

IDENTIFICATION OF OTHER SYSTEMICALLY IMPORTANT INSTITUTIONS (O-SIIs) AND CALIBRATION OF O-SII CAPITAL BUFFERS



BANCO DE PORTUGAL
EUROSYSTEM

Methodological note • July 2016

1. Introduction

Pursuant to the Legal Framework of Credit Institutions and Financial Companies, and within the scope of the exercise of its powers as macro-prudential authority, Banco de Portugal is responsible for identifying other systemically important institutions (O-SIIs) at the domestic level. They shall be required to hold, on a consolidated, sub-consolidated or individual basis, as applicable, a buffer of up to 2% of the total risk exposure amount, consisting of Common Equity Tier 1 capital.

Furthermore, according to the legal and regulatory provisions set out in Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013¹ on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms (CRD IV)², Banco de Portugal must publish the names of the banking groups that are identified as O-SIIs.

In line with the guidelines issued by the European Banking Authority (EBA)³ (hereinafter EBA Guidelines), Banco de Portugal is also required to publish:

- a summary of the methodology for the supervisory assessment implemented during the O-SII identification process, including optional indicators, if any;
- the scores of the institutions designated as O-SIIs, indicating which institutions score above the threshold stated in the EBA Guidelines and therefore automatically designated as O-SIIs;
- a description of the methodology used to determine the O-SII buffer requirements;
- the buffer requirements applicable to the different O-SIIs.

With a view to complying with the regulatory provisions, this document sets out the methodology to identify O-SIIs, as well as the calibration approach as regards the imposition of capital buffers on O-SIIs in Portugal.

According to the new regulatory framework⁴, Banco de Portugal, within the scope of its powers as macro-prudential authority, may impose higher own funds requirements on systemically important institutions in order to compensate for the higher risk that these institutions pose to the financial system due to its size, importance for the economy of the Member State or the European Union, business complexity and/or degree of interconnection with other institutions in the financial sector thus potentially exerting effects of contagion to the rest of the non-financial and financial system.

This macro-prudential policy instrument, by enhancing the resilience of the financial system as a whole and increasing the capacity of the systemically important institutions to absorb potential losses, contributes to the compliance with one of Banco de Portugal's macro-prudential policy intermediate objectives⁵. The goal of this intermediate objective is to strengthen the resilience of systemically important institutions in order to reduce incentives for taking excessive risks.

Banco de Portugal's decision to impose an O-SII buffer is based, in a first step, on the identification of O-SIIs, adopting the methodology set out in the EBA Guidelines. After the identification of the O-SIIs in Portugal, in a second step, the capital buffer to be applied to each of those institutions is calculated, based on the principle that the capital buffer level must be higher, the greater the systemic importance of the banking group in question.

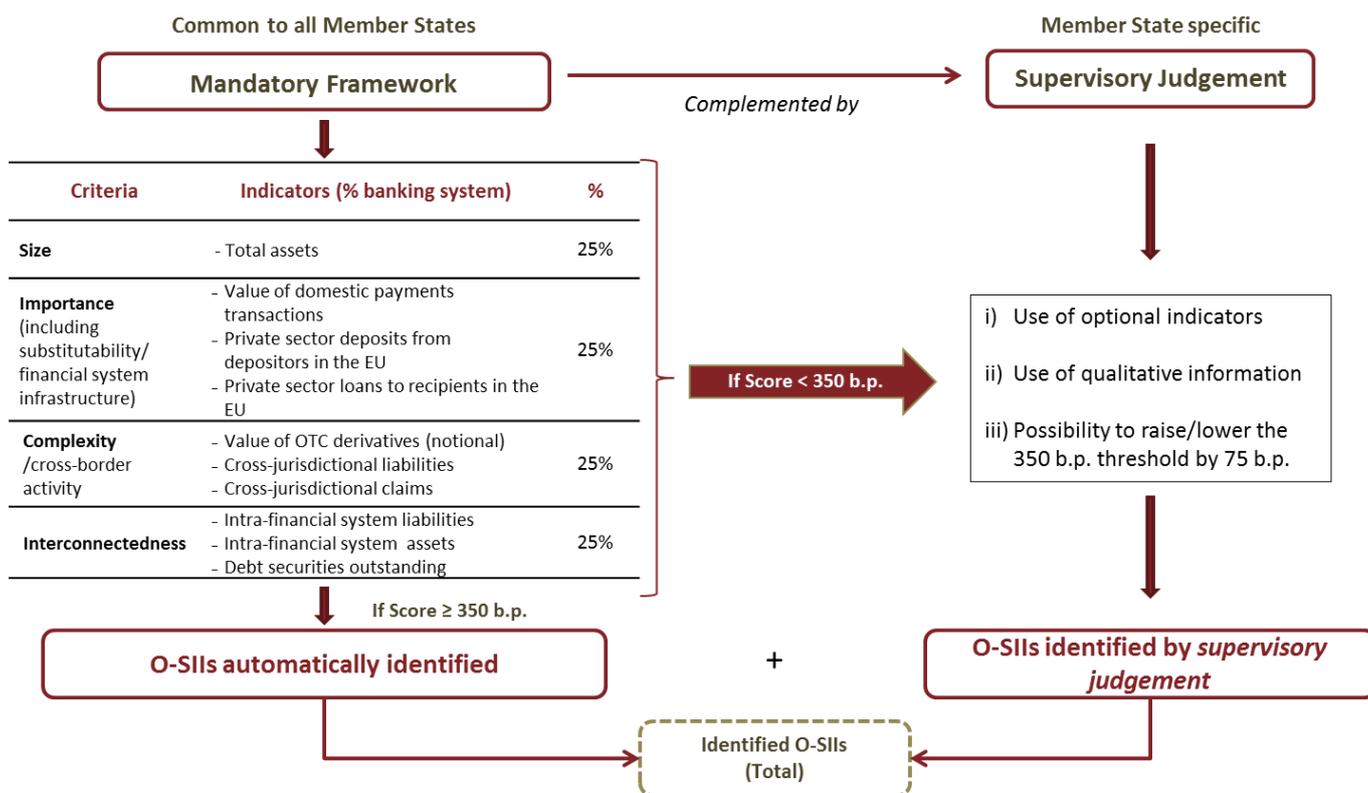
The remainder of this document is organised as follows: Section 2 describes the methodology used to identify O-SIIs, and Section 3 presents the calibration methodology of the O-SII buffer.

