

THE COUNTERCYCLICAL CAPITAL BUFFER: ADJUSTING THE PRINCIPLES FOR APPLYING THE REQUIREMENT

The countercyclical capital buffer requirement has so far been the only tool in the Eesti Pank macroprudential framework that has been used only for mitigating cyclical risks. It is intended to minimise the risks that come from rapid growth in the credit cycle. As the growth in the debt of the non-financial sector has not been persistently faster than long-term growth in the economy for more than 10 years, the buffer requirement has remained at zero since it was introduced in 2016. The systemic risk buffer requirement has helped to reduce the structural risks coming from the economic environment. When the Covid-19 pandemic erupted in spring 2020, Eesti Pank extraordinarily and temporarily cut the systemic risk buffer rate from 1% to 0%. Eesti Pank considered various ways of reinstating the buffer requirement in autumn this year, and preferred to use the countercyclical capital buffer. This also means that the principles used so far for applying the countercyclical capital buffer need adjusting.

The goal and application of the countercyclical capital buffer requirement

The role of the countercyclical capital buffer (CCyB) in the framework of macroprudential measures is to strengthen the capitalisation of the banks in good times so that they would have sufficient capital in any possible future crisis to cover large loan losses and ensure their capacity to keep lending. The CCyB requirement can if necessary be rapidly cut or removed to ease the regulatory limits on lending and so ease a crisis.

There are two different strategies used internationally for applying the CCyB, as it is imposed when credit is growing fast or it is imposed pre-emptively.

- The principle of imposing it when credit is growing fast comes from the framework published in 2010 by the Basel committee¹⁶, and is followed in most countries including Estonia. This strategy leaves the CCyB at zero throughout most of the financial cycle. The rate is raised only if faster growth in credit than in the economy increases cyclical risks, and it is lowered if those risks materialise or are reduced.
- With pre-emptive imposition, the CCyB rate is raised in an earlier part of the financial cycle, when credit is not yet growing excessively fast given the rate of growth in the economy. The buffer rate is generally positive at 1% or 2% except when there is a crisis in financial system or it is recovering from one. If substantial growth is seen in cyclical risks, the CCyB rate can be raised above the base level of 1-2%. The countries in Europe that use this approach include the United Kingdom, Lithuania, Denmark and Ireland, and since 2021 Sweden.

If the cyclical risks caused by rapid credit growth are high, then the CCyB applied under the two approaches will be the same. This makes the two approaches equivalent in how they fulfil the goals of the CCyB, as the capital buffers built up against a financial cycle crisis are of the same size. Although the structural component in the pre-emptive imposition may disguise the cyclical nature of the instrument, there are several advantages to this approach.

1. A critical increase in cyclical risk may be hard to identify in time. Indicators based on backward-looking data are used in the assessment, and they are released as statistics with a lag. This means that a pre-emptive requirement reduces the danger of the estimate of an increase in cyclical risk coming too late.
2. The increased CCyB rate will generally come into effect 12 months after the decision is taken. This means that the decision to set the buffer requirement needs to be taken early

16 Guidance for national authorities operating the countercyclical capital buffer, December 2010.

enough that the banks are able to build up the buffer before the probability of risks being realised has reached a high level.

3. Pre-emptive application together with gradual rises in the requirement helps banks to adapt to the higher capital requirements without causing the tensions that would arise in the market if the buffer were to be raised by a large amount in one go.

Eesti Pank's adjusted principles for applying the countercyclical capital buffer

Eesti Pank plans to start using the pre-emptive application principle for the countercyclical capital buffer requirement. The buffer requirement will start to have two parts (see Figure A1.1).

1. The base requirement, which will mainly be at a positive rate of 1%, except in emergencies, when it can be released.
2. The cyclical requirement, which will be added to the base requirement if the cyclical risks from rapid credit growth are increasing.

The countercyclical capital buffer rate will be the sum of the rates for the two requirements:

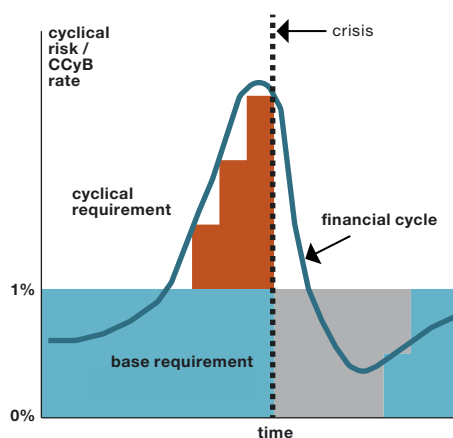
$$r_{CCyB} = r_{base} + r_{cyclical}$$

Assessing the rise in the buffer rate. Except during crises and recovery periods, the base rate will always be unchanged at a fixed level. Eesti Pank will assess the calibration of this rate regularly every two or three years. If the base rate is cut to 0% because of a crisis, the CCyB will be held at zero until there is no danger that raising it would hamper lending and the recovery of the economy. The base rate will be raised to a target level in one or more steps and it will start rising when three conditions have been met.

