THE COUNTERCYCLICAL CAPITAL BUFFER RATE

EESTI PANK'S ASSESSMENT OF THE COUNTERCYCLICAL CAPITAL BUFFER RATE (Q3 2024)

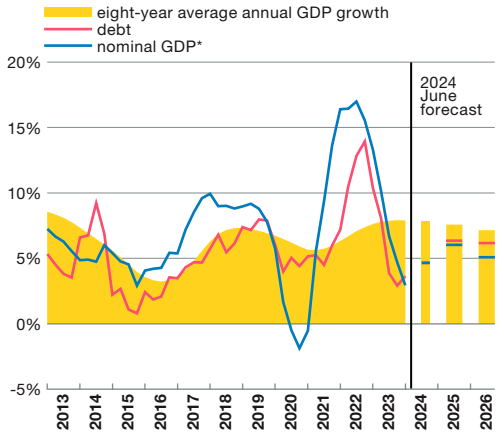
Eesti Pank raised the countercyclical capital buffer rate to 1.5% to strengthen the resilience of the banks because of the risks that followed from the rapid growth in credit in 2021-2022. The new rate started to apply from 1 December 2023. Although growth in debt has now eased off in Estonia, it is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

The reasoning for the buffer rate. The growth in borrowing by the non-financial sector has been moderate in the past year and the danger of cyclical risks building up has eased. Although the slower growth in debt in numerical terms in comparison to long-term nominal GDP has reduced the buffer benchmark rate to 1%, the share of overdue and non-performing loans in the loan portfolios of the banks has increased further, and so there remains the risk of loan losses occurring. This makes it currently justified for the banks to continue to hold a 1.5% countercyclical capital buffer to cover the realisation of this risk.

- The applicable countercyclical capital buffer rate: **1.5%**
- The gap between the growth in debt and the growth in long-term nominal GDP: **–4 pp**
- The debt-to-GDP ratio: **110%** (change in the quarter –0.1 pp, change over the year +0.7 pp)
- The buffer benchmark rate: **1%** (including the cyclical component 0%)

The yearly growth in the debt of the non-financial sector was 3.6% in the first quarter, which was a slower rate than the long-term average growth of 7.9% in nominal GDP. The growth in the debt of the non-financial sector has been slower than the long-term growth in nominal GDP for three consecutive quarters now, indicating that the risks from the financial cycle have stopped accumulating in Estonia[1]. The June economic forecast from Eesti Pank expects the rate of growth in debt to pick up again this year, though it will remain quite moderate in comparison to the long-term growth in nominal GDP in the coming years (see Figure 1).

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



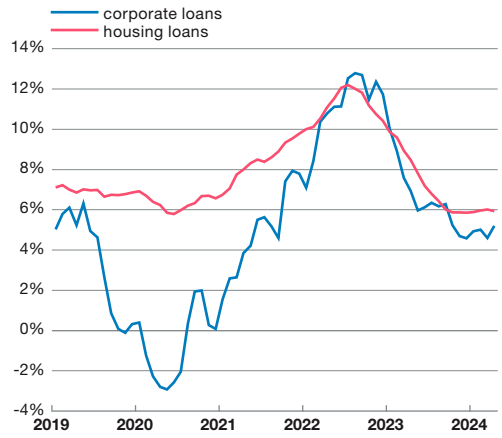
* Four-quarter moving average yearly GDP growth
Sources: Eesti Pank, Statistics Estonia

The indebtedness of the non-financial sector in the first quarter of 2024 was essentially unchanged. The indebtedness of the non-financial sector, or the debt-to-GDP ratio, has remained around 110% for the past four quarters. The Eesti Pank June forecast expects that indebtedness will start to increase again gradually in the coming years as debt grows faster than nominal GDP, and it is forecast to be around 112% by the end of 2026.

Borrowing activity in the whole non-financial sector has been more subdued than a year ago. Banking statistics show that companies and households took some 1% less in new loans in the first quarter of 2024 and 2% less in the second than they did in the same quarters of last year. It has primarily been companies that have reduced their borrowing activity, as they took 5% less in new loans in the second quarter of 2024 than they did a year earlier. At the same time, around 11% more was issued in

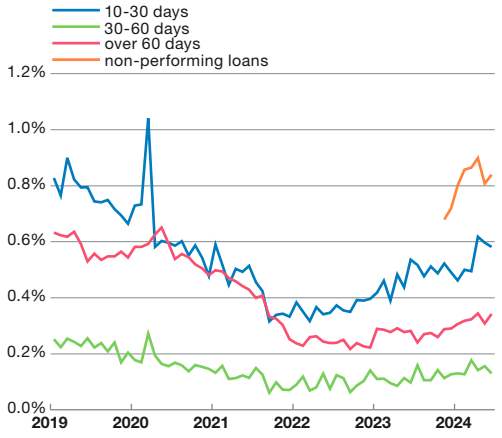
1 In assessing the countercyclical capital buffer requirement, Eesti Pank uses average nominal GDP growth over the past eight years as long-term GDP growth, which helps smooth the short-term volatility in the rate of growth.

Figure 2. Annual growth of corporate loans and housing loans



Source: Eesti Pank

Figure 3. Share of overdue loans in the loan portfolio of banks



Source: Eesti Pank

new loans to households in the second quarter than a year earlier. The yearly growth in the portfolio of corporate loans and housing loans to households remained at around 5-6% in the first half of the year (see Figure 2).

The standardised credit-to-GDP gap calculated using the methodology of the Basel Committee on Banking Supervision was -5 percentage points at the end of the first quarter of 2024. The additional gap, which is also used by Eesti Pank, was -10 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 found using the Basel methodology is at 0%. The Eesti Pank June forecast predicts that moving forward the credit-to-GDP gap will gradually start to narrow, and will become positive by the end of 2026.

The share of loans in the loan portfolios of the banks that were not paid on time increased in the second quarter of 2024 as the recession in the economy continued beyond two years. The share of loans in the portfolios of the banks that were overdue by more than 60 days at the end of June 2024 reached 0.3% (see Figure 3), and the share of non-performing loans reached 0.8%. This is not a high level in historical terms, but it still indicates that there are more borrowers facing difficulties with servicing their loans than there were two years ago. Current trends do not give any reason to think that the problems in repaying loans have already eased, and so there remains a risk of loan losses occurring.

In summary, the estimate of Eesti Pank in September 2024 is that the danger of cyclical risks accumulating further has diminished, but there remains the threat in the current economic climate of loan servicing deteriorating further and so of the loan losses of the banks increasing. This makes it justified for the banks to continue to hold a 1.5% countercyclical capital buffer moving forwards.