

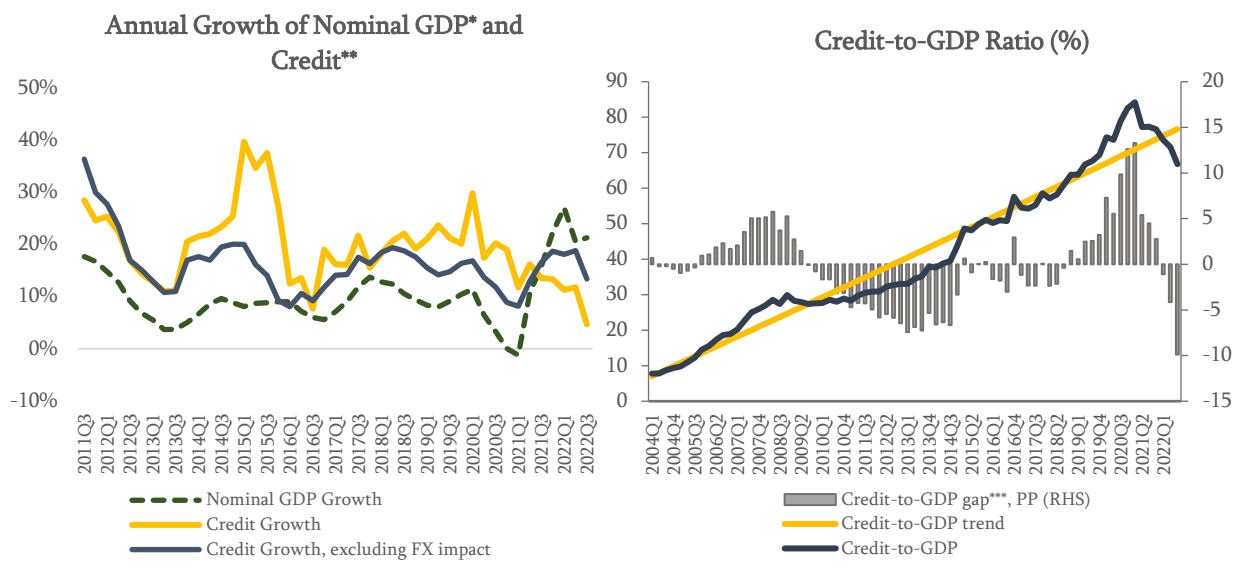


Financial Stability Committee's Decision

According to the [Basel Committee recommendation](#) the Financial Stability Committee of the NBG decided to revise the framework for setting countercyclical capital buffer. In order to accumulate capital buffers for periods of stress, Basel Committee suggested countries to set positive cycle-neutral countercyclical capital buffer. While under the current methodology a base rate for countercyclical capital buffer equals to zero and becomes positive in case of excess credit activity, a base rate for positive cycle-neutral countercyclical capital buffer is positive in normal periods as well (see the appendix to review the methodology). Increasing share of countries have already set positive buffer as their base rate. For such jurisdictions a base rate for positive cycle-neutral countercyclical capital buffer ranges from 1 to 2%. The National Bank of Georgia analyzes international experience about implementing positive cycle-neutral countercyclical capital buffer and will determine the size of the buffer on the next committee meeting.

Financial Stability Committee believes that it is important for the financial sector to accumulate capital buffers in the period of high economic growth in order to use them in the periods of stress and decided to leave the countercyclical capital buffer unchanged, at 0%, until the revised framework is officially adopted. Currently, credit activity remains at sustainable level, financial indicators of banks are improved, economic growth remains at high level, while the tendency of rising house price and rent is depicted on the real estate market. Considering current conditions, financial stability committee finds it important for the financial sector to accumulate capital buffers and use them in the periods of stress, as happened in the beginning of the pandemic. Taking into account risks coming from the current regional situation, capital buffers will help banks mitigate risks and, in the periods of stress, it will promote smooth lending and fast economic recovery.

Financial Sector remains resilient and continues smooth lending to the economy. During 2022, the quality of banking sector assets, profitability and capital and liquidity ratios improved, which allowed banks to recover capital buffers before the date set by the NBG. It should be noted that, as a result of implemented measures during the year and tightened monetary policy, credit activity slowed down. In October 2022, the annual growth rate of credit portfolio, excluding the exchange rate effect, declined by 1.5 percentage points compared to August and amounted to 13.8%. The Credit-to-GDP ratio decreased during the last one year, which reflects the impact of high economic growth and exchange rate appreciation. Consequently, in the third quarter of 2022, the Credit-to-GDP ratio is below its long run trend. However, existing level of the Credit-to-GDP ratio is comparable to peer countries.



Source: NBG; Geostat

* Nominal GDP growth reflects the YoY GDP growth of the last 4 quarters.

** Credit includes loans directly issued by commercial banks and microfinance institutions as well as bonds issued domestically by the non-financial sector.

*** Credit-to-GDP gap is the deviation of Credit-to-GDP ratio from its long-run trend. The trend is estimated using HP filter in line with the Basel recommendations

The National Bank of Georgia continues monitoring the country's financial stability and assessing domestic and foreign risks. If necessary, it will use all available instruments to minimize the possible risks.

