

# Understanding the Role of Bank Capital Buffers



Scope  
Ratings

With the intense market focus on gauging the “right” level of capital, what is not always clear is that banks are subject to both prudential capital requirements and capital buffers. Serving specific purposes, the capital buffers are generally macro-prudential in nature. We look at the capital conservation, countercyclical and systemic buffers comprising the combined buffer and which is of particular relevance for Additional Tier 1 (AT1) investors.

The capital conservation buffer is fixed at 2.5% and applies to all banks. Meanwhile, most countercyclical capital buffers have been set at 0% in light of the persisting sluggish economic environment in Europe. It is with systemic buffers that we see the greatest variation in application.

For systemically important institutions (SII), there are differences in how they are determined as well as the level of additional capital imposed upon them. Further, some national authorities have opted to use the systemic risk buffer rather than O-SII buffers due to its greater versatility. Normally, the highest of the G-SII, O-SII and systemic risk buffer applies. However, when the systemic risk buffer relates only to domestic exposures, this buffer is additive to the G-SII or O-SII buffer.

These varying approaches mean that the level of regulatory capital banks are asked to hold can differ significantly. As shown below, SII are subject to supplementary requirements ranging from 0% to 5%, with applicable countercyclical buffers being on top.

**Figure 1: Use of capital buffers in selected countries**

| Country     | Counter-cyclical buffer | G-SII buffer | O-SII buffer | Systemic risk buffer | Domestic systemic buffer <sup>1</sup> |
|-------------|-------------------------|--------------|--------------|----------------------|---------------------------------------|
| France      | 0%                      | 1.0%-2.0%    | 0.25%-1.5%   | none                 | 1.5%                                  |
| Germany     | 0%                      | 2.0%         | 0.5%-1.5%    | none                 | 1.5%                                  |
| Italy       | 0%                      | 1.0%         | 0%           | none                 | 0%                                    |
| Netherlands | 0%                      | 1.0%         | 1.0%-2.0%    | 3.0%                 | 3.0%                                  |
| Spain       | 0%                      | 1.0%         | 0%-1.0%      | none                 | 1.0%                                  |
| Denmark     | 0%                      | n/a          | 0%           | 1.0%-3.0%            | 3.0%                                  |
| Norway      | 1.5%                    | n/a          | 2.0%         | 3.0%                 | 5.0%                                  |
| Sweden      | 1.5% <sup>2</sup>       | 1.0%         | 2.0%         | 5.0%                 | 5.0%                                  |
| UK          | 0%                      | 1.0%-2.5%    | tbd          | 0%-3.0%              | 3.0%                                  |

Notes: 1. The domestic systemic buffer is the higher of the O-SII and systemic risk buffer, except for Norway where the O-SII and systemic risk buffers are summed. 2. Countercyclical buffer set to rise to 2% in March 2017.  
Source: ESRB, Scope Ratings

Even excluding the Nordic countries, there is meaningful variation in the use of domestic systemic buffers. We question whether at some point the ECB may exercise its powers to ensure a level playing field in Europe. Under Article 5.2 of Council Regulation (EU) No 1024/2013, the ECB may, if deemed necessary, apply higher requirements for capital buffers than set by national authorities.

On a broader level, we question whether banks can effectively use the capital buffers as they are in effect macroprudential measures employed by regulators to address specific risks. Further, under CRD IV, if a bank breaches the combined buffer, it faces restrictions on the discretionary distributions (e.g. dividends and AT1 coupons).

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However, as these risks diminish or increase the buffers should do the same. With the countercyclical buffer being determined quarterly, this is one buffer which national authorities should be able to adjust more readily. After the recent referendum, the Bank of England (BoE) lowered the UK buffer rate in light of the changed risk outlook. Meanwhile, Norway and Sweden have progressively increased their respective buffer rates over the last couple of years. Systemic buffers are probably less likely to change unless they are being used to address certain specific macroprudential risks such as problematic exposures to commercial real estate.