2. Identification of the O-SIIs – methodology

The methodology set out in the EBA Guidelines follows an approach comprising two steps (see Figure 1). In the first step, which is common to all Member States, a quantitative analysis is based on a fixed set of mandatory indicators. In this analysis, the banking groups meeting the conditions established in the EBA Guidelines, i.e. qualifying above a certain score threshold (set out at 350 basis points), are designated as O-SIIs.

The second step encompasses the possibility to assess the banking groups that are not directly identified as O-SIIs in the first step, but that may be identified as such under certain conditions. The purpose of this second step is to take into account each Member State's specificities, in particular their financial systems.

Figure 1 • Methodology set out in the EBA Guidelines



2.1. Mandatory framework (1st step)

In the first step, four criteria are defined to evaluate the institutions' systemic importance, considering the highest consolidation level. These criteria include the size of the institutions, their importance to the economy of the relevant Member State or the European Union, the complexity of the business model as well as cross-border activity, and, finally the interconnectedness of the banking group with the rest of the financial system. The four criteria each consist of one or more mandatory indicators to measure them. All criteria should be weighted equally at a weight of 25%. This weight is fixed and equally divided by the number of indicators integrating each criterion, as shown in Figure 1.

After each indicator is calculated and weighted by the respective factor, these are multiplied by 10,000 in order to express the scores in terms of basis points. Institutions with a total score above the 350 basis point threshold, as defined in the EBA Guidelines, are automatically identified as O-SIIs.

2.2. Judgment by Banco de Portugal (2nd step)

The purpose of the second step is to provide flexibility on Banco de Portugal as regards the additional identification of institutions designated as systemically important institutions, in addition to those resulting from applying the mandatory framework, taking into account the specificities of each Member State, in particular their financial systems.

This step enables Banco de Portugal to:

- select an additional set of indicators set out in the EBA Guidelines⁶;
- use qualitative information;
- raise or decrease the 350 basis points threshold by a maximum of 75 basis points.

Where this possibility results from the identification of an additional number of systemically important institutions, Banco de Portugal shall also publish information on:

- which optional indicator(s) are used to inform on their designation as O-SIIs;
- why this indicator is relevant for the Member State;
- why the institution is systemically important in terms of the optional indicator(s) used.

As set out in the EBA Guidelines, and considering the Portuguese geographical context, it was decided to assess the relative importance of each institution in terms of banking activity carried on in the Portuguese Islands (Azores and Madeira). In this sense, in addition to the mandatory indicators used in the first step, other indicators are used such as credit granted and deposits received in the mentioned regions, and are included in the criterion assessing the importance of each institution for the economy of the Member State concerned or the European Union.

