

THE COUNTERCYCLICAL CAPITAL BUFFER RATE

EESTI PANK'S ASSESSMENT OF THE COUNTERCYCLICAL CAPITAL BUFFER RATE (Q4 2021)

Eesti Pank decided on 29 November 2021 to extend the basis for applying the countercyclical buffer and to raise the buffer rate to 1%. The higher buffer rate will start to apply from 7 December 2022. The countercyclical capital buffer requirement is going to have two parts, with a base requirement of 1% that will mainly remain unchanged, and a cyclical requirement that Eesti Pank can raise if the systemic risk coming from the credit cycle increases. Eesti Pank's assessment in November 2021 is that the systemic risks coming from the credit cycle are not currently large, and so the countercyclical capital buffer rate will be set at the base requirement of 1%.

- The applicable countercyclical capital buffer rate: **1%**, of which the cyclical component: 0%
- The standardised credit-to-GDP ratio: **121%**; its deviation from the long-term trend: **-3 percentage points**
- The buffer guide: **0%**
- **The reasoning behind the buffer rate.** The positive outlook for growth in the economy, the good profitability and capitalisation of the banking sector, and the efficient operation of the credit market all support the countercyclical capital buffer rate being set at the base requirement of 1%. The growth in the debt of the non-financial sector was a little faster in the middle of 2021 than the long-term growth in nominal GDP. If this were to remain the case, the risks of the credit cycle would increase and it could prove necessary to raise the countercyclical capital buffer rate above 1%.

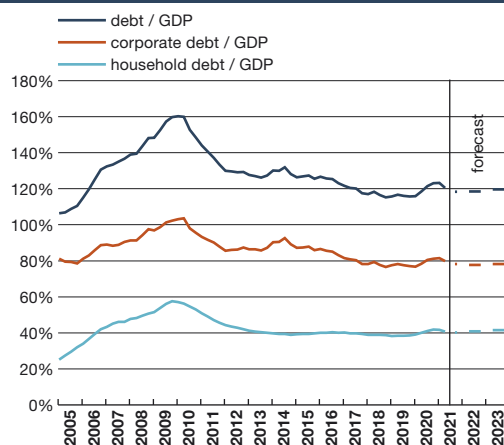
Eesti Pank decided to extend the framework for the countercyclical buffer. The changes were prompted by the need to restore the buffer requirement that was released during the start of the Covid-19 pandemic in spring 2020. Eesti Pank decided to replace the earlier 1% systemic risk buffer requirement by establishing a 1% base requirement in the framework of the countercyclical buffer. The countercyclical capital buffer requirement will moving forwards have two parts, with a base requirement that will mainly remain positive at 1% except during crises, when it may be released, and a cyclical requirement that is added to the base requirement if rapid credit growth causes cyclical risks to increase¹.

The uncertainty caused by the pandemic had abated by autumn 2021 and the conditions for setting the base requirement for the countercyclical buffer had been met. The first condition was that several economic indicators, including GDP growth, consumption, wage growth and employment, indicated in the second quarter that the Estonian economy was again on a path of growth. The second was that the profitability of the banking sector was eye-catchingly good while no substantial loan losses were expected in the near term that could weaken the capitalisation of the banks. The third was that the lending market in Estonia was functioning normally, as the banks were able to satisfy the demand for loans from companies and households sufficiently without setting excessive restrictions on the loan supply.

Eesti Pank assesses the need to change the cyclical requirement that is added to the base requirement of the countercyclical buffer once a quarter. The central indicator in assessing cyclical risks is the rate of growth of non-financial sector debt and how far this departs from the rate of

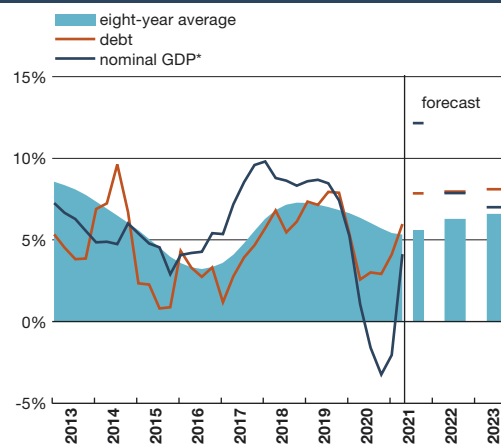
¹ See the Financial Stability Review 2/2021. Appendix 1. The countercyclical capital buffer: adjusting the principles for applying the requirement.

