THE COUNTERCYCLICAL CAPITAL BUFFER RATE

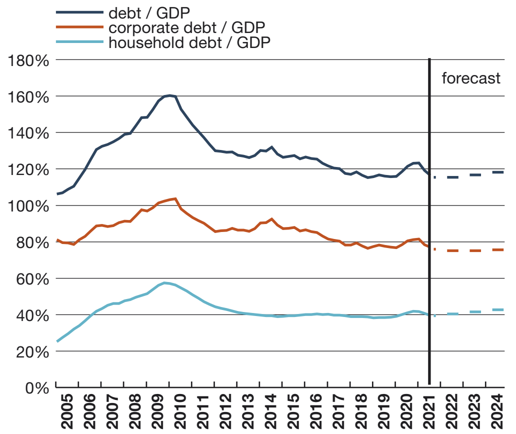
EESTI PANK'S ASSESSMENT OF THE COUNTERCYCLICAL CAPITAL BUFFER RATE (Q1 2022)

The assessment of Eesti Pank in mid-February 2022 is that the risks coming from the credit cycle are increasing as the economy grows. Eesti Pank decided in November 2021 that the banks would have to hold a countercyclical capital buffer at the base level of 1% from 7 December 2022. The indicators for growth in debt and for indebtedness in the non-financial sector show that it is justified to keep the cyclical component of the buffer requirement at its current rate of 0% in the first quarter of 2022. Credit growth risks are growing though, and in the near future it may prove necessary to increase the countercyclical capital buffer requirements to cover those risks.

- The applicable countercyclical capital buffer rate: **1%**, of which the cyclical component is 0%, from 7 December 2022
- The standardised credit-to-GDP ratio: **117%**; its deviation from the long-term trend: **–6 percentage points**
- The buffer guide: **0%**
- **The reasoning for the buffer rate.** The growth in the debt of the non-financial sector in autumn 2021 was a little below the long-term growth in nominal GDP, and indebtedness did not increase. It is probable however looking forward that the growth in debt may soon start to exceed consistently the long-term growth in nominal GDP, and so the systemic risks from the credit cycle may increase. For this reason it may prove necessary in the near future to raise the countercyclical capital buffer requirement above its current base level of 1% to cover those risks.

Indebtedness in the non-financial sector has returned to its level from before the Covid-19 pandemic after a temporary rise. The recession caused by the pandemic in 2020 led the debt-to-GDP ratio to rise, but the rapid recovery of the economy meant this rise did not last for long, and by the third quarter of 2021 the ratio had fallen back to almost the same level of 117% that it was at before the pandemic. Looking forwards, it is probable that rapid growth in the economy will cause indebtedness to decline for some time yet, but then it will start to increase (see Figure 1).

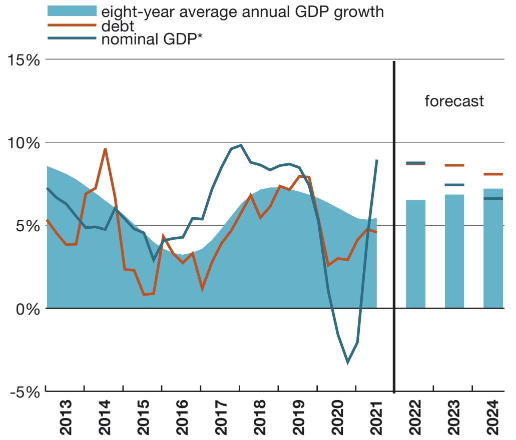
Figure 1. Non-financial sector indebtedness



Sources: Statistics Estonia, Eesti Pank

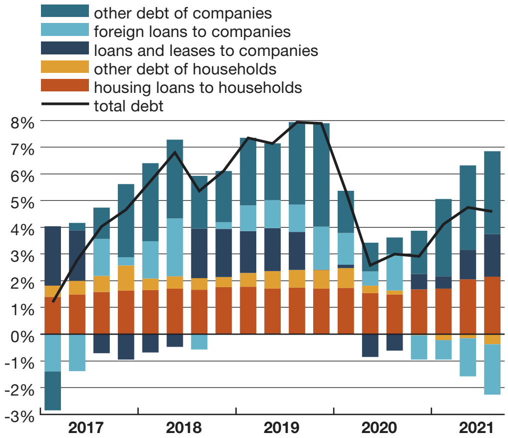
Yearly growth in the debt of the non-financial sector was essentially unchanged in the third quarter. The debt of the non-financial sector grew by 4.6% over the year in the third quarter, which was a slower rate than that of nominal economic growth for the current year at 9%, and than the long-term average nominal economic growth of 5.4%. The Eesti Pank December forecast expects that non-financial sector debt will grow faster in the coming years and will start to exceed both the long-term average and the growth in current nominal GDP (see Figure 2). Growth in debt remaining faster than that in long-term nominal GDP for several quarters would indicate an increase in the risks coming from the credit cycle. This may make it necessary in the near future to raise the countercyclical capital buffer requirement to cover those risks.

