EUROPEAN CENTRAL BANK
EUROSYSTEM

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COUNTERCYCLICAL CAPITAL BUFFER – POSITION OF THE EUROSYSTEM ON THE COMMISSION'S CONSULTATION DOCUMENT

This document provides the Eurosystem's replies on the Consultation Document by the European Commission on its Countercyclical Capital Buffer (CCB) proposal.[1] The position is based on two main principles: first, the CCB is considered to be an important element of a wider macro-prudential policy framework. Therefore, the buffering mechanism should be designed and calibrated so as to become an effective policy measure in promoting financial stability and enhancing the resilience of the financial system in periods when excessive credit growth is associated with the build-up of systemic risk. Second, the CCB should play a role in promoting a single market for financial services in the EU. This principle calls for a harmonised implementation among Member States in order to ensure a level playing field for internationally active banks and banking groups. In this context, the European Systemic Risk Board (ESRB) and the European Banking Authority (EBA) should play a key role in ensuring consistent and effective implementation of the CCB across Member States.

Question 1. Could the general orientations indicated above foster a build-up in bank capital in good times and facilitate its release in bad times? Would you prefer the approach to determining the bank-specific buffer add-on as set out in paragraph 12, or would you prefer the alternatives set out under A and B? Please give reasons for your answer.

As a general principle, the Eurosystem supports the work carried out by the Basel Committee on Banking Supervision with regard to the development of a CCB mechanism as a new macro-prudential policy tool. In this context, it is important to ensure that the implementation of the CCB in the EU is closely aligned with the Basel Committee's proposal in this field.

Against this background, the approach set out in paragraph 12 of the Consultation Document is considered as the most favourable from the perspective of achieving the policy objective of strengthening the resilience of the banking system. In particular, by focusing on exposures on an "ultimate risk basis" rather than on a "place

[1] The Eurosystem's reply, which benefited from observations of the members of the General Council, aims to help the Commission to formulate an appropriate legislative proposal in the context of the revision of the Capital Requirements Directive (CRD). It should, however, not prejudge individual country positions. Importantly, member states will express their views on particular topics when the draft legislative proposal on CRD will be issued for consultation.

of booking basis”, this approach is best suited for aligning the outcome of the buffering mechanism with the policy objective and ensuring its credibility.

The proposed credit-to-GDP gap indicator and the methodology to be applied for the calculation of the buffer guide would represent the appropriate starting reference point. However, various analyses carried out by the Basel Committee, the European Central Bank and other stakeholders revealed that the credit-to-GDP gap indicator may have certain drawbacks and may thus not transmit the right signals in all circumstances concerning the build-up and release of the buffer. In this regard, the proposal by the Basel Committee not to apply the benchmark mechanically is supported. The buffer guide should be accompanied by other indicators of systemic risk both of a national and international origin. These indicators should be meaningful in the context of informing authorities in their decisions whether and when banks should build-up or release capital buffers. (See answers to Q 2-6 and Q 11 for further details.)

The alternative approaches under A and B (paragraphs 21-25 of the Consultation Document), would, in contrast, not align the outcome of the buffering mechanism with the policy objective and would also allow for significant regulatory arbitrage. (See also the answer to Question 2). These options are therefore not supported by the Eurosystem.

Question 2. Would the approach for dealing with internationally active banks set out in paragraphs 12 to 20 help to ensure a level playing field between domestic and foreign banks? Is there a significant incentive for regulatory arbitrage, in that credit institutions may gain substantial benefits by booking exposures into jurisdictions with lower capital add-ons? Which of the three alternatives reduces the chances of regulatory arbitrage?

The approach in paragraphs 12 – 20 is consistent with the Basel Committee’s proposal for CCB, which, however, is expected to have different impacts on domestic and internationally active institutions. In particular, internationally active banks are, on average, expected to face a more stable buffer requirement over time, given the broad geographic diversification of their portfolios and the proposed weighting mechanism applied to the buffer add-ons. At the same time, domestically active banks will be exposed to the buffer requirements of their respective jurisdictions, which may either be higher or lower than the above mentioned “internationally weighted average”. Overall, the essence of the mechanism is that the buffer requirements will depend on the geographical orientation of banks’ portfolio, and not on the banks’ establishments that generate the exposures. In this regard, the Basel proposal for CCBs is neutral with respect to the nationality of the originating institution and thus ensures a level playing field for domestic and foreign banks.

