DET SYSTEMISKE RISIKORÅD

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Q&A about the countercyclical capital buffer

A tool for ensuring a more robust financial sector

The Systemic Risk Council has an advisory function. The Council is to suggest initiatives to prevent or reduce systemic financial risks that may put all or parts of the economyunder pressure, as seen during the most recent financial crisis. One of the Council's tasks is to assess what is a suitable level for the countercyclical capital buffer.

The buffer is a new tool introduced in international regulation after the financial crisis as part of a larger set of reforms aiming to make the financial sector more robust. So far, the buffer has not been activated in Denmark, and this is the first time the Systemic Risk Council recommends that it be activated.

What is the countercyclical capital buffer?

The buffer is a capital requirement imposed on banks and mortgage banks. A key feature of the buffer is that the requirement is eased when the financial sector is stressed. Release of the buffer is to counter a situation in which banks and mortgage banks become more hesitant to lend in times of crisis.

So the countercyclical capital buffer differs from other capital requirements imposed on credit institutions in that it varies with the level of risk in the financial system. The purpose is not to halt soaring house prices or excessive lending growth when the economy is expanding. It is easier for the institutions to increase their equity capital via retained earnings in good times.

In monetary terms, what does the activation of the buffer mean?

A countercyclical buffer of 0.5 per cent increases the aggregate regulatory requirement for Danish credit institutions' equity capital by kr. 7 billion. By comparison, total earnings were kr. 38 billion in 2016, and the sector's excess capital adequacy was kr. 115 billion. Earnings and excess capital adequacy vary from one institution to another, but the vast majority are now sufficiently well-capitalised to be able to meet both the future capital requirements being phased in by 2019 and a countercyclical capital buffer of 0.5 per cent.

Will activation of the buffer entail expenses for the institutions?

No. The buffer requirement means that the institutions must finance a larger share of their balance sheets by means of equity. This can be achieved by retaining earnings rather than paying them out as dividends or share buy-backs.

Irrespective of whether earnings are paid out or retained, they belong to the shareholders as they own the institutions.

Why should the buffer be activated now?

The buffer is to be activated when risks in the financial system are increasing. This is typically in periods when consumers and firms take an optimistic view of the economy, house prices are rising and credit conditions are accommodative. The Systemic Risk Council advises that the buffer be activated in a timely manner to ensure that it has been built up if the financial system becomes significantly stressed. That will give the sector a better opportunity to adapt to the requirements than rapid phasing-in would. Furthermore, there is a lag of 12 months from the date when the Minister for Industry, Business and Financial Affairs announces decisions relating to the buffer rate until the changes take effect.

So it is important to have information that provides an early indication that risk is building up. For example, property prices often increase before lending in periods leading up to financial crises. Moreover, the aggregate debt level of Danish households is very high. So although growth in lending is currently limited, build-up of debt from an already high level will amplify risks associated with future credit growth.

How does the Council assess whether risks are increasing?
Identifying and quantifying risks is a complex process. Consequently, the Systemic Risk Council uses various sources of information to assess the current stage of financial developments. This information is based on international studies of how risks develop, among other factors. Future crises are not likely to be identical to those previously seen, but some patterns tend to be repeated. The buffer rate is not set mechanically on the basis of indicators, and as quantification of risk developments is subject to uncertainty, the Council's recommendations on the buffer rate will always be based on an overall assessment of financial developments. So it is important that the monitoring of systemic risks covers a broad area and offers a holistic approach to potential risks.

How is the buffer activated?
The Minister for Industry, Business and Financial Affairs decides whether to activate the buffer. Every quarter, the Systemic Risk Council assesses the level of the buffer rate. If the Council finds that the buffer rate should be changed, it will publish a recommendation addressed to the Minister. The buffer rate has been 0 per cent since the Council's first assessment in December 2014.

Which criteria must be met before the buffer can be activated?
There are no specific criteria for when the buffer can be activated. The legislation says that decisions on the buffer rate must be founded on a broad information basis, including a number of indicators that are relevant for identifying risks in the financial system.

Has the buffer been activated in other countries?
Yes, the buffer has been activated in Sweden, Norway, the Czech Republic, Slovakia, Iceland and the UK. National decisions to activate or increase the buffer rate have been founded on a broad information basis, and relevant indicators have pointed to build-up of risk. For example, Iceland and the UK activated the buffer at an early stage of financial developments.

Can the Minister refuse to comply with a recommendation from the Systemic Risk Council?
The Minister must either comply with the recommendation or explain why it is not complied with.

Is the buffer a guarantee against a new financial crisis?
No, the buffer is an instrument aimed at preventing banks from reducing their lending too much if a new financial crisis occurs.