FAQs on the first increase of the countercyclical capital buffer

1. What is the countercyclical capital buffer (CCyB)?

How does the CCyB work?

The countercyclical capital buffer is a preventive tool designed to make the financial system more resilient to cyclical risks. During spells in which cyclical systemic risks build up, the CCyB creates additional capital buffers in the financial system, thereby reducing the likelihood that the supply of credit will be curbed excessively in periods of stress. In phases in which cyclical systemic risks ease off or materialise, the CCyB can be lowered again. This can prevent the banking system from having a procyclical effect.

What is procyclicality?

Procyclicality is mutually reinforcing interaction between the banking system and the real economy in economic upswings and downturns. This kind of interaction can be triggered in an environment of low interest rates, for example. Spells of low interest rates and rising asset prices present the danger of risks generally being underestimated, of the value of collateral being overstated, and of lending activity being expanded. That makes the financial system vulnerable to price corrections. If a reassessment of risks coincides with mounting loan losses in this kind of situation, the banking system might be forced to curb the supply of credit in an effort to comply with regulatory minimum capital requirements. Curbing the supply of credit can amplify an economic downturn, which in turn can drive up loan losses. The procyclical effect of the banking system in a scenario like this should not be confused with a normal (cyclical) decline in the supply of credit in a recession.

Procyclical interaction of this kind between the banking system and the real economy was in evidence during the last financial crisis in 2008. The lessons learned from that episode led to the creation, post crisis, of a capital buffer – the CCyB – that was designed specifically to counter the build-up of cyclical systemic risks. The legal basis for the CCyB is provided by the Banking Act (*Kreditwesengesetz* – KWG) and the Solvency Regulation (*Solvabilitätsverordnung* – SolvV), being the legislation transposing the European Capital Requirements Directive (CRD IV) into German law.

Whom does the CCyB apply to?

The German CCyB applies to all German banks and to subsidiaries of foreign banks established in Germany. These institutions are required to apply the CCyB to their domestic exposures (e.g. the loans they grant). Similarly, banks in other Member States of the European Economic Area (EEA) are required to apply the CCyB to their exposures to Germany up to a level of 2.5% (reciprocity). Voluntary reciprocity is envisaged for higher CCyB rates. Reciprocity up to a buffer rate of 2.5% is also mandatory for all Basel Committee member jurisdictions. Given that foreign exposures are taken into account, it is possible that different institutions will have to comply with different CCyB rates. A detailed account of how the institution-specific CCyB rate is calculated can be found in BaFin's FAQs on the countercyclical capital buffer.[1] Because of the CCyB requirements in other jurisdictions, the CCyB is already operational for a number of German credit institutions.

According to data for the second quarter of 2019, 12 Member States of the European Economic Area (EEA) have introduced or announced a positive CCyB rate. A summary can be found on the ESRB's website.[2] In these countries, CCyB rates have been set between 0.25% (Luxembourg) and 2.5% (Sweden and Norway). These foreign CCyBs already need to be taken into account by German credit institutions with exposures to the countries concerned.

How is the CCyB rate set?

The CCyB rate can be set at between 0% and 2.5% of RWAs. It is also possible to set a rate higher than 2.5% in exceptional circumstances. The CCyB must be satisfied with Common Equity Tier 1 capital (CET1).

The decision on setting the CCyB rate follows the principle of guided discretion, as recommended by the European Systemic Risk Board (ESRB, recommendation ESRB 2014/1). In other words, the decision is based, on the one hand, on the current development of a series of macroeconomic indicators, and, on the other, on additional information which is currently deemed relevant to the CCyB decision.

The Bundesbank monitors how the indicators evolve and assesses the appropriateness of the CCyB rate with the aid of further analyses. BaFin validates this assessment and feeds it into the CCyB rate it sets. One major indicator for the rules-based component is the credit-to-GDP gap, which signals deviations in the relationship between the credit volume and economic activity from its long-term trend. Germany's credit-to-GDP gap has been narrowing steadily since 2011. Further information on this indicator is provided in a methodological note published by BaFin and the Bundesbank.[3]

[1] https://www.bafin.de/SharedDocs/Veroeffentlichungen/DE/FAQ/faq_antizyklischer_kapitalpuffer.html
[2] https://www.esrb.europa.eu/national_policy/ccb/html/index.en.html
[3] https://www.bundesbank.de/resource/blob/598690/e627e8ef7407a27adf5d001bfafb4e92/mL/der-antizyklische-kapitalpuffer-data.pdf

Who decides on the CCyB rate?

BaFin sets the German CCyB rate and reviews its appropriateness every quarter, taking into account any recommendations made by the German Financial Stability Committee (G-FSC).

The CCyB rate set by BaFin is notified to the European Central Bank (ECB) and the European Systemic Risk Board (ESRB) at quarterly intervals. The ECB assesses the appropriateness of the CCyB and can set a higher CCyB rate (by virtue of legal powers granted by the SSM Regulation), while the ESRB publishes information on the CCyB rates set in EEA Member States on its website.[4]

How much time are banks given to satisfy the CCyB requirement?

Banks are given 12 months to satisfy the buffer requirement. So if a positive CCyB rate is set as from the third quarter of 2019, credit institutions need to have built up the CCyB in full by no later than the third quarter of 2020. The appropriateness of the CCyB rate is also subject to quarterly review by BaFin during the phase-in period – particularly in terms of GDP and credit growth – and BaFin makes any adjustments it deems necessary.

