

THE COUNTERCYCLICAL CAPITAL BUFFER RATE

Eesti Pank's assessment of the countercyclical capital buffer rate (Q1 2016)

The Executive Board of Eesti Pank decided on 29 February 2016 to keep the countercyclical capital buffer rate at 0%.

In accordance with Article 136(7) of EU Directive 2013/36/EU, Eesti Pank is notifying the ESRB of its decision on the buffer rate and publishing the decision and related information on its own website.

- The applicable countercyclical capital buffer rate: **0%**
- The standardised credit-to-GDP ratio: **128%** and its deviation from the long-term trend: **-14 percentage points**
- The buffer guide: **0%**
- Reasoning for the buffer rate: assessment of the credit cycle in Estonia shows that credit growth is currently in line with the general development of the economy and is forecast to remain so, and there is no indication of excess credit risk accumulating. Credit growth in the non-financial sector is backed by moderate GDP growth and rapid growth in deposits, and the growth in housing loans is supported by sustained growth in incomes.

Section 86⁴⁶ of the Credit Institutions Act states that Eesti Pank is responsible for setting the rate for the countercyclical capital buffer. The same section gives the general principles for assessing the buffer rate based on Article 136 of EU Directive 2013/36/EU and the requirements for announcements of information from Eesti Pank.

The buffer is set in order to protect the banking sector against losses that could be caused by cyclical systemic credit risks building up in the economy. Banks can use the additional capital buffers they have built up during the growth phase of the financial cycle to cover losses that may arise when the cycle turns down and to continue supplying credit to the real economy.

The basis for setting the countercyclical capital buffer rate is the assessment by Eesti Pank of the cyclical systemic credit risk in Estonia. The assessment combines a quantitative approach based on economic indicators with expert judgement¹. One of the main indicators that is regularly assessed is the credit-to-GDP gap and the buffer guide calculated from it, though this is not the only indicator used in the decision on the buffer rate. The greatest weight in the assessment of the buffer rate is given to the indicators that best show the current position of the credit cycle.

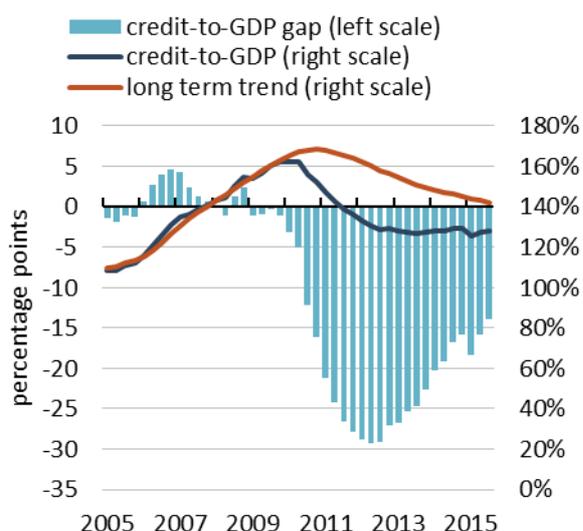
Indicators used in the assessment of the countercyclical capital buffer rate

- **Credit-to-GDP gap**

The credit-to-GDP ratio for the non-financial sector in Estonia was 128% in the third quarter of 2015. The credit-to-GDP ratio has not changed particularly in the past three years, and remains about 34 percentage

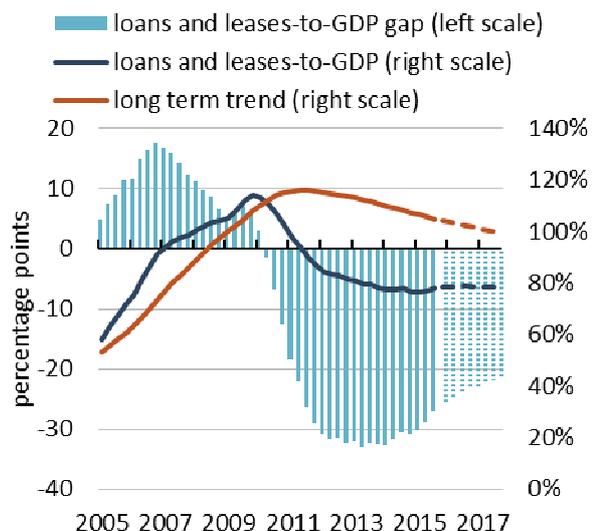
¹ The assessment methodology is described in more detail in the Eesti Pank document "[Countercyclical Capital Buffer. The principles and indicators for setting the buffer rate in Estonia](http://www.eestipank.ee/sites/eestipank.ee/files/files/Finantsstabiilsus/ccb_eng.pdf)". October 2015. http://www.eestipank.ee/sites/eestipank.ee/files/files/Finantsstabiilsus/ccb_eng.pdf

