THE COUNTERCYCLICAL CAPITAL BUFFER RATE

EESTI PANK'S ASSESSMENT OF THE COUNTERCYCLICAL CAPITAL BUFFER RATE (Q1 2025)

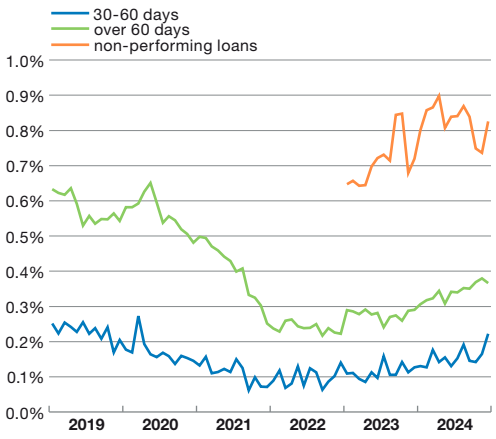
Eesti Pank raised the countercyclical capital buffer rate to 1.5% to strengthen the resilience of the banks because of the risks that followed from the rapid growth in credit in 2021-2022. The new rate started to apply from 1 December 2023. Eesti Pank considers it appropriate in the first quarter of 2025 to keep the countercyclical buffer rate at 1.5%.

The reasoning for the buffer rate. The growth in the debt of the non-financial sector has been slower in the past five quarters than the long-term growth in the economy, but it would be premature to reduce the capital buffer requirement as the volume of overdue loans has increased further. The growth in debt accelerated sharply in the third quarter of 2024, and the strong growth in bank loans in the final months of the year points to the risk that growth in debt may have exceeded the long-term average nominal growth in the economy in the fourth quarter. Looking forwards, it will only be possible to cut the countercyclical capital buffer requirement to the base level of 1% in 2025 if the macroeconomic indicators improve, there is no further increase in the volume of overdue loans, and growth in debt does not accelerate to a level where it causes a new increase in cyclical risks.

- The applicable countercyclical capital buffer rate: **1.5%**
- The gap between the growth in debt and the growth in long-term nominal GDP: **–0.7 pp**
- The debt-to-GDP ratio: 114% (change in the quarter **+2.4 pp**, change over the year **+4.6 pp**)
- The buffer benchmark rate: **1%** (including the cyclical component of **0%**)

The quality of the loan portfolio has deteriorated further. 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 reached 0.4% at the end of 2024, and the share of non-performing loans reached 0.8% (see Figure 1). This is a low level in historical terms, but the increase in the volume of loans overdue still indicates that there are more borrowers facing difficulties with servicing their loans than there were two years ago, which could cause the loan losses of the banks to increase. As long as the volumes of overdue and non-performing loans are increasing, the danger will remain that the risks from the rapid growth in lending a few years ago could amplify the loan losses of the recession.

Figure 1. Share of overdue loans in the loan portfolio of banks

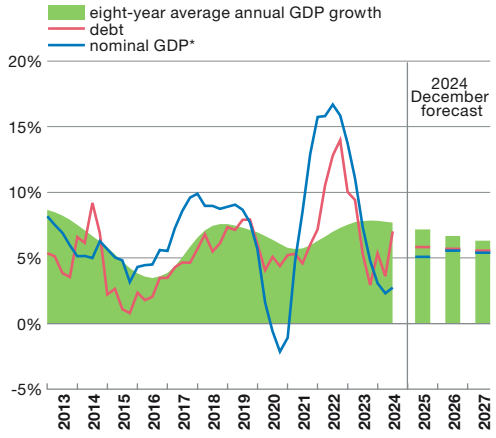


Source: Eesti Pank

The growth in the debt of the non-financial sector increased sharply in the third quarter of 2024. The yearly growth in the debt was 3.6% at the end of June 2024, but by the end of the third quarter it had increased to 7%. The growth in debt was still lower than the long-term[1] nominal growth in GDP of 7.7% (see Figure 2), and so one of the main indicators used by Eesti Pank for assessing cyclical risk remained negative in the third quarter. The growth in debt may however have been faster than that in long-term GDP at the end of 2024 because there was a notable rise in the rate of yearly growth in the portfolio of bank loans, which provide the largest part of the debt of the non-financial sector. The yearly growth in bank loans

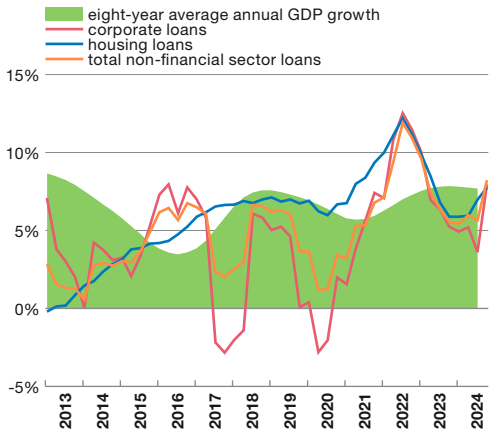
1 In assessing the countercyclical capital buffer requirement, Eesti Pank uses average nominal GDP growth over the past eight years as long-term GDP growth.

Figure 2. Forecast for annual growth of non-financial sector debt and nominal GDP



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

Figure 3. Annual growth of the non-financial sector loan portfolio and average long-term nominal GDP



Sources: Eesti Pank, Statistics Estonia

to the non-financial sector accelerated to 8.2% at the end of 2024, which was a higher figure than that for long-term nominal GDP growth (see Figure 3). Yearly growth was fast for corporate loans at 8%, and also for housing loans to households at 7.8%.

The rapid growth in the debt of the non-financial sector increased indebtedness. By the end of September 2024 the indebtedness of the non-financial sector was 4.6 percentage points larger than a year previously at almost 114%. Indebtedness grew during the Covid-19 pandemic in the second half of 2020 for technical reasons because nominal GDP shrank, but the growth now in indebtedness in the non-financial sector comes from the debt growing. It was a decade ago that indebtedness last grew so fast because of the growth in debt. The December 2024 forecast from Eesti Pank shows indebtedness increasing in the coming years.

The standardised credit-to-GDP gap calculated using the methodology of the Basel Committee on Banking Supervision turned positive in the third quarter of 2024 for the first time in a long time because of the growth in indebtedness. The gap was -2 percentage points in the second quarter of 2024, but by the end of the third quarter it had become 1 percentage point. This indicator does not adequately show the risks coming from changes in the financial cycle because the time series for it is short. It was also distorted a lot by the large credit boom of 2005–2007 and the deep recession that followed.

Overall Eesti Pank considers in March 2025 that although the rate of growth in the debt of the non-financial sector was slower in the third quarter of 2024 than long-term growth in the economy, it would be premature to lower the countercyclical capital buffer now. This is because the volume of overdue loans has increased further. It should also be noted that the growth in debt accelerated sharply in the third quarter of 2024 and the growth in bank loans was strong in the final months of the year, which points to the risk that growth in debt may have exceeded the long-term average nominal growth in the economy in the fourth quarter. Looking forwards, it will only be possible to cut the countercyclical capital buffer requirement to the base level of 1% in 2025 if the macroeconomic indicators improve, there is no further increase in the volume of overdue loans, and growth in debt does not accelerate to a level where it causes a new increase in cyclical risks.