Analysis

Capital buffer requirements included in the macroprudential toolkit are supporting the risk-bearing capacity of banks

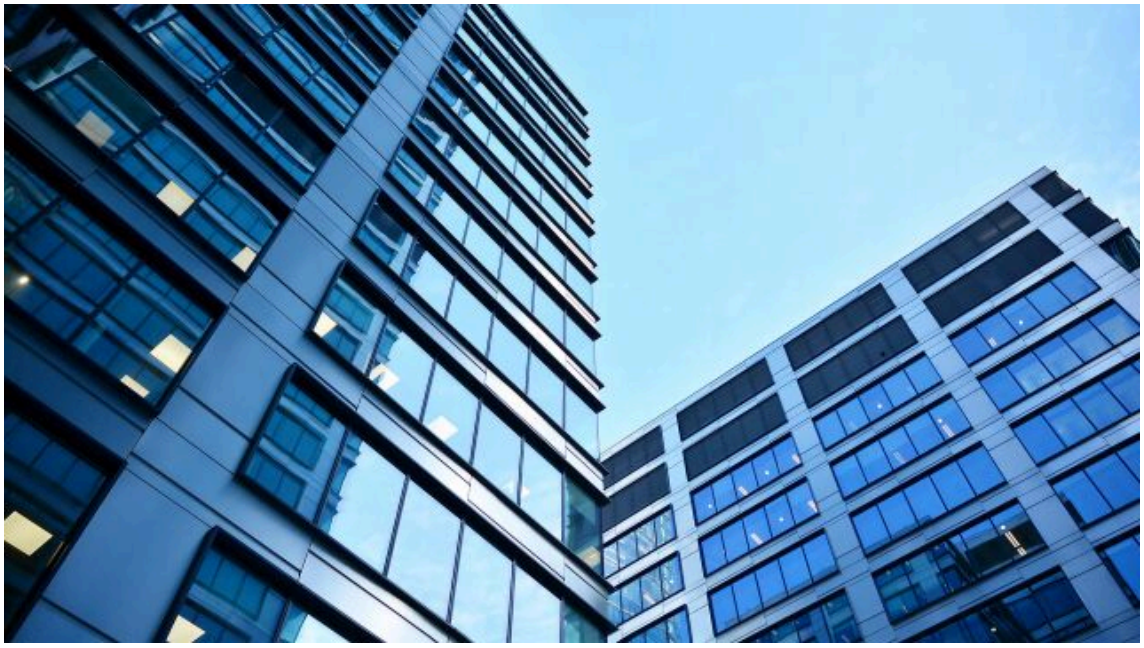
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Capital buffer requirements imposed on banks are among the key instruments available in the macroprudential policy toolkit. They safeguard the risk-bearing capacity of banks. Some of the requirements are imposed on the basis of the structural features of banks or the financial system. The countercyclical capital buffer (CCyB) requirement, in turn, is set on the basis of cyclical conditions. It can be relaxed in difficult economic conditions, if necessary, and thereby support bank lending. To ensure there is scope for lowering the CCyB requirement, it should be possible to set the requirement above zero already at the neutral phase of the credit cycle.



The objective of macroprudential policy is to prevent systemic risks that threaten the stability of the financial system, and to prevent and mitigate any ensuing financial crises and other disruptions and their adverse effects on the real economy.[1] The objective is safeguarding the stability of the financial system as a whole, but since in many countries – such as Finland – banks are a key part of the financial system, ensuring the stability of the banking sector is a key element of macroprudential policy.

The capital buffer requirements[2] that are imposed on banks and other credit institutions are among the most important macroprudential instruments. A capital buffer requirement means that banks are required to hold, in addition to the risk-weighted minimum capital requirements[3], a certain percentage of the highest quality Common Equity Tier 1 (CET1) capital relative to their risk-weighted assets in case of various systemic risks. The primary purpose of the capital buffer requirements is to ensure that banks have sufficient risk-bearing capacity so that they can continue operating even in difficult conditions. The goal is to prevent and reduce systemic risks, in particular, created within the banking system and the effects of these.

Smooth financial intermediation is particularly important in times of economic disruptions and downturns. It is essential that a weakening of a bank's position does not amplify an economic downturn via tighter lending conditions. Capital buffer requirements help banks prepare for a situation in which credit growth is slow or is decreasing, or for an even more difficult financial system crisis or other severe disruption.

As a result of the capital buffer requirements, banks' capital buffers are stronger than before. In difficult conditions, banks with a solid capital position are usually better able to continue lending and raise market financing. They are also better prepared to absorb losses resulting from stress or crisis situations. During very weak cyclical conditions, it may be necessary for macroprudential authorities to relax the capital buffer requirements on banks and thereby support bank lending, if for example banks' losses would otherwise limit their ability to provide credit.