Figure 1. Standardised credit-to-GDP gap



Sources: Statistics Estonia, Eesti Pank

Figure 1b. Additional credit-to-GDP gap



Sources: Statistics Estonia, Eesti Pank

points below the peak it reached in the middle of 2010. The debt of the non-financial sector was up in the third quarter by 2.5% over the year, which is a somewhat slower rise than a year earlier.

The standardised credit-to-GDP gap² was -14 percentage points in the third quarter of 2015 (see Figure 1). The credit-to-GDP gap has been negative since 2009 but it has been narrowing since 2013 because of the fall in the long-term trend, as the credit-to-GDP gap has not changed.

The additional credit-to-GDP gap, which is calculated from narrower credit aggregates³ has been consistently negative, but it has narrowed. In the second quarter of 2015 the gap was -28.9 percentage points and in the third quarter it was -27 percentage points (see Figure 1b). The Eesti Pank forecast released in December expects the credit-to-GDP ratio to remain around 78% in the years ahead and the negative gap to continue to close, mainly because the long-term trend remains downwards. If the gap is negative, the buffer guide is 0%.

- **Annual growth in the loan stock**

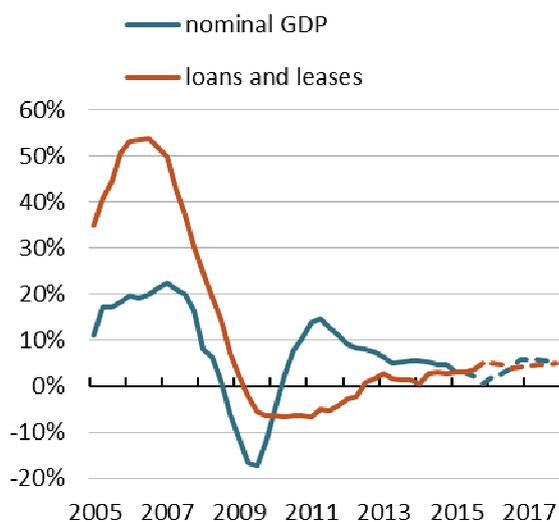
Moderate economic growth in Estonia, where nominal annual GDP growth was 2.2% in the third quarter of 2015, and favourable interest rates on loans saw the loan stock continue to increase in the second half of 2015 (see Figure 2). **Annual growth in the loan and lease portfolio of the banks was 4.9% in the fourth quarter.**

The stock of loans to companies increased by 5.3% in the fourth quarter of 2015. Growth in loans to households accelerated slightly, mainly due to housing loans, and was supported by relatively fast growth in incomes. The stock of housing loans was 4.2% larger in the fourth quarter of 2015 than a year earlier (see Figure 3).

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 resources borrowed and bonds issued by the Estonian private sector both within Estonia and abroad.

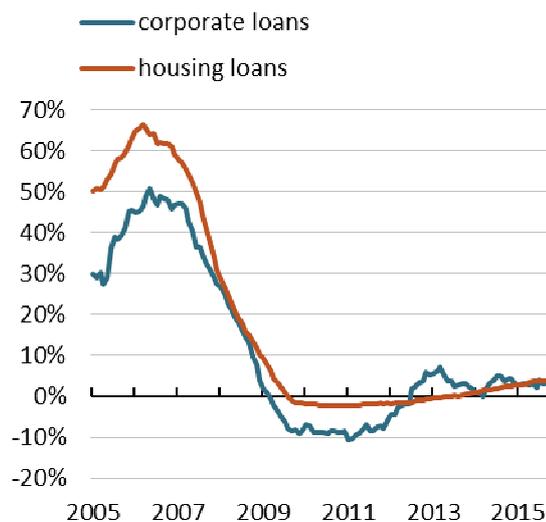
³ The additional credit-to-GDP ratio is calculated using a narrow aggregate of credit that covers domestic loans and leases issued by banks operating in Estonia.