### Countercyclical buffer to help maintain the flow of credit

Per CRD IV, financial institutions should accumulate “a sufficient capital base to absorb losses in stressed periods”. It is our understanding that the capital conservation buffer was designed to ensure that banks do not breach their minimum capital requirements in a period of stress.

In addition, the countercyclical capital buffer should be built up “when aggregate growth in credit and other asset classes ... are judged to be associated with a build-up of system-wide risk”. During a stress period, the countercyclical buffer could then be reduced to maintain the flow of credit in the economy.

The countercyclical buffer is determined at national level, with the deviation of the credit-to-GDP gap from its long-term trend acting as the basis for determining the buffer rate. Designated authorities are however encouraged to also consider other relevant supervisory and macroeconomic information when setting the buffer rate. In light of the muted economic environment in Europe, most countercyclical buffer rates have been set at 0%. Of note, the UK adopted a somewhat different approach; considering the appropriate countercyclical buffer to be 1% in normal conditions as this would allow banks to gradually build up the buffer and permit a reduction in the buffer as needed.

### Reducing buffer in a stress period: the UK example

Shortly following the results of the UK's referendum on EU membership, the BoE announced with immediate effect that it was reducing the countercyclical capital buffer rate on banks' UK exposures to 0% from 0.5%. As well, current supervisory buffers which cover the same risks as the UK countercyclical capital buffer would also be reduced. In doing so, the BoE communicated that the resilience of the UK financial system was based on a “regulatory framework which allows capital and liquidity buffers to be drawn on, as needed, to allow the system to cushion shocks and maintain the provision of financial services to the real economy”.

For details on how various European authorities set countercyclical capital buffers, please refer to Scope's report “*The countercyclical capital buffer: Its relevance for assessing bank risk*”, January 2016.

### Systemic buffers for mitigating non-cyclical systemic and macroprudential risks

In addition to the capital conservation and countercyclical capital buffers, national authorities can use systemic buffers to prevent and mitigate long-term non-cyclical systemic or macroprudential risks. Systemic buffers include additional capital buffers for global and other systemically important institutions (G-SIIs and O-SIIs, respectively) and the systemic risk buffer.

G-SII and O-SII buffers are meant to compensate for the higher risks that these institutions pose for the global or respective national financial system. Most EU countries identified and set buffer requirements for systemically important institutions in 2015. Under the EBA framework, a score derived from four indicators (size, importance to the

domestic economy, complexity and interconnectedness) determines whether an institution is an O-SII. An institution with a score above the 350bps threshold is normally designated as an O-SII. National authorities, however, can use supervisory judgement to include banks which are below the O-SII threshold or set a 0% buffer for a bank designated as an O-SII. National authorities determine O-SII buffers which are capped at 2%.

If used, national authorities can set a systemic risk buffer ranging from 1% to 5%. Systemic risk buffers can apply to all institutions, or to a subset of institutions with similar risk profiles in their business activities.

CRD IV details the interaction between the systemic risk buffer and G-SII and O-SII buffers. Generally when an institution is subject to a G-SII or O-SII buffer and a systemic risk buffer, the highest buffer applies. When the systemic risk buffer applies only to domestic exposures however, this should be additive to the G-SII or O-SII buffer.

As with the capital conservation and countercyclical buffers, systemic buffers need to be met with CET1 capital not used to meet other requirements.

### Variation in the use of systemic buffers

In its review of macroprudential policy<sup>1</sup>, the ESRB noted that while the G-SII and O-SII buffers are tools specifically designed to address risks arising from systemically important institutions, in practice national authorities are also using the systemic risk buffer as a substitute for the O-SII buffer because of its greater flexibility. The study further highlighted the wide diversity in motives for using the systemic risk buffer and therefore the potential risks to a level playing field. As well, some countries allow for the phasing-in of the buffer while others do not.

