INSTITUTION-SPECIFIC COUNTERCYCLICAL CAPITAL BUFFER

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Contents

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The cross-border dimension of credit institutions' financial intermediation activity means that potential losses associated with excessive credit growth may stem from exposures to the domestic private non-financial sector but also from exposures to other countries. To guarantee that the banking sector is properly protected against cyclical systemic risk, the countercyclical buffer rate to be met by each institution, the so-called institution-specific countercyclical buffer rate, is calculated on the basis of the geographical location of the relevant credit exposures for the calculation of the countercyclical capital buffer.

This document reviews the framework underlying the calculation of the institution-specific countercyclical buffer rate in Portugal. In particular, it details: (i) the recognition (or reciprocity) by Banco de Portugal of buffer rates set by authorities of EU/EEA Member States or third countries, and (ii) the role assigned to Banco de Portugal in setting the buffer rate for exposures to third countries. This document also describes the methodology defined by Banco de Portugal to identify material third countries for the Portuguese banking system and the type of indicators that must be monitored to follow cyclical systemic risk in such countries.

1. Institution-specific countercyclical capital buffer[1]

The institution-specific countercyclical capital buffer is calculated by multiplying the institution-specific countercyclical buffer rate by its total risk exposure amount. In turn, the institution-specific countercyclical buffer rate consists of a weighted average of the buffer rates applicable in the countries where the relevant credit exposures of the credit institution are located. [2,3] The weights are calculated as the amount of relevant credit exposures to a given country divided by the total amount of all relevant credit exposures.

Banco de Portugal is responsible for setting, on a quarterly basis, the buffer rate for exposures to the domestic private non-financial sector and, to that end, has developed an analytical framework to support its decisions.[4] Furthermore, Recommendation ESRB/2014/1 of the European Systemic Risk Board (ESRB) defines a series of guidelines aiming at establishing a common approach to set the countercyclical buffer rate for relevant credit exposures to the domestic sector of each European Union/European Economic Area (EU/EEA) Member State.

With regard to the countercyclical buffer rate for foreign relevant credit exposures, it is necessary to distinguish the following cases:

[1]The legal basis underlying the implementation of the countercyclical capital buffer in the European Union is defined in Articles 130 and 135 to 140 of Directive 2013/36/EU (CRD IV). This Directive was transposed into Portuguese law by Decree-Law No 157/2014 of 24 October 2014 amending the Legal Framework Regime of Credit Institutions and Financial Companies (Portuguese acronym: RGICSF) and also implements a number of provisions of Regulation (EU) No 575/2013 (CRR). In particular, Title VII-A Section III of RGICSF lays down the legal basis for the implementation of the countercyclical capital buffer in Portugal.

[2]In this context, 'credit institutions' refers to credit institutions and investment firms in Portugal subject to the supervision of Banco de Portugal or the European Central Bank within the framework of the Single Supervisory Mechanism, as applicable.

[3]When calculating the institution-specific countercyclical capital buffer, relevant credit exposures include credit exposures, exposures held in the trading book and securitizations exposures whose counterparty is the private non-financial sector pursuant to Article 138-L of RGICSF.

[4]See Banco de Portugal (2015), *Countercyclical capital buffer in Portugal: How will it work?*, for more details on the analytical framework underlying the implementation of the countercyclical capital buffer in Portugal.

- Reciprocity or recognition of a buffer rate set by an authority of an EU/EEA Member State

  A buffer rate set up to 2.5 per cent by the authority of an EU/EEA Member State must be reciprocated, i.e. Banco de Portugal automatically recognises, without the need for an analysis or formal decision, the buffer rate set by another EU/EEA Member State and credit institutions must immediately consider this rate when calculating their institution-specific countercyclical buffer rate. For a buffer rate set above 2.5 per cent by the authority of an EU/EEA Member State, Banco de Portugal will decide on its recognition case-by-case, taking into account the cross-border implications of its decision and the guidelines of Recommendation ESRB/2014/1, which, in general, advises the recognition. Banco de Portugal's recognition of a decision made by the authority of an EU/EEA Member State covers the recognition of decisions to increase, maintain or reduce the buffer rate. If Banco de Portugal decides not to recognise the buffer rate set above 2.5 per cent, it shall notify the ESRB, the European Central Bank and the authority of the EU/EEA Member State responsible for setting the buffer rate.

