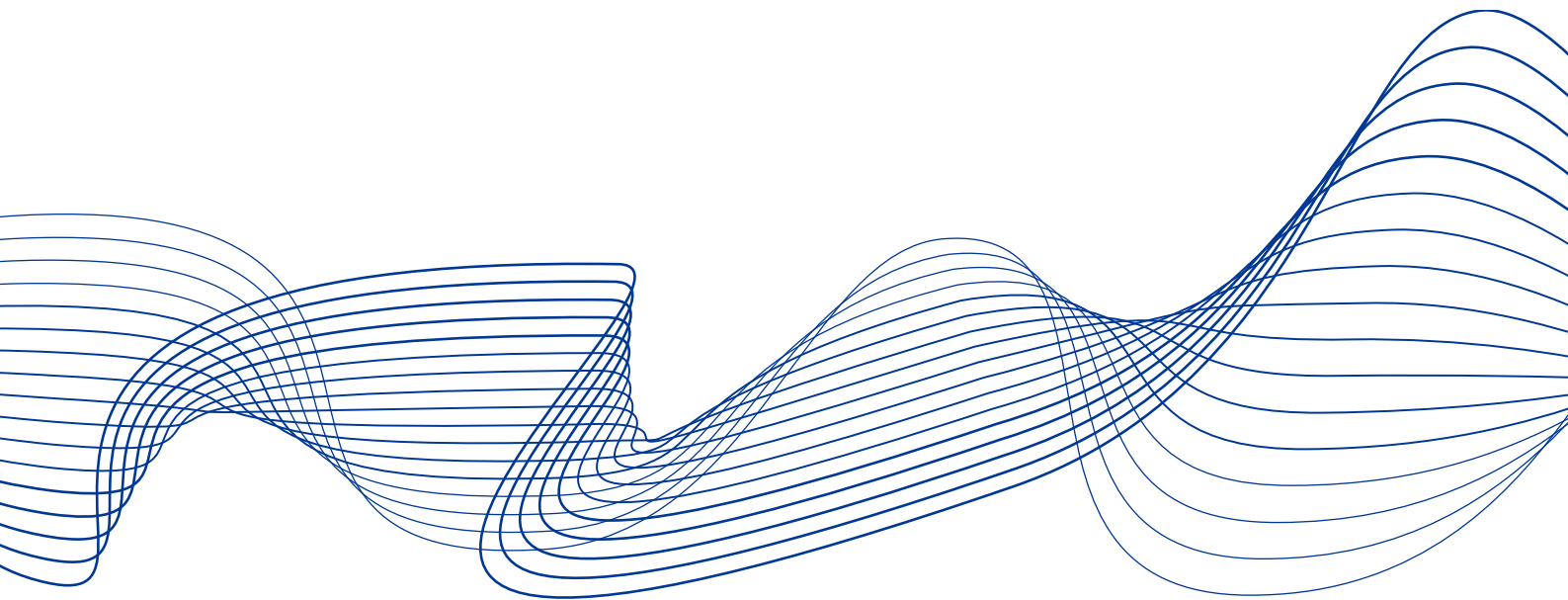


**Opinion to the European  
Commission on structural  
macroprudential buffers**

**December 2017**



**ESRB**  
European Systemic Risk Board  
European System of Financial Supervision

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# Executive summary

**The ESRB welcomes the European Commission's intention from 2016 of reviewing the existing macroprudential framework and stresses that the proposed removal of Pillar 2 from the macroprudential framework needs to be balanced by enhancing flexibility in other macroprudential instruments.** The ESRB highlighted its priorities in its response to the Commission Consultation Paper on the Review of the Macro-prudential framework, published on 24 October 2016. The ESRB agrees with the European Commission's view that – based on the experience gathered over the last couple of years – both the institutional set-up and the existing macroprudential toolkit require some targeted adaptations in order to improve the effectiveness of macroprudential measures. The ESRB is mindful of the Commission's legislative proposals currently under negotiation and of its short-term priorities regarding the review of the macroprudential framework. Against this background, this opinion, while not explicitly discussing the Commission's proposal, tries to contribute to the ongoing discussion on how the removal of Pillar 2 from the macroprudential toolkit could be balanced with additional flexibility with respect to the use of structural buffers. Nevertheless, additional changes beyond the area of structural buffers may also be warranted to sufficiently compensate for the loss in flexibility that the removal of Pillar 2 from the macroprudential toolkit would cause.