The outbreak of the COVID-19 pandemic in spring 2020 was the first situation in which banks' capital buffer requirements and also other requirements were lowered extensively.[4] For example, national CCyB requirements were reduced or deactivated completely in many EU countries. Before the pandemic, Finland did not have a positive cycle-neutral CCyB requirement that could have been relaxed during the pandemic. The Board of the Financial Supervisory Authority (FIN-FSA), which takes the macroprudential decisions, considered it essential – in a very exceptional and uncertain pandemic situation – to ensure the ability of banks to provide credit, and so it lowered the structural buffer requirements in force at that time. The policy responses during the pandemic thus provide a good basis for a more detailed assessment of how the capital buffer

requirements for banks included in macroprudential policy should be developed.

Capital buffer requirements are imposed to guard against various risks and vulnerabilities

The purpose of capital buffer requirements included in the macroprudential toolkit is to ensure that credit institutions have sufficient capital and risk-bearing capacity to guard against risks to financial stability. Different buffers have different purposes, however, as there are differences in the risks they are designed to prevent. The capital buffer requirements applied in Finland[5] are given in Table 1.

Banks' capital buffer requirements in Finland

Capital buffer requirement	Risk basis	Justifications for setting or adjustments	Rate applied in Finland	Maximum rate in Finland
Capital conservation buffer (CCoB) requirement	General systemic risks	Permanently valid	2.5%	2.5%
Systemic risk buffer (SyRB) requirement	Structural systemic risks	Risks/ changes in risks	1.0% (as of 1 April 2024)	5.0%
G-SII requirement for global systemically important banks	Structural risks caused by systemically important banks	Risks/ changes in risks	-	3.5%
O-SII requirement for other systemically important institutions	Structural risks caused by systemically important banks	Risks/ changes in risks	0.5%–2.5% (three banks)	3.0%
Countercyclical capital buffer (CCyB) requirement	Cyclical systemic risks	Risks/ changes in risks or financial market	-	2.5%

Sources: Financial Supervisory Authority and Bank of Finland.

Banks' capital buffer requirements in Finland				
		disruptions		

Sources: Financial Supervisory Authority and Bank of Finland.

The capital conservation buffer (CCoB) requirement is valid permanently. It is designed to ensure that banks build up their Common Equity Tier 1 capital in normal circumstances to prepare for difficult times and losses.[6] In Finland, as in the other EU countries, the statutory CCoB rate is 2.5%.

Decisions on the other capital buffer requirements for banks are taken in Finland by the Board of the FIN-FSA. The CCyB requirement can be imposed on banks if there is a risk of overheating in the credit cycle. Possible signs of overheating may include excessive growth in lending or a steep rise in housing prices. The CCyB requirement is necessary for mitigating cyclical systemic risks. Economic downturns following an overheating of the credit cycle can be especially difficult and cause major losses to banks.[7]

The primary objective of the CCyB requirement is to ensure that the banking sector's capital buffers are so strong that it can continue providing credit to the real economy also in the contraction phase of the credit cycle, despite possible losses. A secondary objective is that the CCyB requirement could curb the overheating of the credit cycle in an upswing by increasing the price of credit and thereby, to some extent, dampening the demand for credit. In Finland, the financial cycle has been very moderate in recent years, and the CCyB requirement has therefore not been raised above zero.[8]

Some banks are so important to the functioning of the financial system that any difficulties they experience could threaten the stability of the entire global financial and banking system. Capital buffer requirements may be imposed on such individual banks either in the form of buffer requirements for global systemically important institutions (G-SII buffers) or for other systemically important institutions (O-SII buffers). The importance of the institution is assessed based on various criteria, including size, interconnectedness and complexity. Authorities also assess whether other operators could replace their activities. Finland has set O-SII buffer rates for Nordea (2.5%), OP Group (1.5%) and Municipal Finance (0.5%).

Financial and banking systems may also contain specific structural vulnerabilities. These can mean that systemic risks and threats stemming from them may be very significant to the whole financial system and the economy. Such vulnerabilities include high risk exposures of the banking sector to certain types of borrowers and strong interconnectedness between the sector and foreign

financial systems. In response to such threats, it may be necessary to set systemic risk buffer (SyRB) requirements.[9] In March 2023, the FIN-FSA Board decided to set an SyRB requirement of 1.0% for all Finnish credit institutions.[10] The requirement will enter into force in April 2024.

Besides the capital buffer requirements imposed in Finland, banks may be required to comply with capital buffer requirements imposed by certain foreign authorities. Compliance with foreign CCyB requirements is based directly on the level set by law for the particular volume of assets in each country. In addition, the FIN-FSA Board may recognise an SyRB requirement imposed in a country of the European Economic Area (EEA) to the extent it concerns exposures in that country.