- Recognition of a buffer rate set by an authority of a third country[5]

  The legal framework in force establishes the mandatory recognition of a buffer rate set up to 2.5 per cent by the authority of a third country. However, Recommendation ESRB/2015/1 recognises that certain cases may be ambiguous as to whether a particular measure adopted by the authority of a third country should be interpreted as the definition of a countercyclical buffer rate and advises that such cases be reported to the ESRB. In this context, Banco de Portugal shall review the analytical framework underlying the implementation of the countercyclical capital buffer in the third country to decide whether a given measure adopted by the authority of a third country may be classified as the definition of a buffer rate, where the Portuguese banking system's exposure to that third country is deemed material. The recognition of a buffer rate set above 2.5 per cent by the authority of a third country is voluntary. This means that the recognition of a buffer rate set by an authority of a third country may differ among EU/EEA Member States, which could undermine the level playing field among Union institutions and generate incentives for regulatory arbitrage. To prevent such situation, Recommendation ESRB/2015/1 establishes that EU/EEA Member States shall coordinate the recognition of a buffer rate set above 2.5 per cent by an authority of a third country through the ESRB. In turn, the ESRB will be responsible for providing guidance, via recommendation, to EU/EEA Member States on whether and to what extent the buffer rate set above 2.5 per cent should be recognised. Furthermore, Recommendation ESRB/2015/1 establishes that the ESRB will monitor the buffer rates set by authorities of third countries that are members of the Basel Committee on Banking Supervision and that the authorities of EU/EEA Member States should inform the ESRB when the authority of a third country that is not a member of the Basel Committee on Banking Supervision sets a buffer rate above 2.5 per cent. As in the previous case, the recognition of a decision made by the authority of a third country covers the recognition of decisions to increase, maintain or reduce the buffer rate.

[5] Third country is any jurisdiction outside the European Economic Area. The European Economic Area includes the European Union Member States, Iceland, Liechtenstein and Norway.

- Setting of a buffer rate for relevant credit exposures to a third country

  Banco de Portugal may set the buffer rate for relevant credit exposures to a third country in two situations: (i) if the authority of the third country has not set a buffer rate and there is evidence of risk accumulation; or (ii) if the buffer rate set is deemed insufficient to protect the domestic banking sector from risks arising from excessive credit growth in that third country. Consequently, also in this case, EU/EEA Member States may assess risk in third countries differently, resulting in distinct requirements within the Union regarding exposures to the same third country. To guarantee a common approach among EU/EEA Member States when setting the buffer rate for relevant credit exposures to a third country and prevent the monitoring of a large number of third countries by EU/EEA Member States, Recommendation ESRB/2015/1 establishes the principles that should guide the setting of buffer rates for relevant credit exposures to third countries. Against this background, Banco de Portugal has identified the third countries to which the Portuguese banking system is materially exposed. These third countries will be named as 'material third countries for the Portuguese banking system'. Banco de Portugal will regularly monitor a set of macroeconomic and financial indicators to assess the need for setting a countercyclical buffer rate for relevant credit exposures to those countries. In cases where Banco de Portugal decides to set a buffer rate above 0 per cent or different from that set by the authority of the third country, it shall notify the ESRB of its assessment and the ESRB will decide about the need to coordinate this action across EU/EEA Member States.

2. Communication

As of January 2016, Banco de Portugal's website provides information on buffer rates set by authorities of EU/EEA Member States or third countries, to ease the calculation of the institution-specific countercyclical buffer rate by credit institutions. To complete the information already provided, Banco de Portugal will publish on its website all decisions on the recognition of buffer rates set by authorities of EU/EEA Member States or third countries as well as any setting of buffer rates for exposures to third countries. These decisions will also be published in Banco de Portugal's *Official Bulletin* and *Financial Stability Report* when warranted. This communication strategy is in line with the communication principles established in the context of the Macroprudential Policy Strategy published in December 2015.[6]

[6] See Banco de Portugal (2015), *Macro-prudential policy strategy*, for more details on the communication principles established in the context of the macroprudential policy strategy.

3. Material third countries

This section overviews: (i) the methodology for identifying material third countries for the Portuguese banking system, and (ii) the type of indicators to be monitored to assess cyclical systemic risk developments in those countries.