**Building on the initial ESRB response, this opinion identifies a series of interlinked detailed proposals for changes to the legislative framework with respect to macroprudential structural buffers.** Following the conclusions of the ESRB response of October 2016, this opinion provides further analysis and economic reasoning for proposed changes with respect to macroprudential structural buffers and, where possible, identifies specific proposals for legislative changes. This opinion represents the majority views of the General Board's voting members; individual ESRB members may have different views. However, the ESRB advocates that the proposals need to be considered as a package of mutually reinforcing measures.

**The proposed changes are aimed at improving the effectiveness of the application of the macroprudential toolkit, thereby enabling more effective macroprudential policy while protecting the Single Market.** Being mindful of the current policy stance at the international and European level with regard to capital regulation,<sup>1</sup> the opinion does not call for an increase in overall capital requirements for structural risks. Instead, it advocates sufficient flexibility and transparency in the framework, so that each risk could be sufficiently addressed by a dedicated instrument. Furthermore, these changes, if implemented in full, could allow national authorities to address structural systemic risks even if Pillar 2 is removed from the macroprudential toolkit, as was proposed by the Commission in November 2016.<sup>2</sup> The goal is to avoid overlaps between different

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<sup>1</sup> The position of the BCBS is that the new capital framework should not aim at significantly increasing overall capital requirements (BCBS Press release, 11 January 2016). This position is also supported by recent empirical studies on the optimal level of capital requirements for the whole banking system, which give no clear signals regarding the need to increase current capital requirements to any large extent (see e.g. Main Report Task Force on Operationalising Macroprudential Research (OMRTF), June 2017).

<sup>2</sup> Cf. European Commission: EU Banking Reform: **Strong banks to support growth and restore confidence**, 23 November 2016.



instruments, reduce their complexity and harmonise their diverse activation procedures, which currently may blur the transparency of the framework for both national authorities and the financial industry. Against this background, the proposals are aimed at delineating and clearly separating the two types of structural buffers, which is only possible if the policy purpose of both instruments is clear and if they are sufficiently flexible to fully address the underlying systemic risks. At the same time, the improved flexibility must be balanced by sufficient safeguards to preserve the Single Market and the single rulebook. Hence, the opinion suggests potential additional safeguards that could be added to the framework.

In particular, the ESRB makes the following proposals with respect to the macroprudential structural buffers, in line with the ESRB response of October 2016:

- a substantial increase in the O-SII cap to 3% with the possibility for designated authorities to impose buffers higher than 3%, subject to approval from the European Commission, in order to delineate the scope of the O-SII buffer and the systemic risk buffer (SRB);
- a substantial increase in the additional O-SII buffer cap on subsidiaries: the O-SII buffer for subsidiaries of EU parent institutions should not exceed the fully phased-in O-SII or G-SII buffer applicable to the group at consolidated level by more than 2 percentage points;
- the introduction of additional guidance on the calibration of O-SII buffers in the form of an ESRB recommendation;
- removal of the mandatory sequencing for the activation of the SRB, effectively upgrading the SRB to the status of a dedicated tool that addresses system-wide non-cyclical systemic risks (instead of being regarded a residual tool as is currently the case), alongside the countercyclical capital buffers that address cyclical risks and the SII buffers that mitigate the moral hazard risks posed by systemically important institutions (SIIs);
- if changes to the O-SII buffer allowed the moral hazard risks posed by O-SIIs to be addressed completely through the O-SII buffer as proposed in this opinion, it should be clarified that the scope of the SRB is that of an instrument that should not be used to target such risks;
- allowing the SRB to target specific sources of structural systemic risk in a risk-sensitive manner by allowing it to be also used for targeting specific subsets of exposures such as sectoral exposures and allowing for multiple SRB applications to be used for addressing distinct risk sources, if needed, and for the SRB to be available in all Member States;
- introducing the risk coverage principle as a basis for the accumulation of structural buffers;
- simplifying the notification and approval procedure for the SRB;
- introducing automatic reciprocity of the SRB that targets domestic exposures, with possible exemptions;
- improving transparency through communication and harmonised mandatory disclosure with regard to the SRB;
- establishing cooperation requirements between national authorities with regard to macroprudential policy.