The following examples illustrate the various uses of the systemic risk buffer:

- (i) The Netherlands set a 3% systemic risk buffer to mitigate the long-term non-cyclical systemic risk resulting from the large and concentrated banking sector. The maximum O-SII buffer of 2% was considered insufficiently prudent.
- (ii) Norway uses the systemic risk buffer to address exposure concentration.
- (iii) In Hungary, the systemic risk buffer is meant to address risks stemming from the persistently high proportion of commercial real estate problem exposures.
- (iv) In Romania, the systemic risk buffer is meant to address risks related to the ownership structure of banks; an additional buffer is required for those banks whose parent bank is based in a non-investment grade country.

### Designation as systemically important not obvious

Also of interest, the ESRB found that the overlap between reported systemically important institutions and the institutions directly supervised by the ECB is only partial. Within the Single Supervisory Mechanism (SSM), the ECB has assumed the direct supervision of significant institutions; those which meet any one of the following conditions:

- (i) assets exceed EUR 30bn or 20% of GDP;
- (ii) it is one of the three most significant credit institutions in a Member State;
- (iii) it is a recipient of direct assistance from the European Stability Mechanism;

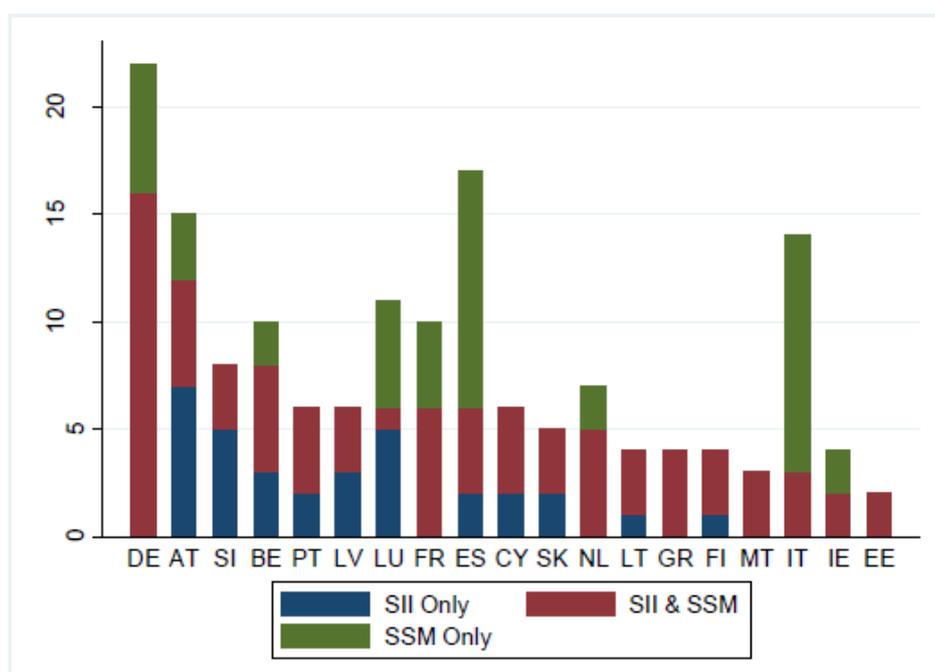
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<sup>1</sup> European Systemic Risk Board. A Review of Macroprudential Policy in the EU in 2015. May 2016.

- (iv) assets exceed €5 billion and the ratio of its cross-border assets/liabilities in more than one other participating Member State to its total assets/liabilities is above 20%.

Figure 2 shows the number of institutions which have been designated exclusively as a SII (SII Only), exclusively as a significant institution directly supervised by the ECB (SSM Only) or both (SII & SSM). In some countries, such as Italy and Spain, more institutions have been classified as significant by the ECB but have not been designated as O-SIIs by respective national authorities. In other countries such as Austria and Slovenia, many non SSM-supervised entities have been designated as O-SIIs.

**Figure 2: Number of systemically important institutions and/or significant institutions directly supervised by the ECB**



Notes: The figure depicts specifically identified institutions irrespective of their consolidation level or the designation of their parent group. The qualification as a significant institution directly supervised by the ECB refers to the situation as of 30 December 2015. For AT, it has been assumed that the institutions subject to the systemic risk buffer are also systemically important.

Source: ESRB



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