Internationally active banks (irrespective of whether they are domestically or foreign owned) have more possibilities to decide whether they continue their business activities in the country which activated the counter-cyclical buffer or book (part of) their credit as an exposure in countries with a lower capital buffer

requirements.[2] In this regard, the ESRB and the EBA could play a role by issuing principles and supervisory standards for authorities that may help to mitigate the possible circumvention of the buffer mechanism (see also answers to question 6). From the perspective of the countries, the Basel Committee's proposal supports a system of reciprocal arrangements which, if implemented consistently, can go a long way to ensuring a level playing field.[3]

Concerning the alternative options A and B the Eurosystem is of the view that they provide for a substantial scope for regulatory arbitrage. In particular, given their focus on the originator institutions, banks with multiple branches throughout the EU can choose to book their credit in the country with the lowest capital buffer. As a result banks' capital buffers will not be related to the macroprudential conditions in the country in which their counterparty is located and banks will be building insufficient buffers against the risks building in that country. In such circumstances the action of policymakers in a country experiencing strong credit growth would not be credible in seeking to build resilience in the face of a possible downturn. In particular, while policy makers in that country could require domestic banks to hold more buffers (subject to any ceiling), branches of foreign banks could continue lending into the country at lower buffers. If banks faced different buffers on their credit exposures according to where they are located, the regulation would promote a very uneven playing field.

Question 3. Should the buffer requirement apply at a solo, sub-consolidated and consolidated basis (i.e. in accordance with the scope of application laid down in Articles 68 to 72 of 2006/48/EU)? Should supervisors be entitled to require credit institutions to hold the counter-cyclical buffer on a solo basis?

The buffer requirement should apply at a solo, sub-consolidated and consolidated basis, in accordance with the scope of application laid down in Articles 68 to 72 of Directive 2006/48/EU. This mechanism would ensure that a buffer is available at each level where a minimum capital requirement is applied, thus strengthening the resilience of the respective entities in periods of excessive credit growth. However, consistent with the capital treatment of the CRD, possible waivers at the solo level may be envisaged, provided the requirements at the consolidated level are met.

Question 4. Could a ceiling of 2.5% for the counter-cyclical buffer limit unduly the ability of national authorities to ensure the resilience of their banking system and constrain excessive credit growth? Please explain your views on the basis of expected costs and benefits.

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[2] This may happen when a bank has client which is internationally active through several subsidiaries across countries, applying different capital add-ons. In this case the originating bank may have the possibility to choose which of the subsidiaries of its client it may want to finance; the subsidiary may then in turn channel the funds received to other group entities.

[3] Another potential source of regulatory arbitrage is that exposures are booked in non-regulated entities, which are subject to no, or less onerous, regulatory capital requirements. This is, however, a more general challenge for financial regulation and not specific to the CCB only, and calls for a careful consideration of the perimeter of regulation.

The ceiling of 2.5% for the counter-cyclical buffer, which comes on top of the 2.5% capital conservation buffer, is seen by the Basel Committee and the Governors and Heads of Supervision (GHOS) as sufficient to ensure the resilience of the banking system. In particular, the analysis carried out by the Top-down Calibration Group of the Basel Committee shows that the maximum amount of the CCB, together with the capital conservation buffer, would have been adequate to absorb the mean/median losses in the past financial crises. Moreover, at its meeting on 12 September 2010, the GHOS also agreed on the tightening of the minimum capital requirements. In addition, further possible capital add-ons are still under discussion (e.g. additional capital requirement for systemically important financial institutions, SIFIs). Overall, the appropriateness of the calibration of the CCB should be assessed in conjunction with the other elements of the reform package, which, taken together, are expected to substantially strengthen the resilience of credit institutions.

This notwithstanding, the ceiling for the CCB might have certain drawbacks in cases when the excessive credit growth continues at a national level despite the application of the CCB. In such situations the ongoing credit expansion could raise concerns from a financial stability perspective, while, at the same time, the ceiling could unduly limit the powers of authorities to intervene. In these circumstances, the ceiling could create a conflict between the objective of CCB and the credibility of policymakers to take action. Therefore, in order to ensure that national supervisors have sufficient room for manoeuvre, it would be preferable in the specific case mentioned above to allow authorities to apply a higher CCB requirement for banks in their jurisdiction. In this case, however, it should be highlighted that – in accordance with the Basel rules text - the international reciprocity provisions apply to the countercyclical buffer only up to the maximum of 2.5%.

Overall, while the calibration of the CCB agreed by the GHOS may be sufficient to address “average” or “median” stress events, it may need to be supplemented by additional prudential measures to address “extreme” developments in the credit cycle. (See also comments on Question 11) The implementation of buffers above the ceiling, however, raises questions with regard to the reciprocal application the measure. In particular, a local buffer beyond the 2.5% cap used as a last resort option to curb excessive credit expansion could discriminate local banks vis-à-vis foreign entities. Therefore, the majority of Eurosystem members are of the view that the possible application of the buffer above the 2.5% ceiling is an area where a coordinated policy action may become necessary at the international level, where the ESRB and the EBA may play a key role in defining and implementing the appropriate policy response.

