit-to-GDP gap has narrowed consistently and is expected to narrow further, the standardised credit-to-GDP gap will still not turn positive in the coming years.

The loan margins of the banks have come down a little. Interest rates on both long-term corporate loans and housing loans to households have fallen a little in the past six months as competition has increased (see Figure 4). The bank lending survey shows that lending conditions for companies and households were eased a little in both the final quarter of 2020 and the first quarter of 2021.

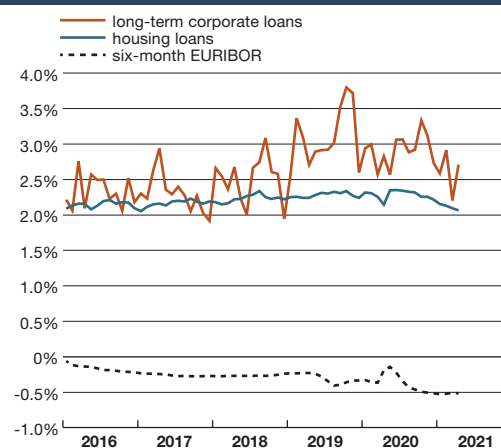
In summary, Eesti Pank does not currently consider it necessary to change the countercyclical buffer rate. The reason for this is that the growth in debt in the non-financial sector is below long-term average nominal GDP growth. Neither is it expected looking forwards that the growth in the debt of the non-financial sector will start to exceed long-term GDP growth consistently before 2023. Although developments so far do not indicate imbalance in the credit market, the risk remains that debt could start to grow faster than forecast, which could then increase the risks from the credit cycle. For this reason Eesti Pank monitors the growth in debt and indicators that affect it, and can if necessary raise the countercyclical capital buffer rate above 0%.

Figure 3. Standardised credit-to-GDP gap



Sources: Statistics Estonia, Eesti Pank

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



Sources: European Central Bank, Eesti Pank

³ 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.

⁴ 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.