CRD IV – CAPITAL BUFFERS

SURVEY OF NATIONAL IMPLEMENTATIONS AND THE STATUS IN ICELAND

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CRR/CRD IV: A HARMONIZATION TASK?

GOLD PLATING IS SOUGHT BY VARIOUS MEMBER STATES

The CRR/CRD-IV allows Member States to use discretion in the way in which the rules are implemented at a national level and to impose **super-equivalent rules** if they are considered necessary (otherwise known as "Gold Plating")

Typical ways through which Gold Plating is achieved:

- Systemic Risk Buffer and O-SII Buffer, beyond Counter-cyclical Buffer and domestic systemically important bank framework
- Risk weight adjustments via IRB, Article 458, or Pillar 2
- Buffer adjustments via Article 458
- Pillar 2 capital buffers
- Phasing in of buffers and deductions
- Leverage ratio enhancements – whether in restricting eligible instruments, increasing the level, or adding buffers
- Pre-approval processes for capital issuance – high trigger AT1
- Minimum Requirement for Eligible Liabilities (MREL) measure as part of the Bank Recovery and Resolution Directive (BRRD)

…while clarity is still lacking on…

- O-SII level setting – EBA explicitly states further regulation is needed in this area (while preserving supervisory judgement)
- Systemic Risk Buffer level setting and activation, interaction with other buffers, and "pecking order"