2. What is a G-FSC recommendation?

To whom is this recommendation addressed?

The G-FSC's macroprudential strategy states that the purpose of its measures is to strengthen the resilience of the financial system. A recommendation by the G-FSC flags dangers to financial stability and puts forward preventive measures which the committee deems suitable and necessary for averting those dangers. Warnings or recommendations can be addressed to the Federal Government, BaFin or any other public sector institution within Germany. If the G-FSC adopts a recommendation, the institution to which that recommendation is addressed must implement that recommendation accordingly or explain to the G-FSC why it will not implement the recommendation. The G-FSC assesses implementation of the recommendation.

The recommendation to increase the German CCyB rate for the first time is addressed to BaFin, which has until 14 June 2019 to state the manner in which it intends to put the recommendation into practice. BaFin is the national designated authority for the deployment of macroprudential instruments.

Why has the G-FSC issued a recommendation to increase the CCyB?

The G-FSC has assessed that, in the current economic setting, the build-up of systemic risks has created a threat to financial stability. If these cyclical systemic risks materialise, there would be the danger that the banks might curb the flow of funding to the real economy in order to bear the resulting losses. This could then give rise to adverse feedback loops between

[4] https://www.esrb.europa.eu/national_policy/ccb/html/index.en.html

the financial system and the real economy, because banks would be hit particularly hard, given their function as a lending channel.

The threat results from three risk areas: (i) potentially underestimated credit risk; (ii) potentially overvalued loan collateral on the back of many years of rising real estate prices; and (iii) interest rate risk, particularly if capital market interest rates stay very low for an even longer period or increase unexpectedly abruptly or strongly, for instance because risk premiums in financial markets rise suddenly.

The committee is concerned about whether the banking system would be able to cushion potential unexpected shocks that might arise if the aforementioned cyclical systemic risks materialise, without excessively curbing the function it performs for the economy as a whole. Based on analyses of the major vulnerabilities in the German financial system, the G-FSC considers it appropriate to raise the CCyB rate. The favourable macroeconomic setting at present should be used to enable the banking system to conserve and/or accumulate sufficient equity capital to render it suitably resilient to cyclical systemic risks, should they materialise. The current data, such as the rate of change in the credit-to-GDP gap or lending to enterprises and increases in residential real estate prices, are not signalling an end to the build-up of risk.

The G-FSC emphasises this assessment by recommending that the CCyB be increased for the first time. The existing vulnerabilities are analysed in detail in the G-FSC recommendation. The CCyB is a preventive tool designed to strengthen the resilience of banks so as to safeguard the functional viability of the financial system even if cyclical systemic risks materialise.

3. Other FAQs

What is financial stability, exactly? What role does macroprudential policy play?

The functional viability of the financial system is of essential importance for the real economy. The financial system coordinates savings and investment, makes it possible to hedge against risks and facilitates payments. Financial stability is a state in which the financial system is able to fulfil these functions at all times. The financial system should neither cause nor add too much to a downturn in overall economic activity. In other words, a stable and resilient financial system is also able to cushion losses caused by unexpected developments. It can absorb both financial and real economic shocks, in particular even when confronted with unforeseen events, in stress situations and in periods of structural adjustment.

The aim of macroprudential policy is to curb systemic risks as a preventive measure with a view to safeguarding financial stability. Macroprudential oversight focuses on interdependencies within the system as a whole, which means it dovetails with microprudential supervision, where attention is devoted to the solvency of individual financial institutions.

What is the German Financial Stability Committee?

The German Financial Stability Committee (G-FSC) is Germany's chief macroprudential forum. It was established at the beginning of 2013 on the basis of section 2 of the Act on Monitoring Financial Stability (*Finanzstabilitätsgesetz*) and is located at the Federal Ministry of Finance. Its members are representatives from the Federal Ministry of Finance, BaFin and the Bundesbank. The G-FSC has a mandate to regularly assess key issues which have a bearing on financial stability in Germany. Analyses prepared by the Bundesbank serve as a basis for these assessments. If the committee identifies risks to the stability of the financial system, it can warn against them or issue recommendations to avert them, such as the deployment of macroprudential instruments.

Preserving domestic financial stability is a national task, but it also means taking an international perspective and cooperating closely with institutions in other jurisdictions. In addition to national macroprudential oversight, the European Systemic Risk Board (ESRB), for example, analyses financial stability risks from a European vantage point.

What impact does the CCyB have on the development of the economy as a whole?

The CCyB is not intended as an instrument to steer the economic cycle. Rather, it is there to be activated in the event that vulnerabilities build up in the financial system. The countercyclical capital buffer is a way of building up an additional capital buffer against cyclical risks when the economy is in good shape. This way, the CCyB can have a preventive effect in case multiple banks are simultaneously confronted by unexpected adverse economic developments and mounting losses. As a result, the CCyB makes the financial system more resilient to macroeconomic risks and thus helps to keep lending stable. Releasing the CCyB can then help dampen the negative effects of critical developments on lending and thus on the development of the economy as a whole.

At present, there ought to be sufficient excess capital in the German banking system on aggregate to satisfy a CCyB calibrated at 0.25%. Furthermore, there is a one-year phase-in period, so any banks which might find it a challenge to satisfy the new buffer requirement will have sufficient time to prepare themselves for activation of the CCyB.