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

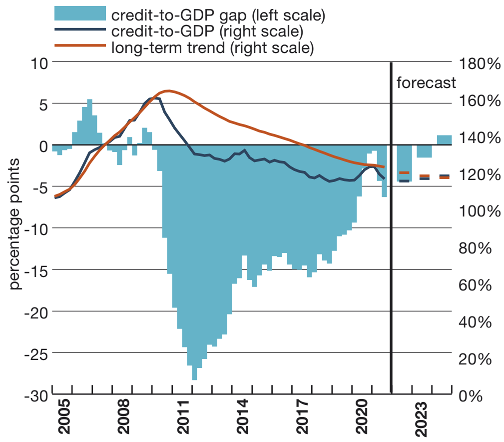
Figure 3. Contributions to the yearly growth in the debt of the non-financial sector



Source: Eesti Pank

Bank loans to companies and housing loans to households are both growing faster than non-financial sector debt overall. Corporate debt was 4% larger in the third quarter than a year earlier and household debt was up 5%, while corporate bank loans were up 6% over the year in the third quarter and housing loans were up 8%. This also means that both corporate bank loans and housing loans to households have increased as a share of the debt of the non-financial sector (see Figure 3). As bank loans are growing fast and competition has increased in the banking market, the risk of vulnerabilities in the banking sector has increased.

Figure 4. Standardised credit-to-GDP gap



Sources: Statistics Estonia, Eesti Pank

The standardised credit-to-GDP[1] gap calculated using the methodology of the Basel Committee on Banking Supervision was -6 percentage points at the end of the third quarter of 2021 (see Figure 4). The additional gap[2], which is also used by Eesti Pank, was -15 percentage points. The negative credit-to-GDP gap means that the credit-to-GDP ratio is currently lower than the long-term trend, and so the buffer guide is at 0%. The Eesti Pank December forecast predicts that moving forward the credit-to-GDP gap will gradually narrow over the coming three years, and will become positive by the end of 2024.

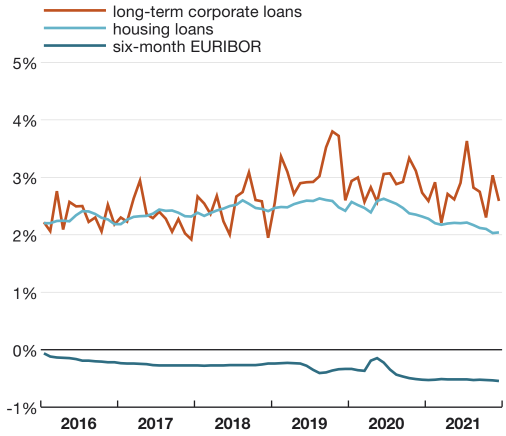
The credit supply from the banks has grown. The amount issued in loans increased in 2021 and the average interest rate fell (see Figure 5), indicating increased competition pressure and a larger supply of loans in the market. The bank lending surveys in 2021 showed though that lending standards eased a little, indicating that the circle of possible borrowers widened for the banks and access to loans improved.

1 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.

2 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.

As of the mid-February 2022 assessment, Eesti Pank does not consider it necessary to change the countercyclical capital buffer rate, but as the risks from the credit cycle will probably increase, it may still become necessary in the near future to raise the requirement of the countercyclical capital buffer rate to a higher level to cover those risks. The basis for the assessment is that growth in debt currently remains below the long-term growth in nominal GDP. It is probable however looking forward that the growth in debt may start in the coming years to exceed the long-term growth in GDP, and indebtedness may start to increase. This would lead the risks from the credit cycle to increase, in which case it would be reasonable to raise the countercyclical capital buffer requirement to cover those risks.

Figure 5. Weighted average interest rates on housing loans and long-term corporate loans



Sources: European Central Bank, Eesti Pank