



EUROPEAN COMMISSION

Internal Market and Services DG

FINANCIAL INSTITUTIONS

Banking and financial conglomerates

Consultation Document

Countercyclical Capital Buffer

Disclaimer

This document is a working document of the Commission services for consultation and does not prejudice the final form of any future decision to be taken by the Commission.

In the interests of transparency, organisations are invited to provide the public with relevant information about themselves by registering in the Interest Representative Register and subscribing to its Code of Conduct.

If you are registered, please indicate the name and address of your organisation and your Interest Representative Register ID number on the first page of your contribution. Your contribution will then be considered as representing the views of your organisation's interest group.

The Commission services ask organisations who wish to submit comments in the context of public consultations to provide the Commission and the public at large with information about whom and what they represent. If an organisation decides not to provide this information, it is the Commission's stated policy to list the contribution as part of the individual contributions. (Consultation Standards, see COM (2002) 704, and Communication on ETI Follow-up, see COM (2007) 127 of 21/03/2007)

You are invited to comment on the views reflected in this paper. These views are only an indication of the approach the European Commission may take and are not its final policy position nor do they constitute a formal proposal by the European Commission.

The Commission's February 2010 Consultative Document¹ included a proposal for a capital conservation buffer. In the meantime, the Basel Committee on Banking Supervision ('BCBS') formed The Macro Variables Task Force (MVTf) to further develop a proposal ('BCBS proposal') to take into account the macro-financial environment in which banks operate with the goal of providing a fully detailed proposal for review by the Basel Committee at its July 2010 meeting. On the basis of the group's work, on 16 July the Basel Committee published a consultative document with the deadline for comments of 10 September 2010.² As the approach set out in that consultative document widens and changes the substance of the initial proposal of the BCBS significantly, the Commission services considered it necessary to put out a second consultation on capital buffers.

¹ http://ec.europa.eu/internal_market/consultations/2010/crd4_en.htm

² <http://www.bis.org/publ/bcbs172.htm>

The purpose of this consultation is to gather stakeholders' views on a proposal for a countercyclical capital buffer. Such a buffer would be added to banks' minimum regulatory capital and the capital conservation buffer and would serve to protect them from periods of excess aggregate credit growth that have often been associated with the build up of system-wide risk. At the same time, it might help to maintain the flow of credit in the economy when the broader financial system experiences stress after a period of excess credit growth.

This consultation focuses on how the proposal for countercyclical buffers set out in the BCBS consultation of 16 July 2010 should be applied in a way that takes proper account of the particular nature of the internal market within the EU. Accordingly, it addresses two specific questions:

(1) how bank-countercyclical buffers should be calculated for EU banks that have established branches in other EU member States

(2) how the jurisdictional add-on should be set for each EU Member State, and the role of the European Systemic Risk Board ('ESRB') and the European Banking Agency (EBA) in this process.

Apart from these specific points, the Commission services propose that the countercyclical buffers would be implemented in the way proposed in the BCBS consultation, and this consultation paper should be read in conjunction with the BCBS document.

This consultation document accordingly includes questions which are relevant to European implementation and the specificities of the EU single market. They take into consideration the formal feedback on the broad concept of a countercyclical buffer contained in the Commission's February 2010 Consultative Document.

In the light of the feedback received from this consultation, the Commission will further consider whether a counter-cyclical buffer should be introduced in the EU through the upcoming amendment to the Capital Requirements Directive³ that is scheduled for adoption by the Commission in 2011, and will decide the appropriate next steps in this matter.

The Commission will take your comments into account when preparing the final policy position and the impact assessment accompanying it. In order to assist us in evaluating your contributions, we would appreciate it if you could maintain the structure of this questionnaire in your replies and **indicate clearly the question you are responding to**.

In replying to these questions, please indicate the expected impact of the potential changes described in each section of this paper on your activities or the activities of firms in your jurisdiction. In addition, in replying to these questions, you are invited to indicate the optimal timing for implementation of the suggested measure.

You are invited to send your contributions until **19th of November 2010** to markt-crd-consultation@ec.europa.eu

Responses will be published on the following website unless requested otherwise: http://ec.europa.eu/internal_market/bank/regcapital/index_en.htm

Data protection rules: http://ec.europa.eu/geninfo/legal_notices_en.htm#personaldata

³ Directives 2006/48/EC and 2006/49/EC.