**The ESRB does not expect any significant impact on existing capital requirements for credit institutions to arise from the adoption of these proposals.**

*First*, increasing the caps or thresholds should be viewed as increased room for manoeuvre for the few EU Member States that already apply higher buffers as well as allowing any authority to promptly address potential risks as they might arise in the future. Greater flexibility should not be interpreted as giving rise to expectations that the O-SII buffers would converge to the level of the cap in all countries. *Second*, the ESRB is of the view that those EU Member States which were already in need of higher capital buffers were using the available tools to reach those levels. The proposal would allow them to use the dedicated instrument to address the risks, and at the same time reduce the use of these alternative measures that have been taken. In this regard, the overall impact on the capital requirements is expected to be neutral. *Third*, a transparent risk-sensitive framework would be more efficient in addressing the risk and altering the behaviour of institutions, which might in turn reduce the need for capital buffers in the future. *Fourth*, the increased flexibility is balanced by further harmonisation of the way the tool is applied and by EU scrutiny, which limits the impact on the Single Market or any potential misuse.



## Background and context

### **This opinion contributes to the ongoing review of the EU macroprudential framework, conducted by the European Commission.**

On 1 August 2016 the European Commission released a Consultation Paper on the Review of the EU Macro-prudential framework, which was aimed at preparing for the review of the EU macroprudential policy framework *with a view to identifying the most urgent issues to be addressed in a review of the relevant legislative texts.*<sup>3</sup> As recognised by the Commission in its Consultation Document, *initial experiences have revealed some room for improvement in the framework which suggests that it could need to be adjusted in order to ensure that it is working optimally.*<sup>4</sup> In this regard, the ESRB outlined a number of priorities in its response published on 24 October 2016, which also serve as guidance for this opinion:

- Comprehensiveness, flexibility and simplicity in the design of the macroprudential toolkit for banking are of the essence. In each country, there should be an adequate set of tools available to appropriately respond to a wide range of systemic risks. Substantial flexibility should be allowed in their use;
- Clarification of policy goals and procedures to avoid overlaps would facilitate the day-to-day management and effectiveness of macroprudential policies;
- The reciprocation of national exposure-based measures should become the rule, albeit with exceptions in justified cases;
- Simplification of the activation procedures for the tools, compared with the current situation, is warranted. The hierarchy of instruments for the mandatory sequencing of their activation should be removed and replaced by one single activation procedure, with no inherent “pecking order”, so as to remove adverse incentives in the selection of macroprudential instruments and thus to ensure that the choice of an instrument entirely relies on its appropriateness to tackle identified risks;
- The proposal for individual structural macroprudential instruments should be seen as a package of amendments that mutually reinforce each other.

### **This opinion provides further details on the use of structural macroprudential instruments, building on the ESRB’s previous response.**

The ESRB reaffirms its view that, overall, the CRD IV/CRR<sup>5</sup> legislation provides the essential elements for a sound EU macroprudential framework for the banking sector. However, the effectiveness of the macroprudential toolkit could be further enhanced while maintaining a balance between the flexibility of policies and the integrity of the Single Market. In this document, the ESRB seeks to provide detailed suggestions for targeted amendments

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<sup>3</sup> Cf. Consultation Document, p. 5.