Question 5. Should decisions for the counter-cyclical buffer be made transparent, explained and communicated to the market? Do you see a role for the ESRB in this regard? Please explain the reasons for your reply.

To enable accountability, national authorities should disclose publicly their respective national decisions and the underlying reasoning. In particular, given that the credit-to-GDP gap indicator may have certain drawbacks and is not always a reliable instrument to signal excessive credit growth (or the need to release the buffer) it is of paramount importance that buffer decisions are clearly explained to market participants in order to enhance the credibility of the buffering mechanism. Transparency on decisions for CCB is of particular importance to ensure that the CCB is indeed drawn upon in the event of a downturn and do not constitute a new level of permanent minimum requirements. Public communication is necessary to avoid misinterpreting the decline in the total level of capital and penalising banks that use their CCB.

At the EU level the ESRB, as a body looking into the interaction between the financial system and the real economy, would be in good position to be involved in the disclosure of CCBs. As such it could play a role in helping to promote a clear distinction between macroprudential decisions on countercyclical capital buffers from microprudential decisions on banks capital, ensuring that the macroprudential reasons for buffer requirements are well understood. (Question 6 highlights some areas where policy decisions on the setting of buffers could be undertaken at the ESRB.) In addition, the EBA could also provide public information on the effective implementation of the buffers by national supervisory authorities.

Question 6. What are your views on the following potential roles for the ESRB and EBA:

(a) The development of principles and technical standards as regards the exchange of information and promotion of consistency of the buffer decisions?

While ensuring an international level playing field by laying down the requirements for the setting of CCBs as detailed as possible in the CRD itself, the ESRB and the EBA, given their respective roles on the European supervisory framework, could issue 'policy principles' and 'technical standards' to specify additional requirements that would allow for the framework to be responsive to the evolution of the financial system and the different shocks it faces.

Regarding policy principles, the ESRB, given its macroprudential mandate, could issue two types of principles: those surrounding the CCB policy framework; and guidelines to aid policy decisions about the operation of the buffers, in particular to ensure consistent policymaking across the EU.

With regard to the framework for CCBs, the ESRB, over time as experience is gathered in their operation, could issue recommendations about potential modifications to the framework, for example covering their objectives, communication requirements, regulatory perimeter/scope.

In addition, the ERSB could issue, in the form of recommendations, policy guidelines designed to promote consistent policymaking for CCBs across Member States. Those guidelines, for example, could cover: the minimum set of key indicators, in addition to the benchmark indicator of the 'credit-to-GDP gap'; other information to be potentially used in arriving at policy decisions on the buffers; and other policy aspects surrounding the build up and release of the buffers.

At the operational level, the implementation of CCBs by banks and supervisory authorities would need to be guided by *technical standards.* Consistent with the EBA regulation, the EBA could develop 'regulatory technical standards' that aim at, inter alia, promoting convergence of practices in: disclosure requirements for banks and supervisors; the calculation of buffer requirements by banks and supervisors including rules on the determination of the geographical location of credit exposures; the implementation of limitations to distributions/dividends; the physical setting-up and release of buffers by national supervisors etc. These standards should be purely of a microprudential nature. The EBA and the ESRB would regularly share views on the interaction between these technical standards and the macro-prudential policies of the EU.

(b) Issuance by the ESRB, on the basis of its regular risk assessments, of specific recommendations on the levels of counter-cyclical buffers established by national authorities?

For the setting of CCBs in the EU, the majority of the Eurosystem members are of the view that issuance of specific recommendations on the levels of buffers might be envisaged in three potential policy dimensions: (1) national or country-specific, (2) EU or intra-EU regions, (3) extra EU. Importantly, the scope for the ESRB to play a role in these respects is dependent on the CRD making provision for it to do so, for example in the event that a ceiling is imposed on the level of the CCB. In that case, the CRD should clearly exempt from the ceiling any enhancements recommended by the ESRB, irrespective of whether or not those enhancements required CCBs to exceed the ceiling.
However, certain Eurosystem members are of the view that the ESRB should play only an advisory role concerning the levels of buffers and that the CRD should not exempt from the ceiling any enhancements recommended by the ESRB.
(1) The setting of national or country-specific buffers

Differences in financial systems across the EU and the comparative advantage of national authorities in determining country-specific financial conditions support the setting of country-specific capital buffers by competent national authorities. As envisaged in the Basel Committee's proposals, buffers should be held according to the geographical location of the credit risk exposure. This requires reciprocal arrangements for national buffers. For such reciprocity to be effective, home and host countries must have confidence in each

other's buffer settings. To ensure trust and consistency in their application across the EU, the ESRB could provide for a forum where national authorities discuss their domestic buffer policy settings (incl. decisions to increase or draw-down). In the ESRB, such discussions could combine the views of national supervisors with central bank outlooks for the macro-economy and financial system stability. The majority of the Eurosystem members are of the view that in case that the buffer settings are not considered appropriate, the ESRB could issue a recommendation to the authorities concerned.