CRR/CRD IV BUFFERS

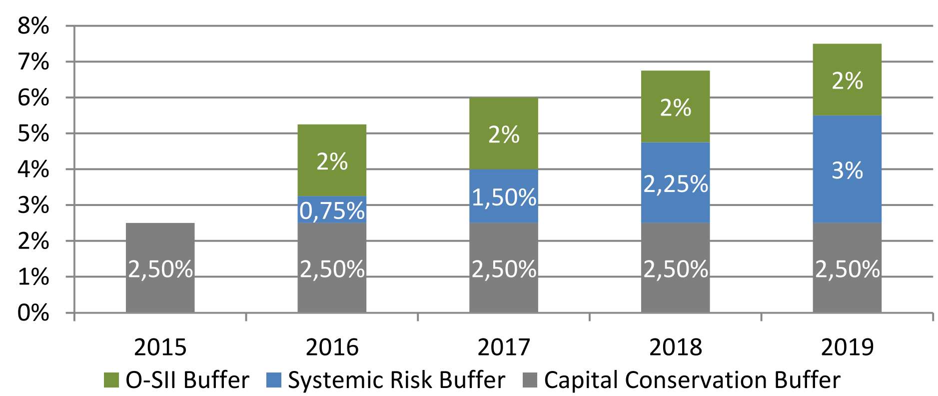
COMPETENT AUTHORITIES AND CURRENT STATE OF PLAY – SEPTEMBER 2014

	Cap Con Buf	CA	Count Cyc Buf	CA	Syst Risk Buf	CA	O-SII / G-SII (explicit communication)	CA
Iceland	✓ [Phased]	FME	[0-2.5%]	TBD [FME / Financial Stability Council]	[3%]	[FME]	[2%]	[FME]
Austria	✓ Phased	FMA	-	FMA (OeNB input; FMSC recommend)	-	FMA	-	FMA
Belgium	✓ Phased	NBB	-	NBB	-	NBB	-	NBB
Croatia	× No phasing	National Bank	-(2015)	National Bank	1.5% to 3% (2014)	National Bank	-	National Bank
Czech Republic	× No phasing	National Bank	-	National Bank	-	National Bank	-	National Bank
Denmark	✓ Phased	DFSA	-	DFSA	3% ('14), 5% ('15)	DFSA	1% - 3% phased	DFSA/MinFin
Estonia	× No phasing	Eesti Pank	-	Eesti Pank	2% (2014)	Eesti Pank	-	Eesti Pank
Finland	× 2015	Finanssivalvonta	-	Finanssivalvonta (consult MinFin, CB)	-	Finanssivalvonta	-	Finanssivalvonta
Germany	✓ Phased	BaFin	-	FinMin / handover to BaFin + Bbank	-	MinFin	-	MinFin + Bbank
Ireland	✓ Phased	CBI	-	CBI	n/a at present	-	-	CBI
Italy	× No phasing	Bankitalia	-	Bankitalia	-	n/a	Fully loaded as of 2016	Bankitalia
Latvia	× No phasing	FCMC (Financial and Cap Mkt Com)	-	FCMC	-	FCMC	-	FCMC
Luxembourg	× No phasing	CSSF	TBC; draft law	CSSF	TBC; draft law	CSSF	TBC; draft law	CSSF/Cmte
Netherlands	✓ Phased	DnB	-	DnB	3% phased	DnB	1% (SNS) phased	DnB
Norway	× No phasing	FSA	1% from 2016	MinFin based on CB and FSA input	3% (2014)	FSA	1% ('15) & 2% ('16)	FSA
Spain	✓ Phased	BdE	-	BdE	-	BdE	-	BdE
Sweden	× No phasing	SFSA	CCyB of [1.5%] Autumn 2014	SFSA	3% (2015)	SFSA	-	SFSA
UK	✓ Phased (but 7% effective minimum)	Prudential Regulatory Authority	-	Financial Policy Cmte (Bank of England)	Up to 3% (timing TBD)	Her Majesty's Treasury	-	Prudential Regulatory Authority

THE FME'S INTERPRETATION OF THE CRR/CRD-IV

Surplus capital	>0%
Capital Conservation Buffer	2,5%
Other-SII Buffer	0-2%
Systemic Risk Buffer	0-3%
Countercyclical Capital Buffer	0-2,5%
SREP (Pillar 2)	0-5%
Tier 2	2,0%
Additional Tier 1	1,5%
Common Equilty Tier 1	4,5%

- The FME has presented its intention to recommend that a combined buffer value of 7,5% be phased in over 5 years.
- The recommendation is controversial, e.g.:
  - The Other-SII and Systemic Risk Buffers should only be cumulative under special circumstances
  - The overlap between Pillar 2 and the CRD-IV capital buffers is not addressed
- No guidance on the mix of CET1, AT1 and T2 in the SREP box.



THE CAPITAL CONSERVATION BUFFER

CRD-IV ARTICLE 129

1. Member States shall require institutions to maintain in addition to the Common Equity Tier 1 capital maintained to meet the own funds requirement imposed by [Pillar I], a capital conservation buffer of Common Equity Tier 1 capital equal to 2,5 % of [RWA] …

6. Where an institution fails to meet fully the requirement under paragraph 1 of this Article, it shall be subject to the restrictions on distributions …

- The Capital Conservation Buffer is the only buffer addressed in first bill introducing the CRD-IV into Icelandic law, where it is called *Verndunarauki* and set at 2,5% of RWA.
- The bill will go before Althing in its Fall 2014 session.
- The Capital Conservation Buffer is not controversial, although the interaction of this and other buffers with the Pillar 2 result has been the source of debate.
- The remaining capital buffers specified in the CRD-IV will be addressed in a second bill, which is yet to be drafted but is likely to be passed into law in 2015

THE INSTITUTION-SPECIFIC COUNTERCYCLICAL CAPITAL BUFFER

LIMITING PRO-CYCLICALITY (CRD-IV ARTICLE 130)

The Basel Committee on Banking Supervision (BCBS) sees the Countercyclical capital buffer as resulting in the following benefits:

i. Protecting the banking sector from losses resulting from periods of excess credit growth followed by periods of stress;
ii. Helping ensure credit remains available during periods of stress;
iii. During the build-up phase, as credit is being granted at a rapid pace, it may cause the cost of credit to increase, acting as a brake on bank lending.

- The purpose of this buffer is to reduce pro-cyclicality (amplification of the effects of the business cycle) in banking.
- At different times, the FME has referred to this buffer as *Hagsveifluauki*, *Hagsveiflujöfnunarauki* and *Sveiflu-jöfnunarauki*.
- The FME has indicated that at the current state of the Icelandic economy, it is appropriate to set the countercyclical capital buffer at 0%.
- It is unclear which authority will control the level of this buffer in Iceland.