Figure 2. Annual growth of loans and leases and nominal GDP



Sources: Statistics Estonia, Eesti Pank

Figure 3. Annual growth of corporate loans and housing loans



Source: Eesti Pank

The deposits of the non-financial sector continued to grow quickly in the last months of 2015 with corporate deposits seeing annual growth of 15.8% in the fourth quarter, and households annual growth of 7.4%. A fall in the volume of non-resident deposits raised the loan-to-deposit ratio to 105% in the final quarter of the year. The ratio with only resident deposits remained unchanged at 122% in the quarter.

The December forecast 2015 by Eesti Pank expects growth in the loan and lease portfolio of the non-financial sector to accelerate somewhat in the next couple of years too, though it will remain close to GDP growth. Credit growth is currently in line with the general development of the economy and is forecast to remain so, and there is no indication of excess credit risk accumulating.

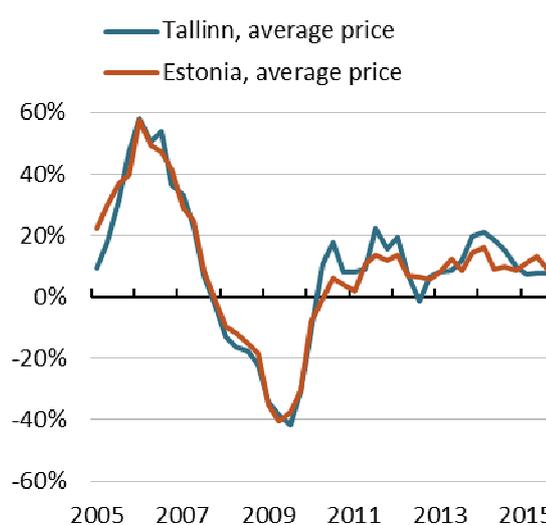
- **The ratio of average apartment prices and average gross monthly wages**

The average square metre price of apartments rose 4% in Tallinn in the fourth quarter of 2015 and 8% in the rest of Estonia (see Figure 4). Activity in the market has increased most in Tallinn, where 16% more transactions were made than a year earlier. The rise in market activity elsewhere in Estonia was smaller at 5%.

The ratio of square metre prices for apartments to gross monthly wages for Estonia was no different from in the second quarter of 2015 and stood at 0.96 in the third quarter and at 1.3 in Tallinn (see Figure 5).

Moving forward, the risk remains of demand increasing for real estate and housing loans if incomes continue to rise and interest rates remain low. To

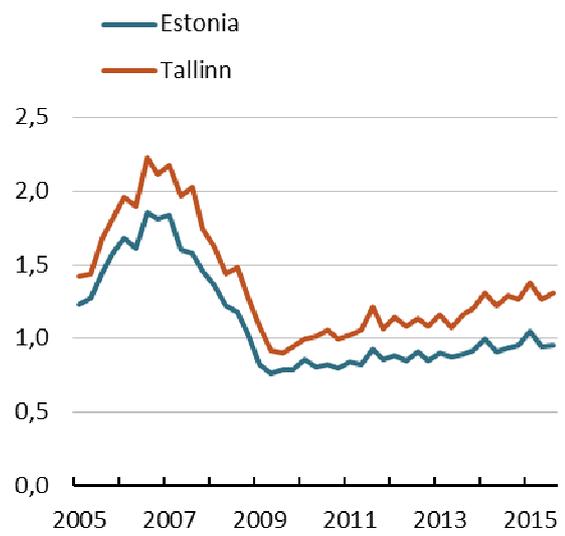
Figure 4. Annual growth of housing prices



Sources: Estonian Land Board

dampen the risks from housing loans, Eesti Pank introduced requirements for new housing loans from 1 March 2015 that limited their 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.

Figure 5. Ratio of square metre price for apartments to monthly gross wage



Sources: Estonian Land Board, Statistics Estonia