<sup>4</sup> The intention of undertaking such a review has also been emphasised in the context of the Commission’s communication on the Capital Markets Union (see COM(2015) 468) and the Five Presidents’ Report on Completing Europe’s Economic and Monetary Union, **published** in June 2015.

<sup>5</sup> “CRD IV” refers to Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms. “CRR” refers to Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012.



to the framework for macroprudential instruments intended to address structural risks, namely the buffers for globally systemically important institutions (G-SII buffer), for other systemically important institutions (O-SII buffer) and the SRB. Where possible this opinion supports its arguments by giving evidence based either on current experience of the macroprudential policy or on theoretical reasoning.

**Implementing these proposals will become more crucial if Pillar 2 is removed from the macroprudential toolkit.** The Commission put forward the idea of removing Pillar 2 from the macroprudential toolkit in its EU Banking reform legislative proposal in November 2016.<sup>6</sup> A number of ESRB members support this proposal on the grounds that Pillar 2 was designed to target idiosyncratic risks but the difficulties of coordination between authorities and the lack of transparency in its use can impair flexibility and blur policy signals. On the other hand, other members favour the use of Pillar 2 for macroprudential purposes because of its flexibility. Removing Pillar 2 from the macroprudential toolkit would clearly decrease flexibility that national authorities have when addressing systemic risk. Its impact could be mitigated, in part, by increasing the flexibility of structural macroprudential instruments, as outlined in this opinion, to enable authorities to fully address structural systemic risks with the remaining instruments.

**The opinion is driven by experience gathered during the first few years of macroprudential policy in combination with the available empirical research.** Although no agreement on the optimal level of capital requirements has been achieved yet, there seems to be a general consensus in the empirical literature that policymaking needs to weigh up both the short-term costs (higher interest rates, which might limit credit growth and GDP growth) and the long-term benefits of higher capital requirements. Such benefits include a decrease in the probability and severity of systemic banking crises, and thus greater economic stability and reduced volatility in output. Studies based on the Modigliani-Miller theorem show<sup>7</sup> that, in the long run, the higher capital requirements would probably have only a marginal (if any) impact on the real economy. There would appear to be an optimal level of overall capital requirements where the net benefits are at their highest, but the conclusions on what the optimal level may be vary significantly among researchers. Research also supports the idea of having higher capital requirements for systemically important institutions. At the same time a recent G20 statement must be recalled, in which it was recommended that further significant increases in bank capital requirements should be avoided.<sup>8</sup> In the absence of conclusive evidence as to what the optimal level of capital requirements may be, the proposals focus instead on improving the flexibility and transparency of how structural buffers are applied, rather than increasing their level in absolute terms.

**The debate on whether capital requirements in the (still incomplete) banking union should only be held at the group level or also at the solo level of subsidiaries of banking groups is beyond the scope of this opinion.** Views differ on the free flow of capital within banking groups in the banking union. This opinion focuses solely on the changes to the framework for structural buffers and thus accepts the status quo that capital, including capital buffers, is required to be held both at the solo and group level. If however a political agreement were to be reached on the matter, further changes to the framework for structural buffers would be warranted.

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<sup>6</sup> Cf. European Commission: **EU Banking Reform: Strong banks to support growth and restore confidence**, 23 November 2016.

<sup>7</sup> E.g. Admati et al. (2011), Fallacies, irrelevant facts, and myths in the discussion of capital regulation: why bank equity is not expensive, Rock Center for Corporate Governance at Stanford University Working Paper No 86.

<sup>8</sup> See G20 Hamburg Action Plan, 08 July 2017, p. 8.



# 1 Proposals relating to the SII buffers<sup>9</sup>

**The ESRB is of the view that the increased flexibility required for macroprudential authorities when setting the O-SII buffer needs to be balanced with safeguards for the Single Market and the single rulebook.** The buffers for systemically important institutions (SII buffers) are aimed at internalising negative external effects and thereby correcting misaligned incentives from SIIs, either globally or at national level. Nevertheless, the different ways in which national authorities apply the framework, although to some extent necessary to address national differences, may lead to significant differences in requirements of similarly important institutions, which might be to the detriment of the goal of having a level playing field and the Single Market. With this in mind, the following issues were identified by the ESRB and warrant amendments in the existing legislative framework, with the overarching aim that the authorities can apply the O-SII framework more effectively: (i) an increase in the O-SII buffer cap, (ii) a substantial increase in the additional cap for subsidiaries, and (iii) additional guidance for the calibration of the O-SII buffer in the form of an ESRB recommendation, including (iv) the scope of application of the O-SII buffer.