THE OTHER SYSTEMICALLY IMPORTANT INSTITUTION BUFFERS

CRD-IV ARTICLE 131

3. O-SIIs shall be identified in accordance with paragraph 1. Systemic importance shall be assessed on the basis of at least any of the following criteria:
   a) size;
   b) importance for the economy of the Union or of the relevant Member State;
   c) significance of cross-border activities;
   d) interconnectedness of the institution or group with the financial system.

- It is difficult to argue that the three major Icelandic banks should not be classified as O-SII, although the authority controlling the buffer should be expected to justify the use of the 2% maximum.
- The FME has referred to this buffer as *Auki á kerfislega mikilvæg fyrirtæki* without a distinction for *Other* vs. *Global*.
- The goal of the EU is to protect the singleness of the European financial market and provide a level playing field. An Icelandic bank subject to an O-SII may find it difficult to compete with a comparable foreign bank which is not subject to an O-SII in its jurisdiction.

THE SYSTEMIC RISK BUFFER

CRD-IV ARTICLE 133

Each Member State may introduce a systemic risk buffer of Common Equity Tier 1 capital for the financial sector or one or more subsets of that sector, in order to prevent and mitigate long term non-cyclical systemic or macroprudential risks not covered by [CRR], in the meaning of a risk of disruption in the financial system with the potential to have serious negative consequences to the financial system and the real economy in a specific Member State.

- Substantial clarity is lacking from the Systemic Risk Buffer prescriptive text. To date, there has been very limited disclosure on the methodology used to set the Systemic Risk Buffer and it has primarily been used as the key tool for gold-plating or measures which fit less appropriately into other powers (such as the ring-fencing buffer in the UK)
- The FME has proposed that this buffer be called *Kerfisáhættuauki*
- It has not been decided which authority will control the level of this buffer in Iceland.

INTERACTION OF THE O-SII AND SYSTEMIC RISK BUFFERS

„CUMULATIVE“ VS. „HIGHER OF“

Without reservations, the FME has recommended a buffer requirement which includes the sum of the O-SII and Systemic Risk Buffers.

In general, the CRD-IV specifies that the requirement should be the **higher of** the two buffers.

Article 131 (14): *Where an institution, on an individual or sub-consolidated basis is subject to an O-SII buffer and a systemic risk buffer in accordance with Article 133,* ***the higher of the two shall apply.***

Article 133 (4): … *Where an institution, on an individual or sub-consolidated basis, is subject to an O-SII buffer in accordance with Article 131 and a systemic risk buffer in accordance with this Article,* ***the higher of the two shall apply.***

Article 133 (5): *Notwithstanding paragraph 4, where the systemic risk buffer applies to all exposures located in the Member State that sets that buffer to address the macroprudential risk of that Member State,* ***but does not apply to exposures outside the Member State****, that systemic risk buffer* ***shall be cumulative*** *with the O-SII or G-SII buffer that is applied in accordance with Article 131.*

INTERACTION OF THE SYSTEMIC RISK BUFFERS AND OTHER MEASURES

The SRB is considered to be a very versatile tool, covering a broad set of risks and can be applied to either all institutions or a subset by requiring a higher level of CET1 capital. However:

i. **it is not clear how to assess and interpret structural systemic risk, meaning that the boundaries between the risks covered by the SRB and the risks covered by other tools are not clear, so that the pecking order is unclear;**
ii. the fact that the SRB can be applied to a subset of institutions implies that it can damage the level playing field across institutions;
iii. reciprocity is voluntary, and;
iv. **unclear procedures to be followed for activation.**

[S]ome recommendations to address these shortcomings, namely:

i. mandatory reciprocity of the SRB should be considered;
ii. **the process should be clarified, and;**
iii. guidelines should be written to clarify its activation, exploring possible quantitative indictors and the risks covered.

