THE COUNTERCYCLICAL CAPITAL BUFFER RATE

EESTI PANK'S ASSESSMENT OF THE COUNTERCYCLICAL CAPITAL BUFFER RATE (Q4 2024)

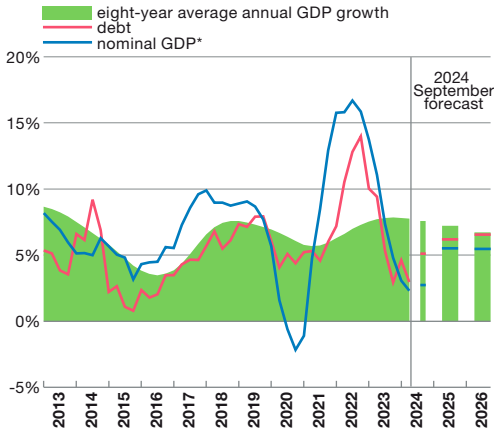
Eesti Pank raised the countercyclical capital buffer rate to 1.5% to strengthen the resilience of the banks because of the risks that followed from the rapid growth in credit in 2021-2022. The new rate started to apply from 1 December 2023. Although growth in debt has now eased off in Estonia, it is 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 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: **–5 pp**
- The debt-to-GDP ratio: **111%** (change in the quarter +1.1 pp, change over the year +0.7 pp)
- The buffer benchmark rate: **1%** (including the cyclical component 0%)

The growth in the debt in the non-financial sector has remained quite modest in the past 12 months. Non-financial sector debt was 3% larger in the second quarter of 2024 than it was a year earlier (see Figure 1). The growth in corporate and household debt has been slower in the past four quarters than the 7.7% long-term growth in nominal GDP[1], which indicates that the risks from the financial cycle have by now clearly stopped accumulating. The September 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.

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



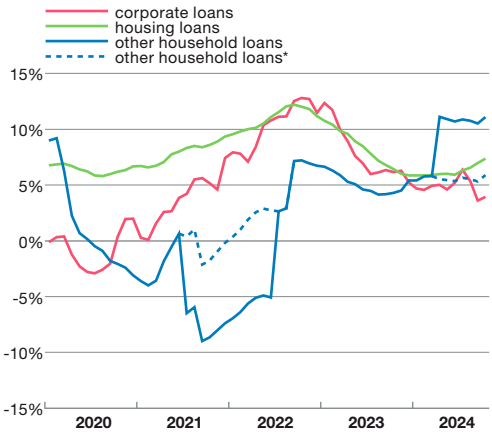
* Four-quarter moving average yearly GDP growth
Sources: Eesti Pank, Statistics Estonia

Slower growth in current nominal GDP has technically caused indebtedness to grow. By the end of June 2024 the indebtedness of the non-financial sector was 0.7 percentage point higher than a year previously and was almost 111%. That indebtedness has increased over the year and over the past quarter does not indicate though that the financial cycle is in an upswing, as the actual growth in debt has been trending downwards for some time now. The Eesti Pank September forecast expects that indebtedness will continue to increase over the next two years.

There has been no particular change in the yearly rate of growth in the portfolio of bank loans to the non-financial sector from a year previously. Different segments have developed differently however. Yearly growth in the corporate loan portfolio slowed to 4% by the end of October 2024, but that in the loan portfolio to households started to grow faster in the second half of the year with support from housing loans (see Figure 2), and it reached 8% at the end of October.

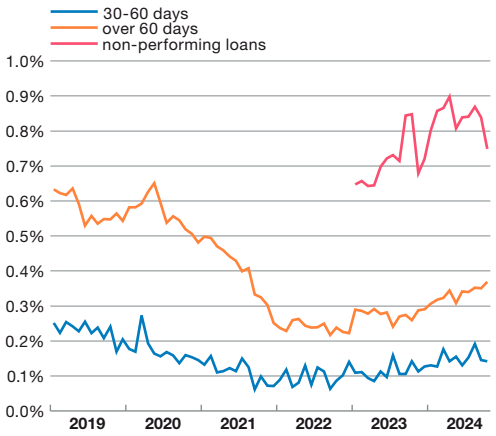
1 In assessing the countercyclical capital buffer requirement, Eesti Pank uses average nominal GDP growth over the past eight years as long-term GDP growth.

Figure 2. Annual growth of corporate and household loans



*adjusted for structural changes
Source: Eesti Pank

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



Source: Eesti Pank

The standardised credit-to-GDP gap calculated using the methodology of the Basel Committee on Banking Supervision was -2 percentage points at the end of the second quarter of 2024. The additional gap, which is also used by Eesti Pank, was -7 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 benchmark rate is at 0%. The Eesti Pank September forecast predicts that the credit-to-GDP gap will narrow moving forward, and it will become positive by the end of 2025.

The quality of the loan portfolio is a little worse than it was a year ago. The share of loans in the loan portfolios of the banks that were not paid on time continued to increase in 2024 as the recession in the economy lasted 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 October 2024 reached 0.4% (see Figure 3), and the share of non-performing loans reached 0.7%. This is not a high level in historical terms, but it still indicates that the weakness in the economy and high base interest rates have made it harder for some borrowers to repay their loans. The risks that accumulated during the upswing of the credit cycle could amplify the problems with repaying loans caused by the recession, and so it is important that assessment of the adequacy of the capital buffer monitor the dynamics of the growth in overdue loans.

In summary, the estimate of Eesti Pank in December 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.