Capital buffer requirements are flexible in a downturn

Macroprudential policies have been implemented more widely in the EU since the global financial crisis. In Finland, the first capital buffer requirements were introduced in accordance with EU legislation in 2015. Capital buffer requirements are therefore still a fairly new way of safeguarding financial stability.

So far, there is little experience of very difficult economic situations in which, due to increased losses and risks, banks' capital levels are threatening to decline at such a rate that there is a risk of no longer meeting the requirements set for minimum capital and additional buffers. In Europe, the first situation in which such a risk was witnessed under the current macroprudential framework was the severe liquidity shock to the financial system and the increased financial and economic uncertainty in spring 2020, following the outbreak of the pandemic.

A serious downturn could become a problem not only for individual banks – due to the increase in losses and risks – but also for the ability of the banking system as a whole to intermediate finance. Below is a description of how banks could adapt to this hypothetical situation and how flexibility in the use of capital buffer requirements could support this adjustment. A problem could arise if banks choose to ignore the available alternatives and decide to limit their lending, thus amplifying the downturn.

ⓘ Different ways for banks to adapt to declining capital ratios caused by

losses and increasing risks

Banks have several ways of adapting to a faltering economy, higher risk levels for assets or a situation where the bank suffers credit losses:

- The best way to improve banks' risk-bearing capacity would be to raise additional funding through share issues or use profits to strengthen capital. However, in a difficult environment, unprofitable banks may find it very hard to raise capital through share issues, and no profits can be retained from a negative result.
- A second option could be for banks to let their capital ratios decline, even if this means an inability to meet the capital buffer requirements set for them. These requirements focus on the need to maintain buffers, but meeting the requirements is not a strict precondition for continuing the bank's operations. In a difficult situation, capital is allowed to fall temporarily below the buffer requirements, giving banks the opportunity to strengthen their capital in a controlled manner and in accordance with an agreed schedule. If the bank does not meet the capital buffer requirements, the authorities will impose restrictions on the distribution of its profits, concerning for instance the payment of dividends or variable compensations. The magnitude of the restrictions depends on how much the bank's own funds fall short of the imposed capital buffer requirements.

  However, banks may be unwilling to let their own funds fall below the capital buffer requirements, and some may want to keep a buffer that exceeds them. This may be for different reasons, one being that it causes restrictions on profit distribution and other obligations that may complicate the acquisition of new capital. Another reason is that banks may fear that falling below the threshold could cause general damage to their reputation, which could, for example, make it more difficult to obtain market funding.

- A third option is for banks to adapt their operations in a way that reduces the risk-weighted assets that require own funds. This may require limiting or targeting lending, for example, to particularly low-risk borrowers. While this approach may improve the capital ratio of an individual bank, limiting lending in the banking sector as a whole may undermine access to financing and thus exacerbate the economic situation.

See Behn, M., Rancoita, E. and Rodriguez d'Acri, C. (2020), 'Macroprudential capital buffers – objectives and usability', ECB Macroprudential Bulletin, vol. 11.

From a macroeconomic point of view, banks should let their capital ratios fall rather than start restricting credit, or, in other words, use their capital buffers to enable continued lending. The Basel Committee on Banking Supervision has stressed that banks' capital buffers in excess of the

minimum requirements are designed to provide flexibility in stress situations, allowing banks to maintain lending.[11] The use of bank buffers has been assessed as the best option for economic growth, which was also the conclusion based on an analysis of the pandemic outbreak shock and the policy measures taken to counter it.[12] According to the assessment, the use of capital buffers in a stress situation would not lead to a significant lowering of risk-bearing capacity.

In order to improve banks' ability and willingness to use their capital buffers for lending, macroprudential authorities should consider whether capital buffer requirements should be lowered during adverse cyclical conditions. A factor in favour of this is that banks whose capital buffers have exceeded the capital buffer requirements more than for other banks have been more likely to continue to grant loans even during adverse conditions. This conclusion is supported by experiences from the pandemic and other research data.[13]

A situation like the one described above would warrant considering the impact of lowered requirements on the banking sector's ability to maintain its risk-bearing capacity. It should also be borne in mind that in a difficult economic environment banks will not necessarily be willing to lower their capital ratios even if the capital buffer requirements are lowered.[14] It should also be noted that other mandatory provisions on banking (such as leverage ratio requirements and the MREL requirements imposed by resolution authorities) may include requirements for banks that overlap with the capital buffer requirements and thus reduce the impact of lowering them.[15]

Lowering the capital buffer requirements would also mean that requirements which could be lowered would need to be in place to begin with. Under current regulations, the capital conservation buffer requirement is fixed and its magnitude cannot be altered. The G-SII and O-SII requirements for systemically important institutions are set on the basis of the characteristics of individual banks and these requirements should only be changed if there is a change in the values of the measures for these characteristics. SyRB requirements are similarly imposed on the basis of structural vulnerabilities in the financial system, and relaxing them would generally not be justified unless the structural risks have changed. The lowering of structural capital buffer requirements in Finland was justified in the exceptional circumstances of the pandemic in spring 2020, but the threshold for making further changes of this kind is very high.