[…] the goal and scope of the SRB is very broad, and has been identified as overlapping in a number of dimensions with other tools (Pillar 2, G/O-SII buffer, Article 458 CRR, Article 124/164 CRR). Because of the uncertainties surrounding the risks covered by the SRB, it is clear that further work should be done to define its goal and purpose, which is the aim of the above proposed additional guidelines. Regarding disclosure, […] some areas of improvement: (i) that if indicators for the activation of the SRB are developed, then these indicators should also be disclosed, and; (ii) other Member States that have institutions with exposures to the country which sets the SRB could be explicitly informed about the structural systemic risk connected to these exposures.

EBA Opinion on the macroprudential rules in CRR/CRD , 30 June 2014

OVERLAP BETWEEN PILLAR 2 AND THE CRD-IV CAPITAL BUFFERS

As EBA's Opinion (June 2014) also evidences, there is substantial flexibility in interpreting how Pillar 2 powers and buffers fit within the remainder of the CRR/CRD IV spectrum

However, the EBA also provides some pointers to a future set of guidelines or (non-binding) best practices, as well as when SRB or CCyB might be a more fitting tool – which might be used in discussions with FME

Some National Competent Authorities […] argue that it therefore would be preferable to keep Pillar 2 solely for microprudential use. Several arguments justify this preference:

(i) the CRR/CRD contains a framework of macroprudential measures which is already very broad, and which is transparent, contrary to Pillar 2,

(ii) the CA is responsible for the use of Pillar 2 and given this responsibility it would be more logical to use Pillar 2 for microprudential purposes,

(iii) there is substantial overlap already between the other macroprudential tools in the CRR, in particular between Pillar 2 and the SRB, between Pillar 2 and Article 458, and between Pillar 2 and the G/O-SII buffer,

(iv) finally there is the issue of transparency. The current Level 1 text does not require disclosure of measures taken under Pillar 2, and this is considered desirable in cases in which bank-specific measures are taken. When Pillar 2 measures are taken to address macroprudential concerns, the lack of disclosure is considered a drawback, and additional disclosure requirements would be advisable .

It should be noted that the exclusion of a macroprudential scope from Pillar 2 does not imply that Pillar 2 would not include forward-looking components (stress tests, for instance), but only that Pillar 2 should focus on bank-specific measures. ***For instance, if a bank is subject to a macro shock that particularly affects its activity and risk profile while another bank is able to avoid this given its own niche, it can be required to hold a Pillar 2 buffer; if the same shock affects a group of banks or the entire banking sector then the response would be macroprudential (for instance, the SRB or the CCB).***

The difference in scope between Pillar 2 (when used as a macroprudential tool) and the SRB is not clear. The scope of the SRB in particular could therefore be further clarified through additional guidelines or a best practice report.

EBA Opinion on the macroprudential rules in CRR/CRD , 30 June 2014

HOW WELL DO CRR/CRD-IV MEASURES ACHIEVE THEIR OBJECTIVES?

EBA OPINION ON THE MACROPRUDENTIAL RULES IN CRR/CRD , 30 JUNE 2014

Not achived / Partially achieved / Achieved	Financial stability (effectiveness and efficiency)	Maintaining a level playing field	Clear goal and purpose of measure	Transparency of Disclosure	Consistency with Basel	Overall Score
Capital Conservation Buffer						
Countercyclical Buffer						
Global-SII Buffer						
Other-SII Buffer						
Systemic Risk Buffer						
Article 124/164 CRR						
Article 458 CRR						
Pillar 2						

Not adequately covered / Moderately covered / Well covered	Structural risks	Cyclical risks	Risk caused by SII	Systemic funding risks	Strucural expososure-based risks	Cyclical exposure-based risks	Other systemic risks
Capital Conservation Buffer							
Countercyclical Buffer		✓					
Global-SII Buffer			✓				
Other-SII Buffer			✓				
Systemic Risk Buffer	✓		✓				
Article 124/164 CRR					(✓)	(✓)	
Article 458 CRR		✓		✓		(✓)	(✓)
Pillar 2	✓	✓	✓	✓	✓	✓	✓
Liquidity rules				?			
Risk adequately covered							

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