(2) The setting of buffers to capture regional or EU-wide conditions or potential for spill-overs

To ensure the resilience of the financial system, the CCBs should also take account of the potential amplification of cycles either due to correlated credit conditions across EU countries or negative spill-over effects e.g. in the event that some countries experience a significant downturn in financial or economic conditions. However, as it would be unlikely that the setting of national buffers considers such issues, they should be addressed at the EU level. The majority of the Eurosystem members are of the view that the ESRB, given its horizontal focus on macro-prudential issues and wide membership, could take a coordinating role, agreeing for example on recommendations on enhancements to national buffers, where appropriate, to take into account such 'external' concerns.

(3) The setting of buffers to capture extra EU exposures

The CCB framework provides for setting buffer requirements for non-EU exposures as well as EU exposures. Where such *buffers are not available for third countries,* ensuring a level playing field across the EU and restricting the potential for regulatory arbitrage requires coordination in the setting of such 'extra-EU' buffers. The ESRB, given its expected cooperation with other international institutions and its focus on world-wide as well as EU macroeconomic and aggregate financial conditions, could be a forum for the coordination, discussion and agreement on such buffers. The build-up or draw-down of extra-EU buffers could be agreed at the ESRB and reflected in an ESRB recommendation.

Where such *buffers are available for third countries*, the ESRB may still discuss the sufficiency of those buffers' settings and help to find a coordinated EU approach, if appropriate.

(c) Oversight by the EBA to ensure that buffers decision are implemented in an efficient and harmonised way?

The peer review process should be organized consistently with the allocation of macro- and micro-prudential responsibilities between the ESRB and the EBA. While the peer discussion of the buffer decisions could take

place at the policy level in the ESRB as described above in response to question 6 (b), more technical peer reviews of the implementation of CCBs by banks and national authorities would also be useful and could be arranged among the national authorities and the EBA.

The EBA would inform the ESRB on the national implementation of the buffers at the EU level. As mentioned, the EBA could also support implementation by providing public information on the effective implementation of the buffers.

(d) What are your views on the possible interaction between the respective roles of the ESRB and the EBA?

Given that the EBA is a Member of the ESRB it will play a full part in any of the deliberations conducted at the ESRB either in setting policy principles as described above or in making policy decisions on the operation of the CCB.

Beyond such roles, the follow-up to ESRB recommendations on CCB could be facilitated by the EBA. In coordination with the national supervisors, the EBA would make the necessary assessments on compliance with ESRB buffer recommendations and provide regular reports on such to the ESRB.

Furthermore, in the event that certain aspects of the EBA standards (e.g. technical standards on the build-up and on the release of buffers) were linked to macro-prudential indicators, the ESRB should contribute to their development and/or review.

Question 7. What type of own fund instruments should be used to meet the counter-cyclical buffer requirement and why?

According to the GHOS agreement of 12 September 2010, the CCB requirements should be fulfilled with common equity Tier 1 or other fully loss absorbing capital. To ensure that banks can rely on this buffer following adverse shocks, the buffer should preferably comprise the highest quality capital possible. In this respect, the corresponding Basel Committee's proposals on own fund instruments should be fully reflected in the CRD, also with reference to the review that the Basel Committee is conducting for possible inclusion of contingent capital in the regulatory capital framework.

Question 8. How should "exposures" be weighed to meet the objectives of the countercyclical buffer (nominal or on the basis of Risk Weighted Assets)?

Given the technical nature of this question, the majority of Eurosystem members are of the view that it should be addressed by the implementation standards to be developed by the EBA, in cooperation with the ESRB.

Question 9. Should the counter-cyclical buffer apply to all exposures or be limited to certain types of exposures and if yes which.

Buffers should apply to the widest possible range of credit exposures both across instruments and economic sectors given that the origins of the next financial distress are not predictable. In addition, incorporating restrictions on types of exposures would create incentives for credit institutions to seek out lending opportunities in areas, which are not taken into consideration in the calculation of the buffer guide and thus, potentially, in buffer decisions as well.

