



FSI - SEACEN Regional Seminar on Basel III and Capital Management by Banks

How Much Capital and When?

Reducing procyclicality and building capital buffers

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- Introduction
- Measures to address procyclicality and build capital buffers
 - Capital conservation buffer
 - Countercyclical capital buffer
- Transitional arrangements
- Open issues



- Procyclicality within the financial system can be defined as the features or characteristics which serve to exacerbate or amplify the underlying cyclicity of economic activity
- The Global Financial Crisis (GFC) exposed procyclical amplification of shocks across the financial system
- Business cycle fluctuations were amplified by:
 - tendency for regulatory capital requirements to increase during periods of downturn and decrease during benign periods
 - tendency of market participants to behave in a procyclical manner

Measures to address procyclicality



- Measures to address procyclicality:
 - Introduction of a Leverage ratio to supplement the risk-based capital requirement
 - More forward looking provisions
 - Conserve capital to build buffers that can be used in stress (Capital conservation buffer)
 - Achieve the broader macro-prudential goal of protecting the banking sector from periods of excessive credit growth (Countercyclical capital buffer)
 - Reduce cyclicity of the minimum requirement
- Today's focus is on capital buffers ...

Capital Conservation Buffer - Objective



- To build up capital buffers above the minimum capital requirement in good times that can be drawn down in periods of stress
 - to avoid breaches of minimum capital requirements and to ensure that capital remains available to support ongoing business through the period of stress

Capital Conservation Buffer - Best practice



- Outside of periods of stress, banks should hold capital buffers above the regulatory minimum
- When buffers have been drawn down, banks should look to rebuild them through reducing discretionary distribution of earnings or raising new capital
- It is not acceptable for banks which have depleted their capital buffers to use future predictions of recovery as justification for maintaining generous distributions
- It is also not acceptable for banks which have depleted their capital buffers to try and use distributions as a way to signal their financial strength

Capital Conservation Buffer - Framework



- A capital conservation buffer of 2.5% will apply above the minimum capital requirement
- Buffer must be held in the form of Common Equity Tier 1 (CET1) capital
- Banks will be subject to capital distribution constraints when capital levels fall within the buffer range
 - Distributions include payments that result in a depletion of CET1 capital:
 - dividends and share buybacks
 - discretionary payments on other Tier 1 capital instruments; and
 - discretionary bonus payments to staff
- Buffer can be drawn down in periods of stress
- Framework will apply at the consolidated level. National supervisors have the discretion to apply it at the solo level

Capital Conservation Buffer - Application



Individual bank minimum capital conservation standards

Common Equity Tier 1 ratio*	Minimum capital conservation ratios (expressed as a % of earnings)
4.5% - 5.125%	100%
>5.125% - 5.75%	80%
>5.75% - 6.375%	60%
>6.375% - 7.0%	40%
>7.0%	0%

*CET1 capital must first be used to meet the minimum capital requirements (including the 6% Tier 1 and 8% Total capital requirements, if necessary), before the remainder can contribute to the capital conservation buffer

Countercyclical Capital Buffer - Objective



- To ensure that the banking sector has a capital buffer during periods of excess credit growth that are judged to be associated with the build-up of system-wide risk
 - To ensure that the banking sector in aggregate has the capital on hand to help maintain the flow of credit in the economy without its solvency being questioned , when the broader financial system experiences stress after a period of excess credit growth

Countercyclical Capital Buffer - Mechanics



- Use of a common starting reference guide - Credit/GDP gap

Involves three steps:

- calculation of aggregate private sector credit/GDP ratio
 - calculation of credit/GDP gap
 - transformation of the gap into the buffer add-on
- Use of other variables
 - Use of judgement with proper communication

Countercyclical Capital Buffer - Principles



- Buffer decisions should be guided by the objective to protect the banking system against potential future losses when excess credit growth is associated with an increase in system-wide risk
- The credit/GDP guide is a useful common reference point in taking buffer decisions. It should be used as part of the information considered by the authorities to take and explain buffer decisions
- Assessments of the information contained in the credit/GDP guide and any other guides should be mindful of the behaviour of the factors that can lead them to give misleading signals
- Promptly releasing the buffer in times of stress can help to reduce the risk of the supply of credit being constrained by regulatory capital requirements
- The buffer is an important instrument in a suite of macro-prudential tools at the disposal of the authorities

Countercyclical Capital Buffer - Framework



- National countercyclical buffer
 - National authorities will make assessments of whether credit growth is excessive, and implement a countercyclical buffer, when warranted
 - Size of the buffer may vary between zero and 2.5%. National authorities have the discretion to implement a buffer in excess of 2.5%, if deemed appropriate
 - Decision to raise the level of the buffer is to be pre-announced by national authorities by up to 12 months.
 - Decision to decrease the level of the buffer will take effect immediately
- Bank specific countercyclical buffer
 - Buffer that will apply to each bank will reflect the geographic composition of its portfolio of credit exposures

Countercyclical Capital Buffer - Framework



- Banks must meet the buffer with CET1 or other fully loss absorbing capital* or be subject to restrictions on distributions
- For internationally active banks, countercyclical capital buffer will be calculated as a weighted average of the buffers applicable in jurisdictions in which a bank has credit exposures
- Jurisdictional reciprocity
 - Host authorities will take the lead in setting the buffer requirement that would apply to credit exposures in their jurisdiction
 - Home authorities will be able to require banks to maintain higher buffers if host authorities' buffer levels are considered insufficient. However, they should not implement a lower buffer in respect of their banks' credit exposures to the host jurisdictions

*The question of permitting other fully loss absorbing capital beyond CET1 is under review by the Basel Committee. Until the Committee provides further guidance, the countercyclical capital buffer is to be met with CET1



- Countercyclical buffer will be implemented through an extension of the capital conservation buffer

Individual bank minimum capital conservation standards, when a bank is subject to a 2.5% countercyclical requirement

Common Equity Tier 1 ratio (including other fully loss absorbing capital)	Minimum capital conservation ratios (expressed as a % of earnings)
4.5% - 5.75%	100%
>5.75% - 7.0%	80%
>7.0% - 8.25%	60%
>8.25% - 9.5%	40%
>9.5%	0%

Countercyclical Capital Buffer - Disclosure



- Countercyclical buffer requirements are to be calculated and publicly disclosed with at least the same frequency as minimum capital requirements
- Banks must also disclose geographic breakdown of their private sector credit exposures used in the calculation of the buffer

Transitional arrangements



	2016	2017	2018	2019
Capital conservation buffer	0.625%	1.25%	1.875%	2.5%
Countercyclical capital buffer*	0.625%	1.25%	1.875%	2.5%

*Assumes application of the maximum countercyclical buffer requirement of 2.5%

- National supervisors have the discretion to impose shorter transition periods, where appropriate

Open issues



- Use of other fully loss absorbing capital
- Interaction of capital buffers with Pillar 2
 - compatibility of existing Pillar 2 approaches with the Basel III Framework?



Questions ?