INTRODUCTION

1. The proposal for countercyclical buffers is designed to ensure that banking sector capital requirements take account of the macro-financial environment in which banks operate. It would be an important and internationally consistent instrument in the range of macro-prudential tools at the disposal of national authorities. It should only be deployed when excess aggregate credit growth is judged to be associated with a build-up of system-wide risk to ensure the banking system has a buffer of capital to protect it against future potential losses.

2. In its February consultation, the Commission's services set out the objectives and the features of the capital conservation buffer. One of the key issues was the extent to which a capital conservation buffer would be indeed counter-cyclical. Respondents took the view that the proposed capital conservation buffer would have only limited counter-cyclical effects as the buffer would probably be considered as a new market minimum. In response, alongside with the Basel Committee, the Commission services are now consider a buffer with a dual structure: the capital conservation buffer (which covers risk on the individual bank level) and the proposed counter-cyclical buffer (which is intended to cover risk at the macro level and can move counter-cyclically with the economic cycle).

3. The primary aim of the proposal is to use a buffer of capital to achieve the broader macro-prudential goal of protecting the banking sector and the real economy from the system-wide risks associated with the boom-bust cycle in aggregate credit growth. In this context, the goal is actually twofold. The first aspect is to ensure that individual credit institutions remain solvent through a period of stress after a period of excess credit growth; the minimum capital requirement and capital conservation buffer are together designed to fulfil this objective. The second aspect is that, in periods of stress, the buffer regime should help to reduce the risk of a mismatch between the supply and demand of credit as a result of the regulatory capital requirements that could undermine financing capacity and the performance of the real economy and result in additional credit losses in the banking system.

4. The countercyclical capital buffer will work by allowing each Member State to use judgement to extend the size of the minimum buffer range established by the capital conservation buffer. This will be implemented by means of a buffer add-on during periods of excess aggregate credit growth that are judged to be associated with an increase in system-wide risk.

5. To assist competent authorities in their decisions on the appropriate setting for the buffer, the Basel Committee has developed a methodology for calculating an internationally consistent buffer guide that can serve as a common starting reference point for buffer decisions by the relevant national authorities. The methodology transforms the aggregate private sector credit/GDP gap into a suggested buffer add-on. It indicates, as a guide, a zero add-on when credit/GDP is near or below its long-term trend and a positive add-on when credit/GDP exceeds its long term trend by an amount which, on the basis of available historical data, suggests there could be excess credit growth that may be associated with a build up of system-wide risk. The calculation also contains some information on the guide's historical performance on a jurisdiction by jurisdiction basis.

6. The evidence suggests that while the credit/GDP gap would often have been a useful guide in taking buffer decisions in the past, it does not necessarily work well in all jurisdictions at all times. Furthermore, the guide is not helpful in indicating when a buffer should be

released.⁴ In order to address these potential shortcomings, judgment coupled with proper communication is an integral part of the proposal. Rather than rely mechanistically on the credit/GDP guide, authorities are expected to apply judgment in the setting of the buffer in their jurisdiction after using the best information available to gauge the build-up of system-wide risk. In this respect, the credit/GDP guide provides a useful common reference point against which the exercise of judgment can be understood.

Role of European Authorities in ensuring consistent application of regime

7. The Commission services would emphasise the need for consistency of buffer decisions, in particular within the EU. It is crucial, therefore, that the use of judgment by national authorities be firmly anchored to a clear set of principles to promote sound decision-making in the setting of the countercyclical capital buffer. By extension, proper communication of buffer decisions should help banks and other stakeholders to understand the rationale underpinning the decisions and should promote sound decision making by authorities responsible for operating the buffer.

8. Where EU banks have exposures to jurisdictions that do not operate and publish buffer add-ons, the competent authorities would have to set their own buffer add-ons for exposures to those jurisdictions. Those buffer add-ons would also need to be consistent and coordinated.

9. The Commission services consider that the ESRB and the EBA would be best placed to promote the consistency of the buffer decisions mentioned in paragraphs 7 and 8 within the EU. This could be achieved through the development of principles by the ESRB and technical standards by the EBA to guide authorities in the use of the judgement.

10. Clear communication of buffer decisions is a key element in promoting accountability and sound decision-making. In the context of the EU internal market, the Commission services consider that the aim should be to ensure the highest level of transparency with regard to the buffer decisions of EU authorities. Given that the risk assessments and the buffer decisions would be based on the authorities' assessment of the current outlook for economic and financial conditions, it is essential that the objectives of the buffering mechanism are clearly defined and the reasons behind buffer decisions made transparent and communicated efficiently to the market. The Commissions' services consider that the ESRB and the EBA should also play a central role in ensuring such communication and transparency.