## Substantial increase in the O-SII buffer cap

**Given their structural and institution-specific nature together with the unclear policy purpose of the SRB, there are significant overlaps between the SII buffers and the SRB in the current framework, as confirmed by experience gathered by the ESRB through notifications of national measures.** Almost one-third of EU Member States use the SRB to target risks stemming from SIIs, which are subject to misaligned incentives. In those countries, the O-SII buffer is often perceived as being too low to mitigate the risk some institutions pose to the financial system, with the end result that the authorities require identified O-SIIs to hold an SRB of up to 3% instead or on top of the O-SII buffer.<sup>10</sup> Moreover, a few countries also apply additional capital requirements via Pillar 2, resulting in overall requirements for O-SII purposes of up to 5%. The existing 2% O-SII buffer cap is thus considered to be restrictive by some Member States and does not adequately take into account the diverse nature of the O-SIIs in the EU. The cap thus contributes to the overlap between the two structural instruments. This also implies that the application of the SRB for the risk related to SIIs limits the flexibility of national authorities to apply the SRB to other structural risks in their respective national economies or to reciprocate other Member States' SRBs.

**The ESRB previously highlighted that the 2% cap of the O-SII buffer should be (at least) substantially increased to allow a clear separation of instruments.** The O-SII buffer framework should allow national authorities to set an O-SII buffer with an appropriate size, without recourse to the SRB or any other instrument, such as Pillar 2. In particular, such flexibility would be needed if

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<sup>9</sup> The concept of "SII buffers" refers collectively to global systemically important banks (G-SIBs) and other systemically important banks (O-SIIs).

<sup>10</sup> Based on the notifications received by the ESRB.





Pillar 2 were to be removed from the macroprudential toolkit, as proposed by the Commission.<sup>11</sup> Provided that each instrument is flexible enough to fully address the targeted risks, the SRB and the O-SII buffer should serve different purposes. Hence using the SRB for the O-SII risk should be avoided. SII buffers should be the only instrument to be used for mitigating the systemic risk of individual institutions. Moreover, a clear distinction of the instruments and how they are used needs to be drawn to ensure both proper communication and evaluation of the effectiveness of the buffers.

**Recent research papers have been arguing in favour of higher capital requirements for systemically important banks.** Research on the optimal level of capital for systemically important banks (see e.g. Federal Reserve Bank of Minneapolis (2016)<sup>12</sup>, Passmore and von Hafften (2016)<sup>13</sup>, Dagher et al. (2016)<sup>14</sup>, Myerson (2014)<sup>15</sup> and Bulow and Klemperer (2013)<sup>16</sup>) argues in favour of imposing capital surcharges that are up to eight percentage points higher for systemically important banks (mostly G-SIBs) than under the Basel III framework in order to ensure their survival in a severe financial crisis. The authors argue that the surcharge on systemically important banks directly addresses the systemic risk and reduces the likelihood of each of these institutions failing, thereby lowering the magnitude of contagion within the financial system. At the same time, it should be noted that most of these studies do not take into account the requirements introduced by the recovery and resolution frameworks<sup>17</sup> and they do not assess the effects of structural buffers separately from the total capital requirements. It should be stressed that the objectives of recovery and resolution frameworks should be seen as complementing the higher loss absorbency requirements for SII. Nevertheless, based on these studies, a cap of 2% for O-SIIs does not seem to be sufficient to secure the resilience of systemically important institutions. Moreover, the analysis is based on advanced economies, and not solely on EU data. Against this background, it could be argued that for many EU countries, in particular small, open market- and export-oriented economies, the analysis might point to even higher capital surcharges being imposed on systemically important banks.

