

THE COUNTERCYCLICAL CAPITAL BUFFER RATE

EESTI PANK'S ASSESSMENT OF THE COUNTERCYCLICAL CAPITAL BUFFER RATE (Q4 2022)

The Eesti Pank assessment in November 2022 is that the growth in credit has increased the risks from the financial cycle in Estonia and so Eesti Pank decided on 28 November 2022 to raise the countercyclical capital buffer rate in response to those risks.

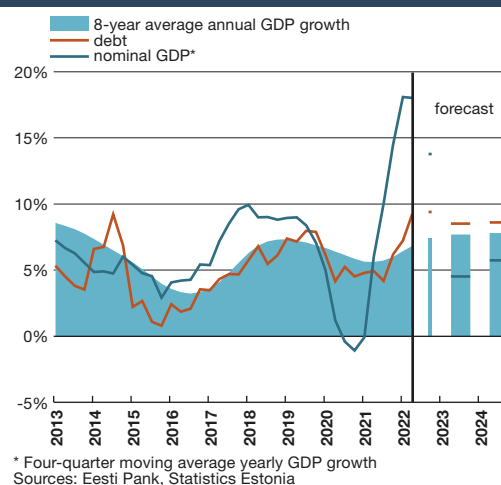
- The applicable countercyclical capital buffer rate: **1%** from 7 December 2022 and **1.5%** from 1 December 2023.
- The standardised credit-to-GDP ratio: 109%; its deviation from the long-term trend: **-11 percentage points**.
- The buffer guide: **0%**
- **The reasoning for the buffer rate.** The significantly faster growth in credit since the final quarter of 2021 has increased the cyclical risks to financial stability in Estonia. The yearly rate of growth in the debt of the non-financial sector increased to 9% by the end of the second quarter of 2022, which is faster than the long-term nominal growth of 6-7% in the economy. Banking statistics show that the rate of growth accelerated further in the third quarter, and yearly growth in housing loans and corporate loans was over 12% at the end of September. Despite the rapid growth in debt in the non-financial sector, indebtedness shown by the debt-to-GDP ratio has continued to decline since high inflation has increased the nominal size of GDP. However, the most recent forecast from Eesti Pank shows indebtedness increasing in the coming years. Faster growth in debt than in the economy means that the non-financial sector will have to cope with an increased loan burden. If the macroeconomic circumstances should unexpectedly and sharply deteriorate, there could be problems in repaying loans that could be made worse by the earlier rapid growth in borrowing. It is consequently necessary to raise the countercyclical capital buffer to ensure that the banks have large capital reserves to cover the accumulated risks.

The yearly rate of growth in the debt of the non-financial sector continued to accelerate in the second quarter of 2022.

The debt of the non-financial sector was up 9.3% over the year in the second quarter, which is the fastest growth seen for eight years. The yearly rate of growth in debt was however still slower than that in nominal GDP. Inflation has made nominal GDP very volatile, and it is reasonable to compare the growth in debt not only to current economic growth, but also to long-term economic growth. 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. Revised data from the financial account show that the growth in debt in

Estonia has exceeded the 6-7% long-term nominal growth in GDP for three consecutive quarters, which indicates an increase in the risks coming from the financial cycle in Estonia (see Figure 1). The Eesti Pank September forecast expects moving forward that the yearly growth in debt will exceed the growth in both long-term and current nominal GDP in the years ahead.

Figure 1. Forecast for annual growth of non-financial sector debt and nominal GDP



Both corporate and household debt liabilities have grown fast. The debt of companies and households was more than 9% larger in the second quarter than it was a year earlier. The growth in corporate bank loans and in housing loans to households exceeded 11%, and both contributed equally to the growth in non-financial sector debt (see Figure 2). Banking statistics show that the rate of growth accelerated further in the third quarter, and yearly growth in housing loans and corporate loans was over 12% at the end of September.

Despite the rapid growth in debt, the indebtedness of the non-financial sector continued to decline in the second quarter of 2022. Strong nominal growth in the economy has helped the Estonian non-financial sector reduce its debt burden. Indebtedness came down to 109% by the end of the second quarter of 2022. It is still expected looking forward though that the slower growth in nominal GDP will see indebtedness stop declining and that it will start to increase again in the coming years.

The standardised credit-to-GDP gap calculated using the methodology of the Basel Committee on Banking Supervision was -11 percentage points at the end of the second quarter of 2022. The additional gap, which is also calculated by Eesti Pank, was -17 percentage points. The negative credit-to-GDP gap means that the credit-to-GDP ratio found with this methodology is currently lower than the long-term trend, and so the buffer guide is at 0%. The Eesti Pank September 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 (see Figure 3).

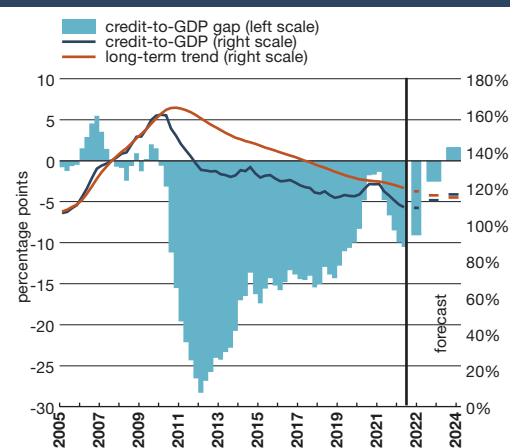
The strong capitalisation of the banking sector will help ensure smooth compliance with the buffer requirement. The capitalisation of the banking sector is currently strong with a CET1 ratio of 23% at the end of the second quarter of 2022, and it is supported by good profitability that is likely to increase in the near term as money market interest rates rise. All systemically important banks should be able to meet the additional buffer requirement from the own funds they hold voluntarily or from profits. This means there is no risk of a rise in the countercyclical capital buffer rate having a significant negative impact on the financing of the economy. The higher requirement will in any case come into force after a year, allowing the banks sufficient time to accumulate additional capital.

In summary, Eesti Pank has decided in the fourth quarter of 2022 to raise the countercyclical capital buffer rate from 1% to 1.5% because of the increased cyclical risks. The requirement will apply from 1 December 2023. The countercyclical capital buffer rate needs to be raised because the growth in debt has increased significantly in Estonia since the final quarter of 2021, and so the cyclical risks to financial stability in Estonia have increased. The yearly rate of growth in the debt of the non-financial sector increased to 9% by the end of the second quarter of 2022, which is faster than the long-term nominal growth of 6-7% in the economy. Data from the financial account show that

Figure 2. Contributions to yearly growth in the debt of the non-financial sector



Figure 3. Standardised credit-to-GDP gap



the growth in debt in Estonia has exceeded long-term nominal growth in GDP for three consecutive quarters, which indicates that the increase in the risks coming from the financial cycle is permanent in nature. The rapid growth in nominal GDP caused by high inflation is leading the indebtedness of the non-financial sector shown in the debt-to-GDP ratio to decline, but it is expected looking forward though that the slower growth in nominal GDP will see indebtedness stop declining and that it will start to increase again in the coming years. If the macroeconomic circumstances should unexpectedly and sharply deteriorate, there could be problems in repaying loans that could be made worse by the earlier rapid growth in borrowing. It is consequently necessary to raise the countercyclical capital buffer to ensure that the banks have large capital reserves to cover the accumulated risks.

It must be remembered though that there is great uncertainty for the coming year about how the credit market in Estonia will develop, as the international economic climate is uncertain. If the Estonian economy were to deteriorate so far that there was a sharp increase in loan losses or serious stresses in financing, Eesti Pank could review its decision to raise the buffer requirement.