Figure 1. Real sector indebtedness



Sources: Statistics Estonia, Eesti Pank

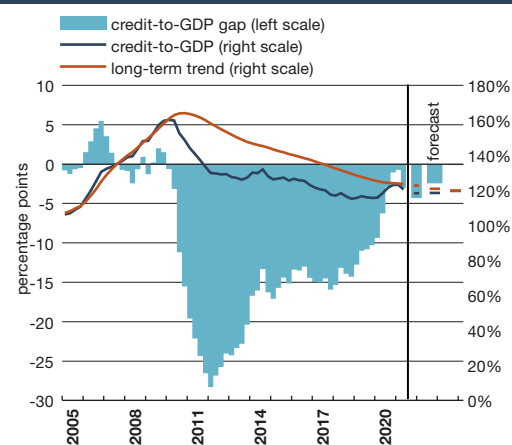
Figure 2. Forecast for the yearly growth of non-financial sector debt and nominal GDP

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

long-term economic growth. The dynamics of the debt-to-GDP ratio are also assessed, along with other indicators of the financial cycle.

The indebtedness of the non-financial sector declined in the second quarter of 2021. The debt-to-GDP ratio in the second quarter of this year was 121% (see Figure 1). The growth in indebtedness in earlier quarters arose because nominal GDP dropped during the recession caused by the pandemic, but the recovery in economic growth has seen indebtedness start to decline again. Indebtedness will probably continue to decline for some time moving forwards as the economy grows. The danger remains though that growth in debt could accelerate in the years ahead and so indebtedness could start to increase again.

Figure 3. Standardised credit-to-GDP gap



Sources: Statistics Estonia, Eesti Pank

The yearly growth in the debt of the non-financial sector accelerated to 6% in the second quarter of 2021 (see Figure 2). The yearly growth in debt in the second quarter also exceeded nominal GDP growth both over the long term and over the current 12 months. Growth in debt in earlier quarters was led by housing loans to households, but in the second quarter of 2021 the yearly growth in corporate debt accelerated for the second consecutive quarter. Corporate debt grew by 6.2% over the year in the second quarter, and household debt grew by 5.6%. The Eesti Pank September forecast predicts that growth in debt will accelerate in the coming years together with growth in the economy, and that it will exceed long-term average nominal GDP growth. Growth in debt remaining faster than that in long-term nominal GDP would indicate an increase in the risks coming from the credit cycle, and so it may prove necessary to increase the countercyclical capital buffer requirements to cover those risks.

The standardised credit-to-GDP² gap calculated using the methodology of the Basel Committee on Banking Supervision was -3 percentage points at the end of the second quarter of 2021 (see Figure 3). The additional gap³, 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 buffer guide remains

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 loans to the non-financial sector and bonds issued both within Estonia and abroad. This is an unconsolidated indicator.

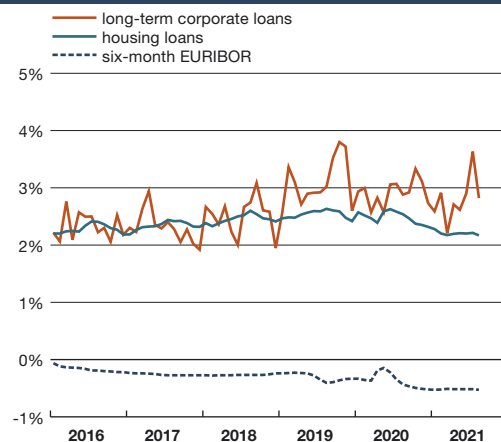
3 The additional credit-to-GDP ratio is calculated using a narrow aggregate of credit that covers domestic loans and leases issued by banks operating in Estonia.

at 0%. The Eesti Pank September forecast predicts that moving forward the credit-to-GDP gap will remain negative over the coming three years.

The lending margins of the banks did not notably change over the quarter in the third quarter of 2021 (see Figure 4). There were no major changes in the credit supply in the third quarter. The bank lending survey shows that there was no change in lending conditions for companies or households in the third quarter.

In summary, Eesti Pank has decided to raise the countercyclical buffer rate base requirement to 1% from 7 December 2022. Equally, Eesti Pank does not currently consider it necessary to raise the cyclical requirement of the buffer, though it may do so in the coming quarters. The basis for the assessment is that growth in debt is not currently exceeding long-term nominal GDP growth consistently. The substantial danger remains though that this could happen in the future, meaning that the risks coming from the credit cycle will increase and so it could prove necessary to raise the base requirement of the countercyclical capital buffer rate above 1% to cover those risks.

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



Sources: European Central Bank, Eesti Pank