3.1 Methodology for identifying material third countries[7]

A third country is initially identified as material for the Portuguese banking system if the amount of relevant credit exposures to that third country exceeds 1 per cent of the total amount of relevant credit exposures using data with a reference date of 31 December 2015. The exposure amount will be calculated according to three metrics:

- Risk-weighted exposures;
- Original exposures;
- Exposures in default.

Risk-weighted exposures are widely used for microprudential supervision purposes. However, their analysis should be backed by other indicators, as they are influenced by the institutions' internal credit risk models and, in this context, do not take sufficiently into account low risk exposures. As a result, the analysis also takes into account the original exposures, which capture the exposure amount from a purely accounting perspective, and the exposures in default, which capture the exposures that may pose higher risk to institutions.[8]

Taking into account the threshold of 1 per cent of the total amount of relevant credit exposures, Banco de Portugal will publish on its website an initial list of material third countries for the Portuguese banking system. This list will be reviewed annually until the second quarter of each year, based on a set of criteria defined for the entry/exit of countries into/from the list. Accordingly, a country is added to the list of material third countries if:

(i) the arithmetic mean of the exposure amount to the third country in percentage of the total exposure amount in the eight quarters preceding the reference date was at least 1 per cent for at least one of the metrics listed above;

(ii) the exposure amount to the third country in percentage of the total exposure amount in each of the two quarters preceding the reference date were at least 1 per cent for at least one of the metrics.

A country is excluded from the list of material third countries if:

(i) the arithmetic mean of the exposure amount to the third country in percentage of the total exposure amount in the twelve quarters preceding the reference date was less than 1 per cent for all metrics;

(ii) the exposure amount to the third country in percentage of the total exposure amount in each of the two quarters preceding the reference date were below 1 per cent for all metrics.

[7] The ESRB identifies on an annual basis the material third countries for the Union's banking system. For that purpose, the ESRB has established a methodology that is presented in Decision ESRB/2015/3. The methodology presented in this section closely follows that one.

[8] Exposures in default pursuant to Article 178 (1) of Regulation (EU) No 575/2013.

These criteria aim to guarantee that the list of material third countries for the Portuguese banking system is stable and adequately covers developments in institutions' cross-border activities. Their implementation is, naturally, conditional on the information available at the time material third countries are identified.

The exposure amount is determined using supervisory data compiled under the Common Reporting Framework (COREP). In particular, information available in Tables C09.01a, C09.01b and C0.9.02 about the geographical location of exposures is used. The geographical location is determined on the basis of the place of residence of the obligor or of the debtor and exposures include exposures to the private non-financial sector in the banking and trading books of institutions subject to own funds requirements associated with credit risk, counterparty risk and free deliveries.[9] Institutions must report this information to Banco de Portugal only where the ratio of non-domestic original exposures to total original exposures is equal or higher than 10 per cent, pursuant to Article 5 (a) (4) of Commission Implementing Regulation (EU) No 680/2014. As such, it is only possible to obtain an approximate value for the true exposure amount to a third country. Data are available as of the first quarter of 2014 on a quarterly basis.

3.2 Monitoring cyclical systemic risk in material third countries

Risks associated with excessive credit growth in material third countries for the Portuguese banking system will be regularly monitored by Banco de Portugal. However, pursuant to Recommendation ESRB/2015/1, Banco de Portugal is exempted from monitoring risks in third countries that are identified by the ESRB as material for the Union's banking system. Consequently, in the annual publication of the list of material third countries for the Portuguese banking system, Banco de Portugal will also signal the third countries that it will monitor.

With the purpose of monitoring risk, Banco de Portugal will follow a set of indicators which, where possible, include the following categories:

- credit market indicators;
- financial market indicators;
- real estate market indicators;
- macroeconomic indicators.

Banco de Portugal will seek to establish bilateral links with the authorities of the material third countries with the purpose of sharing its risk assessment and better understand the dynamics between the financial system and real economy in those third countries. Banco de Portugal will only publish its assessment of cyclical systemic risk developments in a given third country if it is require to decide on the recognition of a countercyclical buffer measure implemented by the authority of the third country or to set the buffer rate for relevant credit exposures to the third country to protect the Portuguese banking system.[10]

[9] The relevant credit exposures used to determine the materiality of third countries for the Portuguese banking system do not necessarily coincide with the relevant credit exposures used to calculate the institution-specific countercyclical capital buffer.
[10] Banco de Portugal may decide to increase, maintain or reduce the buffer rate.