

THE COUNTERCYCLICAL CAPITAL BUFFER RATE

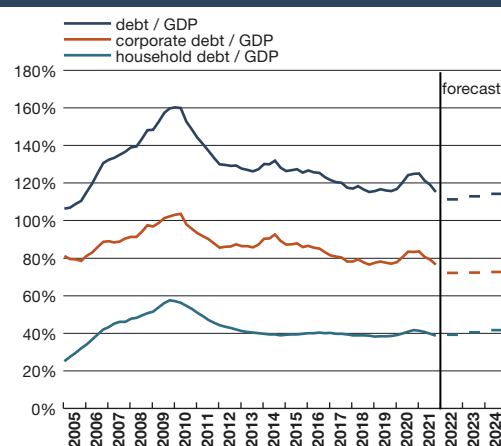
EESTI PANK'S ASSESSMENT OF THE COUNTERCYCLICAL CAPITAL BUFFER RATE (Q2 2022)

The Eesti Pank assessment in May 2022 is that the deterioration in the economic climate caused by the war in Ukraine has overall reduced the risks from excessively fast growth in credit this year, and it is not currently necessary to raise the countercyclical buffer rate. The countercyclical capital buffer rate has two parts: the base rate, which is the base requirement that does not change under ordinary circumstances, and the cyclical component. Eesti Pank set the base rate of the countercyclical capital buffer at 1% in November 2021 and the banks have to comply with that from 7 December 2022. Eesti Pank has not so far changed the cyclical component.

- The applicable countercyclical capital buffer rate: **1%**, of which the cyclical component is 0%, from 7 December 2022
- The standardised credit-to-GDP ratio: **115%**; its deviation from the long-term trend: **-8 percentage points**
- The buffer guide: **0%**
- **The reasoning for the buffer rate.** Growth in debt has accelerated, but it remains slower than the growth in long-term nominal GDP. The deterioration in the economic climate has reduced the risks from excessively fast growth in credit. The risk remains however looking forward that the growth in debt may soon start to exceed consistently the long-term growth in nominal GDP as well as the growth in current 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 rate requirement above its current base level 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, and will continue to decline for some time yet. 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. By the third quarter of 2021 the ratio had fallen back to almost the same level of 119% that it was at before the pandemic, and in the fourth quarter of 2021 the debt-to-GDP ratio fell to 115% (see Figure 1). It is probable that indebtedness will continue to fall for some time looking forward, as high inflation is helping nominal GDP to grow faster than the debt of companies and households. The Eesti Pank March forecast still expects indebtedness to increase in the coming years though.

Figure 1. Non-financial sector indebtedness



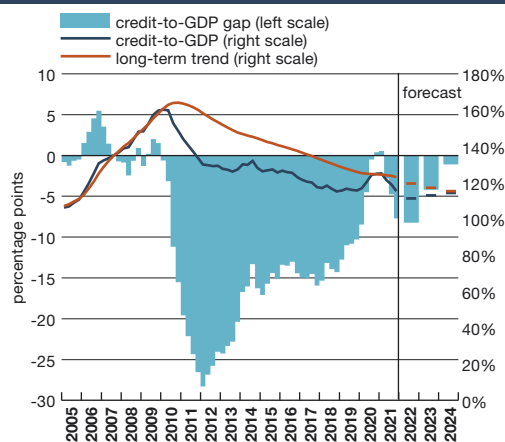
Sources: Statistics Estonia, Eesti Pank

The standardised credit-to-GDP¹ gap calculated using the methodology of the Basel Committee on Banking Supervision was -8 percentage points at the end of the fourth quarter of 2021. The additional gap², which is also used by Eesti Pank, was -16 percentage points. The negative

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.

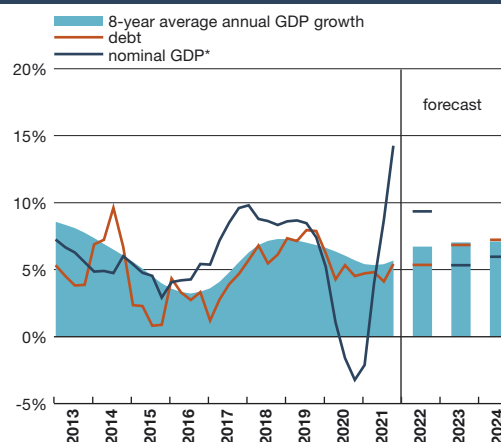
2 The additional credit-to-GDP ratio is calculated using a narrow aggregate of credit that covers domestic loans and leases issued by banks operating in Estonia.