The CCB is aimed to be an aggregate macroprudential tool; in that respect it is similar to interest rates in the monetary policy area and which cannot focus only on one specific sector of the economy. The application of the CCB may therefore have impacts on the allocation of credit from one economic sector to another in case credit institutions become capital constrained and have to decide to which sector they will continue to lend. In this context, it seems reasonable to assume that credit institutions may prefer to keep on lending to the booming sector, while cutting back their lending activity to other sectors. It is therefore important that national supervisors have specific macroprudential policy instruments at hand that would allow them to address sector-specific issues as well. One possibility in this regard is to allow macroprudential policymakers to set specific capital requirements or increase risk weights at a sectoral, as well as aggregate level, if necessary. In this context, the competent national authorities should have the possibility of setting specific requirements for those types of exposures which, in a given situation, may lead to the destabilisation of the financial market and macroeconomic imbalances.[4]

In addition, sector-specific risk indicators should be important complementary variables that should also be taken into account when assessing excessive credit growth.

Question 10. In your view, should investment firms be excluded from the counter cyclical buffer capital requirement? Please support your answer with expected costs and benefits.

[4] Such a situation could occur, for example, when the only category of loans found to be excessively growing would be FX mortgage loans. Excessive growth in this category could lead to speculative bubbles on the markets for certain assets, weaken the effectiveness of monetary policy and constitute an additional risk factor for the stability of financial markets and the economy.

As a general principle, it is the activity of a given financial firm, rather than its legal form, that should be the deciding criterion in regulation. In this context, all regulated entities which are active in the provision of credit should be treated in the same way by the buffering mechanism. Therefore, to the extent that investment firms provide credit to their clients, they should be subject to CCB both to ensure they can maintain lending in the event of shocks (when the buffer is released) and also to ensure a level playing field with their competitors in credit supply (banks).

The CRD should allow that investment firms be brought into the regulatory scope for these purposes. The issue, however, extends beyond investments firms to the shadow banking sector and other non-bank potential suppliers of credit. In this context, national authorities and/or the ESRB should have a role in specifying or making recommendations on the extent of the macroprudential regulatory perimeter.

Question 11. Do you have other suggestions or comments?

The following issues that would require further analysis in order to ensure that the counter-cyclical buffering mechanism is implemented in an effective and efficient way:

First, an internal ECB analysis has revealed that on the basis of statistical analysis the credit-to-GDP gap performs best in terms of the overall banking crisis signalling power for EU countries (including non-Basel member countries). However, since there is large cross-country variation in terms of the signalling power of this indicator, other supplementary indicators could be useful for better crisis prediction. Moreover, relying on a suite of indicators for macro prudential regulation instead of a single indicator would make it more difficult to evade new regulatory requirements. Finally, as already pointed out in the Basel proposal, the credit-to-GDP gap guide is not appropriate in the release phase and other variables should be used to assist the authority in deciding whether and when to release the buffer. Overall, further analysis and the concrete use of the buffer will help to define the appropriate set of indicators to be regularly followed and assessed by authorities.

Second, further investigation would be needed to explore and assess the potential interactions between the CCB and other measures currently available, or envisaged to be introduced, to dampen procyclicality, such as forward looking provisioning, limits on loan-to-value (LTV) or payment-to-income (PTI) ratios, application of downturn probabilities of default (PD) and loss given default (LGD) estimations, margining practices as well as stress testing.

Third, a key concern to be explored further is how the objective of CCB can actually be realised. That is, how can policymakers be sure in a downturn that the buffers built up during the upswing will actually be

used to maintain lending and not, for example, distributed to shareholders? In this context, drawing a clear distinction between the CCB (macroprudential objectives, framework and policy decisions) and microprudential policies is crucial. Further, some guidance on the proper use of the countercyclical buffers (once released) may be needed in the CRD and, in this connection, the ability of supervisors to influence decisions on how banks use buffers should also be explored. The cooperation of macro- and micro-prudential supervisors is critical in this respect.

Overall, in all these cases, the ESRB and the EBA may play a key role in developing high level policy guidance as well as technical standards in order to ensure that the implementation and the enforcement of the buffering mechanism is in line with the underlying objective it aims at achieving.

Finally, it has to be highlighted that many EU countries are in the process of establishing a macro-prudential policy framework, including allocation of mandates and tools. These processes will most likely result in different governance structures in different countries. It is, therefore, important that the Commission, when formulating the legal framework, allows for such differences. In other words, the framework must enable both for central banks as well as supervisory authorities to be the authority in charge of the conduct of national macro-prudential policy.