**In addition, analyses conducted by some EU national authorities point to the fact that the cap of 2% for O-SIIs in their respective economies might be inadequate.** For instance, internal stress test calculations in Germany suggest that the unexpected capital losses arising from a

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<sup>11</sup> See Commission legislative proposal from November 2016.

<sup>12</sup> Federal Reserve Bank of Minneapolis (2016), "The Minneapolis plan to end too big to fail", November.

<sup>13</sup> Passmore and von Hafften (2017), "Are Basel's Capital Surcharges for Global Systemically Important Banks Too Small?", Finance and Economics Discussion Series 2017-021, Washington: Board of Governors of the Federal Reserve System.

<sup>14</sup> Dagher, Jihad, Dell'Ariccia, Giovanni, Laeven, Luc, Ratnovski, Lev and Tong, Hui (2016), "Benefits and Costs of Bank Capital", IMF Staff Discussion Note 16(4).

<sup>15</sup> Myerson, Roger B. (2014), "Rethinking the Principles of Bank Regulation: A Review of Admati and Hellwig's The Bankers' New Clothes", Journal of Economic Literature, Vol. 52(1), pp. 197-210.

<sup>16</sup> Bulow, Jeremy and Klemperer, Paul (2013), "Market-based bank capital regulation", Working Paper 28, Series No 151, Stanford Business School, September.

<sup>17</sup> A reference is made to total loss-absorbing capacity (TLAC) for G-SIBs and to minimum requirement for own funds and eligible liabilities (MREL) for all EU-based banks. For example, the TLAC requirement for G-SIBs will be of at least 18% of RWAs, excluding capital buffers, as of 1 January 2019. The FSB regards higher loss absorbency for systemically important financial institutions and resolution frameworks as complementary. FSB (2010), Reducing the moral hazard posed by systemically important financial institutions. FSB Recommendations and Time Lines.



macroeconomic shock can only be partly absorbed by the calibrated O-SII buffer rate. Moreover, some analyses based on an equal expected impact approach also suggest that buffers for systemically important banks in some EU Member States need to be higher than 2% (ESRB 2016).<sup>18</sup> For example, Skorepa and Seidler (2013)<sup>19</sup> find that – based on the equal expected impact approach – the highest capital buffer in the Czech Republic would be 4% for O-SIIs. Their results were also confirmed by a stress test.

**The introduction of the O-SII buffer cap in the EU is also not fully in line with the global framework for domestic systemically important credit institutions.** The Basel Committee on Banking Supervision (BCBS) envisaged a framework for domestic systemically important banks (D-SIBs) without any cap for the D-SIB buffer. In principle, the higher loss absorbency requirement imposed on a bank should be commensurate with its degree of systemic importance (Principle 9, BCBS 2012).<sup>20</sup> With an O-SII buffer cap of 2%, the macroprudential authorities have a limited number of options available to them for disincentivising banks that already hold a 2% O-SII buffer to further increase their systemic importance. Outside the EU, a few countries have set D-SIB buffers of above 2%, such as the United States (with theoretically unlimited buffers and the currently highest bucket in use, at 4.5%)<sup>21</sup> and Mexico (with the highest bucket at 2.5%, although it is empty). Nonetheless, the majority of non-EU advanced economies have set D-SIB buffers within the range of 0.25% to 2%.