- The business cycle condition. Several economic indicators show that the impact of the crisis has faded. For example GDP growth is approaching its long-term average, the outlook for growth is good, unemployment is falling, the real estate market is recovering, or similar.
- The financial strength of the banks condition. A major part of the loan losses caused by the crisis have been absorbed, and it is not foreseen that potential loan losses could weaken the capitalisation of the banks in the near term. The banking sector is profitable.
- The absence of lending restrictions condition. The lending market is functioning normally, as banks are able to satisfy the demand for loans without setting excessive restrictions on the loan supply.

Eesti Pank will assess whether the cyclical requirement is at an appropriate rate once a quarter. The key indicator in the framework for assessing cyclical risks is the rate of growth of non-financial sector debt and how far this departs from the rate of long-term economic growth. The dynamics of the debt-to-GDP ratio are also assessed using the Basel methodology, along with other indicators of the financial cycle. The quarterly assessment of the credit cycle together with the time series for the main indicators are published on the Eesti Pank website.

Figure A1.1. Conceptual view of the CCyB requirement



Source: Eesti Pank

Principles for lowering the buffer rate. To support lending to the non-financial sector during a crisis, Eesti Pank can fully or partly release the countercyclical capital buffer requirement set for the banks. It is important to remember in this that loan losses generally appear with a lag. Depending on the nature of the crisis and the expected size of the loan losses, the requirement may be fully or partially released, and this may be done in stages in response to the dynamics of the crisis. In releasing the buffer requirement it is important to work together with the microprudential authority, which can help make sure that profits and other payouts from capital do not flow out of the bank, as this would make it harder for the bank to cover any possible future loan losses.

Eesti Pank as the macroprudential authority decides on lowering the buffer rate and this can be done separately for the base and cyclical parts of the requirement. It may for example be reasonable for the part of the CCyB requirement that is dependent on the financial cycle to be released quickly during a crisis, to give the banks rapid relief to continue lending. The base requirement, which is more structural in nature, should not necessarily be released early when a crisis arises though. As with other capital buffers, the banks are able to use the buffer, though this comes with automatic limits on disbursements of capital. If loan losses are large, the base requirement of the CCyB can be released as well.

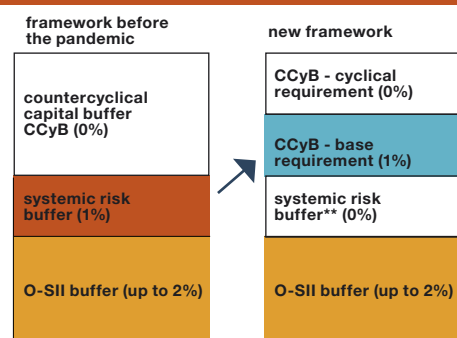
The role of the systemic risk buffer. Changes to the Credit Institutions Act came into force in June 2021 and transposed the amendments to the European Union's Capital Requirements Directive (CRD V). In consequence the application of the systemic risk buffer requirement became notably more flexible. It will for example be possible in future to apply the buffer requirement not only to the total risk exposure of banks, but also to individual loan segments, such as housing loans or commercial real estate loans, or to risk exposures in certain economic sectors.

The systemic risk buffer requirement in Estonia was applied to cover the risks coming from the general macro environment, but that role will in future be played by the base requirement of the countercyclical capital buffer. The systemic risk buffer requirement will remain as a tool in the framework that Eesti Pank is able to use if its risk assessments show additional systemic risks arising.

The transition to the new framework for the countercyclical capital buffer. To replace the 1% systemic risk buffer requirement that applied until 30 April 2021, Eesti Pank will set the countercyclical capital buffer requirement at a base rate level of 1% (see Figure A1.2). Following from its assessment of the cyclical risk, Eesti Pank can decide to raise the rate of the countercyclical capital buffer above 1%.

The higher CCyB rate is generally applied 12 months after the decision is taken, and so as the new buffer framework will come into force in the fourth quarter of this year, the 1% countercyclical capital buffer requirement will start to apply in December 2022.

Figure A1.2. Capital buffer requirements in the macroprudential framework of Eesti Pank*



* the rates in brackets are those that applied before the pandemic or that will apply from Q4 2021

** in the new framework, the systemic risk buffer requirement can also be applied to individual loan segments and sectors

Source: Eesti Pank