3. Calibration of the O-SII buffer

After the identification of the O-SIIs, Banco de Portugal, as the macro-prudential authority, is able to require each O-SII to maintain an additional buffer of up to a maximum of 2% of the total risk exposure amount, consisting of Common Equity Tier 1 capital. According to the legal framework in force, this requirement applies from 1 January 2016, and shall be reviewed by Banco de Portugal at least annually or in case of significant structural changes impacting on the Portuguese financial system.

However, the capital buffer under analysis cannot result in disproportionate effects on the financial system, in full or in part, of other Member States or the European Union, which may hamper the smooth operation of the internal market.

With a view to calibrating the O-SII buffer, Banco de Portugal has used the cluster methodology, adopting the approach used by the Financial Stability Board to calibrate the capital buffers to be required from global systemically important institutions (hereinafter G-SII)⁷.

The cluster methodology is based on the allocation of each identified O-SII to a set of previously defined score clusters. Each

cluster is associated with an O-SII buffer. An institution with a higher score is allocated to a cluster associated with a higher capital buffer, whereas an institution with a lower score is allocated to a cluster associated with a similarly lower capital buffer.

Considering the scores obtained in the identification process, five clusters were set up, to which capital buffers are associated. No institution is allocated to the cluster 5 (associated with higher scores), thus enabling institutions that may become more systemically important in the future to comply with the maximum capital buffer requirement defined (2%).

Based on this calibration methodology, O-SIIs are allocated to clusters, considering the scores obtained by each one in the identification process. Banco de Portugal has also decided that this buffer should be required on a consolidated basis.

Table 2 presents the clusters, the range of scores and the respective O-SII buffer rates.

Banco de Portugal has the ability to modify previous decisions taken under the aforementioned Notice. As soon as updated financial information becomes available, Banco de Portugal will proceed with the evaluation of the consequences of the recent developments on the Portuguese banking system structure and, if, based on that evaluation, a new decision on the O-SII buffer rate is taken, an adequate period of time for the banking institutions to adjust will be defined.

Table 2 • O-SII buffer

Clusters	Scores	O-SII buffer
5	≥ 2800	2.00 %
4	2100-2799	1.00 %
3	1400-2099	0.75 %
2	700-1399	0.50 %
1	350-699	0.25 %

Finally, we would like to stress that non-compliance with these buffers does not mean institutions may not continue to carry out their business. It does however imply restrictions on dividend payments and share buybacks, as well as the submission to Banco de Portugal, by the institutions concerned, of a capital conservation plan establishing a timeframe with the objective of fully meeting the combined buffer requirement⁸. Banco de Portugal and ECB-SSM are both responsible for defining a time frame for the implementation of the plan

Notes

¹ This Directive was transposed into national law through Decree-Law No 157/2014 of 23 November 2014.

² Pursuant to the provisions of Article 131 (12) 'The competent authority or the designated authority shall notify the names of the G-SIIs and O-SIIs (...) to the Commission, the ESRB and EBA, and shall disclose their names to the public'

³ EBA/GL/2014/10 'Guidelines on the criteria to determine the conditions of application of Article 131(3) of Directive 2013/36/EU (CRD) in relation to the assessment of other systemically important institutions (O-SIIs)', published in:
[https://www.eba.europa.eu/documents/10180/930752/EBA-GL-2014-10+\(Guidelines+on+O-SIIs+Assessment\).pdf](https://www.eba.europa.eu/documents/10180/930752/EBA-GL-2014-10+(Guidelines+on+O-SIIs+Assessment).pdf).

⁴ As set out in the Legal Framework of Credit Institutions and Financial Companies, approved by Decree-Law No 298/92 of 31 December 1992.

⁵ For further information on the macro-prudential policy ultimate goal and the intermediate goals, please refer to the article 'Macro-prudential policy in Portugal: objectives and instruments', on Banco de Portugal's website: <https://www.bportugal.pt/en-US/EstabilidadeFinanceira/Documents/Macro-prudential%20policy%20in%20Portugal.pdf>

⁶ Banco de Portugal may decide how many optional indicators to use and how to classify them by criterion, provided that it complies with the guideline ensuring that each indicator belonging to the same criterion has the same weight as the others. Additional information on these indicators is detailed in Annex 2 – Optional indicators of EBA Guidelines.

⁷ This will be defined in an Instruction issued for the purpose by EBA. For further details, please refer to EBA Final Draft RTS on the methodology for the identification of G-SIIs.

⁸ Which is also composed of another type of buffer. For further details, please refer to the Financial Stability Report, November 2015 (Box 4) <http://www.bportugal.pt/en-US/EstabilidadeFinanceira/Publicacoes/RelatoriodeEstabilidadeFinanceira/Pages/RelatoriodeEstabilidadeFinanceira.aspx>