The Financial Stability Committee's next meeting will be held on March 15, 2023.

Appendix: A Revised Framework for the Countercyclical Capital Buffer

Countercyclical capital buffer (CCyB) is a constituent part of the Basel III framework, and one of the key macroprudential policy instruments. It aims to limit excessive lending to the economy that leads to an increase in systemic risks. This is achieved by increasing the countercyclical buffer rate during periods of excess lending. During adverse shocks, the countercyclical buffer should help the financial system not to sharply restrict lending to the economy and thereby not to further deteriorate the position of both the financial sector and the economy as a whole. This is achieved by fully or partially reducing the countercyclical buffer during stressful periods.

Although the countercyclical buffer was initially intended for stress periods following excessive lending, in practice the easing of this buffer was due to shocks of a completely different nature, pandemic and other events.

Table 1. Countercyclical buffer requirement

	set/announced		During COVID-19 pandemic		After COVID-19 pandemic ⁴
Belgium ^{1,5}	0.50%	↓	0.00%	→	0.00%
Germany ^{1,5}	0.25%	↓	0.00%	↑	0.75%
The United Kingdom ²	2.00%	↓	0.00%	↑	2.00%
Luxembourg ¹	0.50%	→	0.50%	→	0.50%
Netherlands ¹	0.00%	↓	0.00%	↑	1.00%
France ¹	0.50%	↓	0.00%	↑	0.50%
Switzerland ²	2.00%	↓	0.00%	↑	2.50%
Sweden ¹	2.50%	↓	0.00%	↑	2.00%
Hong-kong ²	2.50%	→	1.00%	→	1.00%
Bulgaria ³	1.50%	→	0.50%	↑	2.00%
Denmark ³	2.00%	↓	0.00%	↑	2.50%
Ireland ³	1.00%	↓	0.00%	↑	0.50%
Iceland ³	2.00%	↓	0.00%	↑	2.00%
Lithuania ³	1.00%	↓	0.00%	↑	1.00%
Norway ³	2.50%	→	1.00%	↑	2.50%
slovakia ³	2.00%	→	1.00%	↑	1.50%
Chzech ³	2.00%	→	0.50%	↑	2.50%
Croatia ³	0.00%		0.00%	↑	0.50%
Estonia ³	0.00%		0.00%	↑	1.00%
Hungary ³	0.00%		0.00%	↑	0.50%
Romania ³	0.00%		0.00%	↑	1.00%

Table footnotes

¹ BCBS and EU member countries

² BCBS member countries

³ EU member countries

⁴ includes both active and announced buffers

⁵ countries that had only announced positive CcyB buffers before pandemic

Before the COVID-19 pandemic, only eight of the member countries of the Basel Committee on Banking Supervision (BCBS) had introduced or announced positive countercyclical buffers, ranging from 0.25% to 2.5%. In addition, eight countries out of the member states of the European Union (EU), who are not members of the BCBS at the same time, had established a positive countercyclical buffer (see Table 1).

Several countries have introduced a countercyclical buffer framework focused on sectoral risks. For example, Switzerland has used a countercyclical buffer to mitigate specific sectoral risks and set a requirement for risk positions secured by local real estate. A similar approach is adopted in the Spanish legislative framework, although in Spain they have not yet established a positive sectoral countercyclical buffer. In response to similar risks, Germany and Belgium set systemic risk buffers for their respective risk positions. However, the systemic risk buffer, unlike the

countercyclical buffer, is not subject to automatic reduction during shock.

In response to the COVID-19 pandemic, seven out of the eight BCBS member states that had declared a positive countercyclical buffer have fully or partially reduced it, while all eight of the EU member states which are not members of the BCBS, have fully or partially reduced the countercyclical buffer.

The main goal of the supervisory authorities to ease the countercyclical buffer was to allow banks to lend to the economy smoothly. Since the end of the pandemic, five of the seven BCBS member countries already increased or announced an increase in the countercyclical buffer. An additional four countries out of the EU member states increased or announced an increase in the countercyclical buffer.

It is also important to look at the methodology of setting the countercyclical buffer proposed by Basel Committee before the pandemic. In determining of the countercyclical buffer, supervisory authorities of various countries, including the National Bank of Georgia (NBG), use the Credit to GDP ratio proposed by Basel III and the relevant indicators of its deviation from the long-term trend and many other measures, such as credit trends, other indicators of the cyclical position of the financial sector, and characteristics of the country's internal and external macro-financial environment. Moreover, instead of a mechanical and automated approach, they rely on expert judgments. The pandemic has shown the need for countercyclical buffers. However, before the pandemic, some countries did not have countercyclical buffers in place, because indicators did not clearly, or at all, point to the need to increase capital. In addition, the collection and analysis of the necessary data tends to lag. The recommendation of the Basel Committee is that if a positive countercyclical buffer is set, banks are given a-12 month period to comply with this norm. Consequently, the enactment of the positive countercyclical buffer may be lagged.