11. The Commission services emphasise that decisions on the level of the national buffer add-on and on the release of the buffer should be taken after an assessment of as much of the relevant prevailing supervisory and macroeconomic information as possible. This is important given that the operation of the buffer requires information from both supervisory and macroeconomic sources, and that these decisions will have implications for the conduct of monetary and fiscal policies, as well as banking supervision. The timely sharing of information among these authorities is therefore necessary to ensure that the actions of all parties are fully informed and consistent. The Commission' services consider that the ESRB

⁴ Research indicates that macro variables may not be ideal indicator variables for signaling the release phase. While credit and GDP often contract around crises, this is not always the case. For example, during the recent crises real credit growth even increased initially in several countries, such as for example the United Kingdom and Spain. Equally, real GDP continued to grow for over a year after the recent crisis materialized in several countries like Germany, Switzerland, the United Kingdom and the United States. Indicators of credit conditions may, on the other hand, provide useful information to identify bad times. But they are survey based and therefore potentially vulnerable to manipulation.

and the EBA should have an important role in ensuring the exchange of information and a consistent application of principles across the EU.

Application to EU cross-border banks and banking groups

12. Under the approach set out by the Basel Committee, the calculation of bank-specific buffers would reflect the geographic location of their credit exposures: that is, the territory where the creditor or counterparty is located. Following the Basel approach, this core principle should apply, regardless of the location of the entity granting the credit, and regardless of whether it was granted through the parent company of a consolidated group, a subsidiary or a branch. Individual banks would be required to calculate their specific countercyclical buffer as a weighted average of the published buffer add-ons that apply in the various jurisdictions in which their exposures are located. The objective is to ensure that the buffer add-on reflects the country risk of the jurisdictions to which the institution in question has credit exposures.

13. If the EU adopts the approach suggested by the Basel Committee, the Commission services propose that the competent authorities in each Member State would be responsible for setting the buffer add-on applicable to credit exposures to borrowers or counterparties located in their jurisdiction. The level of that "add on" by the counter-cyclical "macro" buffer would not be bank specific, but should be applied for all credit institutions which have exposures in the same Member State or in a third country jurisdiction. The add-on will be subject to a ceiling of 2.5% and will only be imposed when there is evidence that the excess credit growth results in a build-up of system-wide risk. The competent authorities of the home Member State or the consolidating supervisor will be responsible for ensuring that the banks they supervise correctly calculate their bank-specific buffer requirements.

14. The Commission services consider that the countercyclical buffer add-ons should be applied at individual, sub-consolidated and consolidated level. This would be consistent with the application of minimum capital requirements under Articles 68 to 72 CRD. Subsidiaries would generally be expected to hold their own countercyclical buffers, calculated in accordance with the principles set out in paragraphs 12 and 13. However, if the (sub-consolidated or individual) supervisor of a subsidiary agrees, the buffer add-on for the exposures of that subsidiary may be calculated and held at the consolidated parent level. In that case, the consolidating supervisor would be responsible for ensuring that the buffer at consolidated level includes the add-ons required for the exposures of the subsidiary.

15. Applying the Basel proposal to EU cross-border banks and banking groups, this means that the counter-cyclical buffer would be determined and held as follows.

16. Banks with branches in other Member States or third countries would apply the buffer add-on determined by the competent authorities of the countries they have credit exposures, irrespective of whether the credit was granted from the home Member State or from a branch in a host Member State or a third country. The bank-specific buffer will be equal to an average of the add-ons applied in the countries where they have exposures weighted by the exposures. However, it would be held only in the home jurisdiction, and there would be no requirement to keep all or part of the buffer in Member State where the branch is established. A branch is not a separate legal entity, does not have its own capital in the EU, and any requirement to hold the buffer or part of it in the Member State of the branch would be inconsistent with the single market freedoms.

17. In cases of lending through foreign branches or cross-border lending by banks located offshore, the authorities in the home jurisdiction of the bank in question can always calculate

an aggregate buffer using for any given host jurisdiction a buffer equal or greater to the one recommended by the host jurisdiction but may not set the buffer below.

