THE COUNTERCYCLICAL CAPITAL BUFFER RATE

EESTI PANK'S ASSESSMENT OF THE COUNTERCYCLICAL CAPITAL BUFFER RATE (Q1 2024)

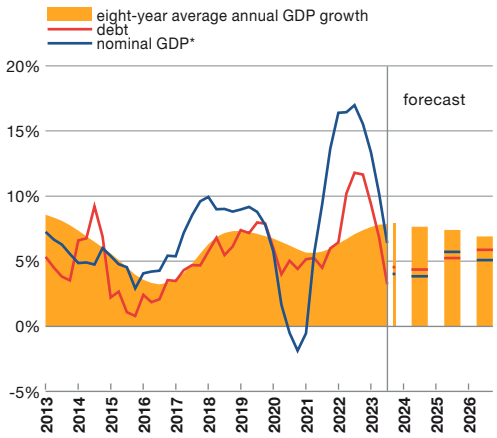
Eesti Pank raised the countercyclical capital buffer rate to 1.5% because of the risks that followed from the rapid growth in credit in 2021-2022. The new rate started to apply from 1 December 2023. Although borrowing has now eased off in Estonia, it is still necessary to maintain the buffers to protect against the risks that accumulated earlier.

- The applicable countercyclical capital buffer rate: **1.5%**
- The standardised credit-to-GDP ratio: **108%**; its deviation from the long-term trend: **–8 percentage points**
- The buffer guide: **0%**

The reasoning for the buffer rate. The yearly rate of growth in the debt of the non-financial sector slowed to almost 3% by the end of the third quarter of 2023. The growth in debt has slowed and is now below both the long-term rate of growth in the economy and the current nominal rate, but the rapid growth in credit in 2021 and 2022 meant that there are still reasons to consider that the risks from the financial cycle remain present in Estonia. If the recession should continue, there could be larger problems in repaying loans. It is consequently necessary 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 slowed further in the third quarter of 2023. The debt of the non-financial sector grew by 3.2% over the year in the third quarter, which was a slower rate than that of nominal GDP growth for the current 12 months, and than long-term[1] nominal growth. Part of the reason that growth in debt slowed was a statistical adjustment, without which the growth in debt in the third quarter would have been 4.8%. Growth in debt has fallen for four consecutive quarters and has remained slower than that in long-term nominal GDP in recent months, which indicates that the risks coming from the financial cycle have stopped accumulating in Estonia. The Eesti Pank December forecast expects that the growth in debt will start to accelerate and investment will start to increase in 2025 (see Figure 1).

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



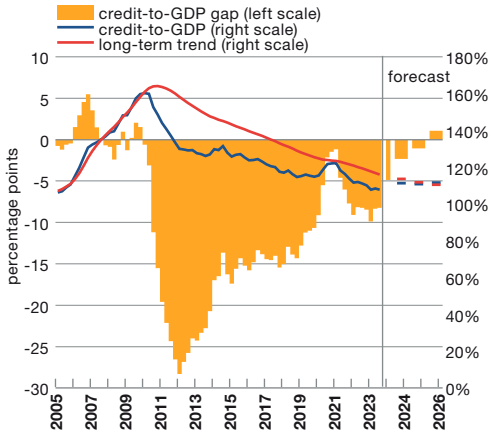
* Four-quarter moving average yearly GDP growth
Sources: Eesti Pank, Statistics Estonia

As economic activity has faded, so indebtedness, or the debt-to-GDP ratio, has fallen further. Debt grew more slowly than nominal GDP in the third quarter, which reduced indebtedness further. Indebtedness is forecast to remain relatively stable in the next three years (see Figure 2).

Borrowing activity has declined since the first half of 2023 because of the high levels of uncertainty and the worse outlook for the economy. Banking statistics show that companies and households took some 6% less in new loans in the third quarter and 5% less in the fourth than they did in the same quarters of the previous year. Borrowing activity dropped most for households taking housing loans, as the amount taken in such loans in the fourth quarter was 16% less than a year before. Reduced borrowing activity is also evident in the slower rate of yearly growth in the loan portfolio. The

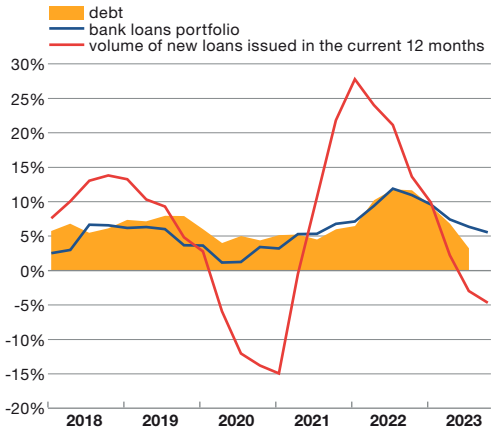
1 In assessing the countercyclical capital buffer requirement, Eesti Pank uses average nominal GDP growth over the past eight years as long-term GDP growth, which helps smooth the short-term volatility in the rate of growth.

Figure 2. Standardised credit-to-GDP gap



Sources: Statistics Estonia, Eesti Pank

Figure 3. Annual growth of non-financial sector debt and bank loans



Source: Eesti Pank

yearly growth in the loan portfolio of the non-financial sector fell to 6% by the end of December 2023 (see Figure 3).

The standardised credit-to-GDP gap calculated using the methodology of the Basel Committee on Banking Supervision was -8 percentage points at the end of the third quarter of 2023. The additional gap, which is also used by Eesti Pank, was -12 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 December forecast predicts that moving forward the credit-to-GDP gap will start to narrow gradually, and will become positive by the end of 2026 (see Figure 2).

The assessment of Eesti Pank in March 2024 is that although the growth in debt has slowed, the risks coming from the credit cycle remain in Estonia because of the fast growth in credit in 2021-2022. To reduce those risks, Eesti Pank raised the countercyclical capital buffer rate in November 2022, and the rate of 1.5% started to apply from 1 December 2023. As borrowing activity has declined and credit growth has slowed, the danger of cyclical risks building up further in future has eased. The risks remain though and so it is still necessary to maintain the buffers.