The current positive cycle-neutral countercyclical buffer proposed by the Basel Committee¹ serves to eliminate the above shortcomings. It is a time-varying buffer that could be lowered during the stressful circumstances that is not related to preceding credit growth. This methodology also mitigates risks such as measurement problems (related to variables), delays in information collection and, accordingly, delayed response by the supervisory authority.

If the default level of the standard countercyclical buffer is equal to zero, which will take a positive value if the Credit-to-GDP ratio deviates from the long-term trend, the default level of the positive cycle-neutral countercyclical buffer should be positive under normal circumstances. The total rate of the countercyclical buffer is obtained by adding two components:

$$CCyB_{total} = CCyB_{neutral} + CCyB_{cyclical}$$

¹ Buffer usability and cyclicity in the Basel framework, October, 2022 - <https://www.bis.org/bcbs/publ/d542.pdf>

whereas, $CCyB_{neutral}$ – denotes neutral level of the countercyclical capital buffer, that has a positive value under normal conditions, i.e. even after the post-crisis economic recovery is completed, when there is no excess credit activity, banking system asset quality is improved, profitability is stable, and current economic trends are positive. On the other hand, $CCyB_{cyclical}$ – denotes cyclical buffer level, which can be determined in accordance with the increase in cyclical risks against the background of excess growth of loans. Cyclical risks include, for instance, an increase in over-indebtedness, the formation of asset price bubbles, overheating of the economy, and other risks.

A growing number of countries, such as Australia, the Netherlands, Sweden, the United Kingdom, Hong Kong, Estonia, Lithuania and Ireland, have started to introduce a positive buffer as a default level. The default level of the positive cycle-neutral countercyclical buffer for these countries varies between 1% and 2%. Some countries have reduced, to some extent, other buffers or requirements when introducing a neutral positive rate, while others have not done these reductions.

During the COVID-19 pandemic, most countries, that have set a positive countercyclical buffer requirement, reduced it immediately after the pandemic began, while others reduced non-countercyclical capital requirements and/or encouraged banks to use a combined buffer. That is to say, the pandemic has shown the need for countercyclical buffers, the release of which would allow banks to continue their activities during stressful periods without additional restrictions, thus supporting lending to the economy. While the countercyclical buffer framework does not provide for automatic restrictions on capital distribution, depending on the severity of the shock, supervisory authorities may exercise discretion and impose certain restrictions on capital distribution.

Since the onset of the COVID-19 pandemic, the Basel Committee and local supervisors have encouraged banks to use soft or non-binding capital buffers such as conservation buffers, systemic risk buffers and Pillar 2 guideline requirements (P2G). The need to use these buffers was more evident in the countries who had not established a positive countercyclical buffer before the pandemic. For instance, Austria recommended banks to use buffers set for systemic risks and other systemically important banks (O-SII). Estonia reduced the systemic risk buffer from 1% to 0%. Finland reduced the systemic risk buffer and capital requirements set for banks individually.

Per NBG instruction, commercial banks could temporarily eliminate their conservation buffer and a portion of the Pillar 2 requirement (in the amount of 2/3 of the unhedged currency credit risk buffer). This was equivalent to a 4.1% reduction in the system-wide regulatory capital requirement. The purpose of this was to neutralize potential losses and promote lending to the economy. Hence, while banks were using the lowered capital requirements they were restricted on distribution of capital, payment of bonuses, etc.

However, the practice has shown that majority of banks avoid operating within combined buffer². The reason for this may be uncertainties related to expected losses: in shock times, banks prefer to maintain buffers to cushion potential losses, as opposed to increased lending.

The parallel MREL³ and TLAC⁴ leverage requirements is another reason in international practice, why banks avoid operating within combined capital buffers. The leverage requirement is not a limiting factor for the Georgian banking sector, where the average weight of risk-weighted assets is higher compared to developed countries. Although the resolution framework is in place, the TLAC and MREL requirements have not yet been implemented. Hence, operating within combined buffers, for the Georgian banking sector, is associated with restrictions on capital distribution.

However, the main reason for banks to strive to keep their capital adequacy ratios above their total capital requirements, including combined buffers, is due to capital distribution constraints and the stigma associated with buffer violations.

Although the combined buffers are not strict in nature and the Basel capital adequacy framework allows for a proportional restriction on capital distribution when violation occurs, only eight of the member countries of the Basel Committee on Banking Supervision have applied this proportional approach. The rest of the countries, for violations of the combined buffer, completely prohibit the distribution of capital, using the automatic limitation mechanism integrated in related regulations or supervisory discretion. Currently, whenever the combined buffer is breached the NBG's capital adequacy requirements framework provides for the automatic restrictions on capital distribution.

Therefore, to continue lending to the economy during shock periods, it is necessary for the banking system to have buffers that can be reduced, and banks will not be forced to voluntarily violate soft buffers.

² Combined buffer – sum of capital conservation, countercyclical and system buffer requirements.

³ Minimum requirement for own funds and eligible liabilities

⁴ Total loss-absorbing capacity