Of the various capital buffer requirements, the countercyclical capital buffer (CCyB) requirement is the best suited for being lowered in an economic or financial disruption, as it can be adjusted in conjunction with cyclical conditions and, in particular, lowered in the event of disruptions to the operation of the financial system.[16] However, the requirement cannot be used in a downturn or a disruption in the financial system if it had not already been set above zero. In this case, it would not

be possible to lower the requirement either, as it cannot be set to a negative level.

Besides the overheating of the credit market, a downturn affecting the lending capacity of the banking sector can also be triggered by an external and extensive shock to the financial system. In order to counter the negative impact of such a systemic disruption on bank lending, authorities should be able to prepare for disruptions by setting a CCyB requirement even if there are no signs of overheating of the credit cycle. The article 'How can Finland's use of the countercyclical capital buffer requirement be further developed?' examines ways to set the CCyB requirement above zero at a neutral phase of the credit cycle and what benefits this would bring. However, changing the way the CCyB requirement is applied would necessitate amendments to Finland's national regulations.

Notes

1. For example in Finland, the Board of the FIN-FSA has specified in its macroprudential strategy that the primary goal of macroprudential policy is to reduce the probability of financial crises and other severe disruptions to the financial system and their adverse effects on the real economy. This will then promote long-term economic growth by preventing the build-up of systemic risks and vulnerabilities, and supporting financial intermediation in the event of disruptions to the economy or the financial system. See https://www.finanssivalvonta.fi/contentassets/9b1b4d24040649e1b3d3a1d167fd485e/mv_27062022/finanssivalvonnan-johtokunnan-makrovakausstrategia_en.pdf. ↑
2. Provisions on banks' capital buffer requirements in Finland are laid down in chapter 10 of the Act on Credit Institutions (610/2014) and the supplementing Ministry of Finance Decrees. ↑
3. The amount of capital banks are required to hold under the capital requirements depends on the estimated risk level of their assets. The estimated risk level is determined on the basis of the risk weights set on the assets. ↑
4. See https://www.ecb.europa.eu/press/pr/date/2020/html/ecb.pr200415~96f622e255.en.html. ↑
5. Most of the capital buffer requirements included in the macroprudential policy toolkit were agreed globally in the standards issued by the Basel Committee on Banking Supervision and have subsequently been regulated extensively in the national legislation of the countries concerned. Within the EU, the minimum capital requirements under the existing Basel standards are in the Capital Requirements Directive. In contrast to the other requirements, the systemic risk buffer (SyRB) requirement is not based on the Basel standards; it is a capital buffer requirement introduced in EU provisions that can be applied to prevent structural risks in the banking and financial systems. ↑
6. See Guidance by the Basel Committee on Banking Supervision on risk-based capital buffer requirements: https://www.bis.org/basel_framework/chapter/RBC/30.htm?inforce=20191215&published=20191215. ↑

7. See Guidance by the Basel Committee on Banking Supervision on setting the countercyclical capital buffer: https://www.bis.org/publ/bcbs187.pdf. ↑
8. For a more detailed discussion on the measurement of cyclical systemic risks, see e.g. Koponen (2022) Voidaanko pankkikriisejä ennustaa? Bank of Finland Bulletin. ('Can banking crises be predicted?') ↑
9. In Finnish legislation, the systemic risk buffer (SyRB) requirement is referred to as a capital buffer requirement imposed on the basis of the structural characteristics of the financial system. ↑
10. See decision by the FIN-FSA Board: https://www.finanssivalvonta.fi/contentassets/84ea9cf01a5d4f7f96a506311d71343d/mv_29032023/jk_paatos_makrovakausvalineet_29032023_en.pdf. ↑
11. Basel Committee on Banking Supervision Newsletter on buffer usability, October 2019, https://www.bis.org/publ/bcbs_nl22.htm. ↑
12. See Borsuk, M., Budnik, K. and Volk, M. (2020), 'Buffer use and lending impact', ECB Macroprudential Bulletin, vol. 11. ↑
13. See Buffer usability and cyclicality in the Basel framework, BCBS, October 2022, https://www.bis.org/bcbs/publ/d542.pdf. ↑
14. See e.g. Andreeva, D., Bochmann, P. and Couaillier, C. (2020) ECB Macroprudential Bulletin, vol. 11. ↑
15. See e.g. Report of the Analytical Task Force on the overlap between capital buffers and minimum requirements, ESRB, December 2021. ↑
16. See chapter 10, section 5 of the Act on Credit Institutions (610/2014). ↑

Keywords

capital buffer requirements, financial stability, macroprudential policy