Figure 2. Standardised credit-to-GDP gap



Sources: Statistics Estonia, Eesti Pank

Figure 3. Forecast for annual growth of non-financial sector debt and nominal GDP

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

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 March forecast predicts that moving forward the credit-to-GDP gap will gradually narrow over the coming three years, but that it will remain negative (see Figure 2).

Yearly growth in non-financial sector debt accelerated in the fourth quarter.

The debt of the non-financial sector increased by 5.4% over the year in the fourth quarter, leaving it below the yearly growth of 14% in GDP. Given the rapid growth in debt however, it is important when assessing the sustainability of debt to compare the growth of debt with the long-term average growth in the economy as well. In assessing the countercyclical capital buffer requirement, Eesti

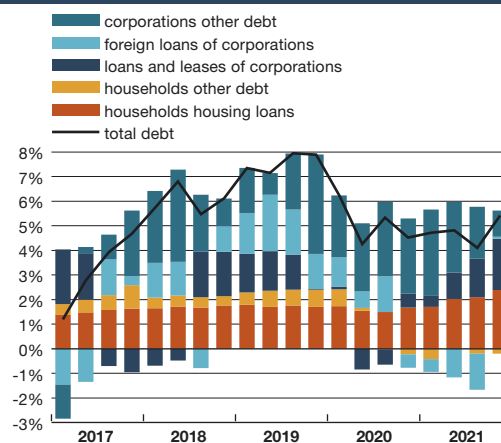
Pank uses average nominal GDP growth over the past eight years as long-term GDP growth, which helps smooth the short-term volatility in the rate of growth. The eight-year average nominal GDP growth in the fourth quarter of 2021 was almost 6%, meaning that the growth in debt in the fourth quarter of 2021 remained lower than that in GDP.

The Eesti Pank March forecast expects that growth in debt will continue to accelerate in the years ahead and so will start to exceed the growth in current nominal GDP (see Figure 3). Growth in debt may already exceed the long-term growth in nominal GDP by the end of 2024. Growth in debt remaining faster than long-term growth in nominal GDP for several consecutive quarters would indicate an increase in the risks coming from the credit cycle, and so it may prove necessary to increase the countercyclical capital buffer rate to cover those risks.

Bank loans to companies and housing loans to households are both growing faster than total non-financial sector debt.

Corporate debt was 5% larger in the fourth quarter than a year earlier and household debt was up 7%, while corporate bank loans were up 7% over the year in the fourth quarter and housing loans were up 9%. Bank loans continued to grow rapidly in the first quarter of 2022. This also means that both corporate bank loans and housing loans to households are increasing as a share of the debt of the non-financial sector (see Figure 4). As bank loans are growing fast against a

Figure 4. Contributions to yearly growth in the debt of the non-financial sector



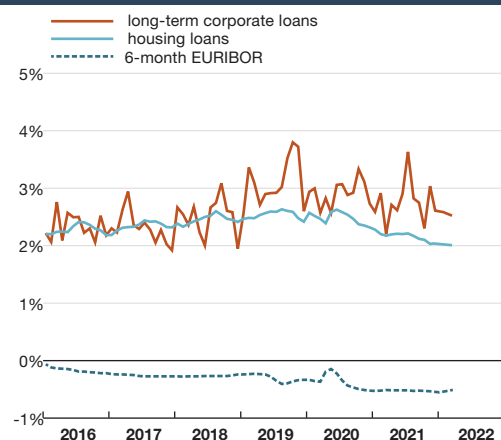
Source: Eesti Pank

backdrop of tight competition in the banking market, there is a risk of vulnerabilities in the banking sector increasing.

Lending conditions of the banks overall did not particularly change in the first quarter of 2022. The bank lending survey in the first quarter of 2022 did not show any clear trends in loan conditions, as conditions tightened somewhat for companies while those for consumption loans to households were eased, but the conditions for housing loans did not change in the first quarter. The interest rates on new bank loans issued have not changed much in the past three months from the end of last year (see Figure 5).

In total, Eesti Pank does not consider it currently necessary to change the countercyclical capital buffer rate, but as the risks from the credit cycle will probably increase, it may still become necessary 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 nominal growth in GDP, and the deterioration in the economic climate has reduced the risks of excessive loan growth this year. The risk remains however looking forward that debt could start to grow faster than previously and could start to exceed consistently the long-term growth in nominal GDP as well as the growth in current GDP. For this reason Eesti Pank is monitoring further developments carefully and can, if the need arises, raise the countercyclical buffer rate above 1%.

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



Source: European Central Bank, Eesti Pank