18. In the case of a consolidated group with subsidiaries, the countercyclical buffers would be calculated and held in each subsidiaries and would be determined by the authorities responsible for each subsidiary within a range of 0- 2.5%. That means that at a consolidated level, the buffer will effectively be equal to a weighted average of the add-ons applied in the countries where the credit institutions included in the consolidated group have exposures. As with the minimum capital requirement, the authorities responsible for each subsidiary would have the right to demand that the countercyclical capital buffer be held at the individual legal entity level or consolidated level within their jurisdiction. If they do not exercise that right, the home authorities of the consolidated parent must ensure the buffer is held at the consolidated level.

19. Under this approach, the countercyclical capital buffer will work by allowing each Member State to use its judgement to extend the size of the minimum buffer range established by the capital conservation buffer. As explained above, that countercyclical add-on will either apply at entity level in case of subsidiaries, or enter in the calculation of the bank-specific buffer where the relevant credit exposures are created through branches, or at consolidated level where the authorities responsible for subsidiaries have renounced to the right to keep the buffer in the host jurisdiction.

20. A capital add on will be subject to a ceiling of 2.5% and will only be imposed when there is evidence that excessive credit growth results in a build up of system wide risk. As the decision is based on judgement and should be taken at the level of national authorities, the quantitative impact will depend on these decisions. The Commission services will however conduct an impact assessment on counter-cyclical buffers on the qualitative basis.

Alternative options for determining bank specific buffers

20. The explanation above of how the institution-specific buffer add-ons would be determined and held in the case of EU cross-border banks and consolidated or sub-consolidated groups applies the approach to determining the level of bank-specific add-ons that is set out in the BCBS consultation (see paragraph 12). However, there may be benefits in also considering some additional scenarios in the context of the EU banking sector and EU Internal Market. It could be argued that that the issue of macro prudential risk should rather be addressed at individual bank level in order to avoid additional capital charges for banks which are not contributing to excessive credit growth. The Commission Services are therefore also consulting on two alternative options.

A. Discretion of Home Supervisors

21. This option would give the home supervisor of a bank with branches in other Member States or third countries the discretion to set the level of a bank-specific countercyclical buffer under a pillar two approach. Under this option the discretion of the home supervisor would be complete and, in particular, it could set the bank specific buffer at a level lower than that recommended by the competent authorities of the host Member states (cf. paragraph 19). The risk that host member States might be concerned that the level set by the home supervisor did not adequately reflect macro-prudential risk in their market could be mitigated by EBA guidance and dispute settlement.

22. Within this option there are also two disclosure possibilities for the consolidated buffer: a) disclosure; b) non disclosure.

B. EU Jurisdiction where the credit is granted

23. An alternative, for banks with branches in other EU Member States, would be that the bank-specific buffers would be calculated as a weighted average of the published buffer add-ons that apply in the various EU jurisdictions from which a bank grants credit. This adoption would mean that the countercyclical buffer for an EU bank with branches both in EU member States and in third countries would be calculated as a weighted average of the jurisdictional add-ons determined in the following way.

24. For credits granted from a credit institution located in the EU, the relevant add-on would be that of the Member State where that establishment is located; that is, either the home Member State or the host State in all cases where the credit was granted from an EU branch. This principle would apply irrespective of where the credit exposure was located. For example, if a bank with its head office in France (the home Member State) grants credits from a branch in Belgium to creditors located in Belgium, France and Germany, the add-on for all those credits would be that set by the Belgian authority. For credits granted from a third country branch, the principle set out in would apply; that is, the add-on of the territory where the credit exposure is located. However, there would be no requirement for a bank that has credit exposures granted through its branches to hold any part of the buffer in the jurisdictions where the branches are located.

25. This approach targets the source of credit growth by focussing on the add-on of the States where credit is generated. It is consistent with the EU Treaty freedoms by ensuring that all entities granting credit from a Member State are subject to the same treatment and would be consistent with the objective of limiting excessive credit growth.

Questions:

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.

2. Would the approach for dealing with internationally active banks set out in paragraphs 12 to 20 help ensuring a level playing field between domestic and foreign (located in other Member States and third countries) banks? Could there be an incentive for regulatory arbitrage since credit institutions may gain benefits from booking exposures in jurisdictions with lower capital add-ons? Which of the three alternatives reduces the chances of regulatory arbitrage? Are there other ways in which potential regulatory arbitrage could be mitigated?

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?

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.

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.

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?

(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?

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

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

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

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

9. Should the counter-cyclical buffer apply to all exposures or be limited to certain types of exposures and if yes which? Please support your answer with reasons.

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.

11. Do you have other comments or suggestions?