**Moreover, the maximum rate of 2% for the O-SII buffer does not seem to be tenable when compared with the G-SII buffer (ESRB 2016).** Judging by the O-SII and G-SII scores, the systemic risk posed by an O-SII for a domestic economy or the EU may, in relative terms, be higher than the risk posed by a G-SII for the global economy (see Chart 1). This finding is also supported by the current CRD IV text, when the higher of the G-SII buffer and the O-SII buffer applies in a scenario where a group is subject to both buffers at the highest consolidation level. However, it is acknowledged that higher concentration scores are a natural result of the narrower scope of measurement (national versus global financial system) and that the two systems might not be fully comparable. Against this background, if 2.5% (3.5%, when taking the empty bucket into account) is considered appropriate to mitigate the impact of an individual bank on the world's economy,<sup>22</sup> the capping of the O-SII buffer at 2% does not seem justified. Furthermore, the G-SII buffer is in principle unlimited, as a new empty bucket will be added if a bank moves into the current empty bucket. Therefore, an increase in the O-SII buffers is warranted to a level that is commensurate with the systemic risk posed to domestic economies by the institutions in question.

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<sup>18</sup> ESRB (2016), ESRB response to the European Commission's Consultation Document on the "Review of the EU Macroprudential Policy Framework", 24 October.

<sup>19</sup> Skorepa, M. and Seidler, J. (2013), "An additional capital requirement based on the domestic systemic importance of a bank", *International Journal of Economic Sciences*, Vol. II, No 3, pp. 131-142.

<sup>20</sup> BCBS (2012), A framework for dealing with domestic systemically important banks, October.

<sup>21</sup> We refer to the Federal Reserve System's capital surcharge for G-SIBs, where it introduced a second method for calibrating the surcharges with buckets from 1% to 5.5% with a 0.5 percentage point increase for every 100 basis points of score above 1130. The current highest active bucket is at 4.5%. See Federal Register, Vol 80, No 157 of 14 August 2015.

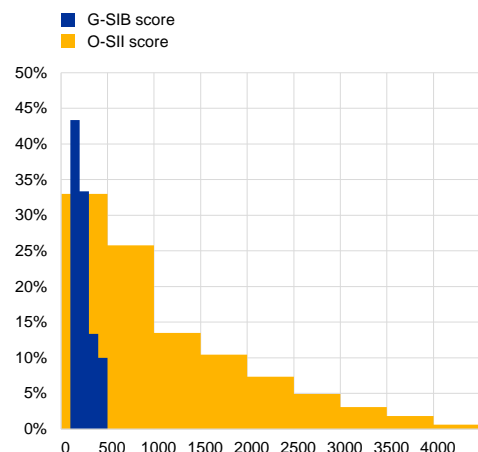
<sup>22</sup> It is recognised that the last bucket has been left empty, while the highest used bucket is 2.5%. However, new buckets will be added if banks' scores increase to reach the highest buckets.



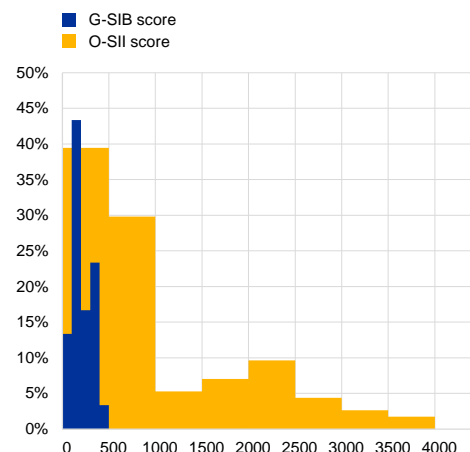
Chart 1

**Comparison of O-SII scores with G-SIB scores**

**Chart 1a: Distribution of total scores**



**Chart 1b: Distribution of size scores**



Sources: Loudis, B. and Allahrakha, M. (2016) and ESRB calculations.  
 Note: O-SII scores refer to 2016 and G-SIB scores to 2015 data.

**Furthermore, ESRB simulations also reiterate the need for an upward revision of the O-SII buffer cap.** ESRB simulations for O-SII buffers produce estimates higher than the 2% O-SII buffer cap.<sup>23</sup> Using the fully proportional approach<sup>24</sup>, the O-SII buffer cap of 2% seems to affect a small number of O-SIIs. Moreover, a median new buffer for these affected institutions would be somewhat higher than the actual 2% buffer (at 2.3%). A higher number of credit institutions would be affected as a result of applying the equal expected impact approach, with the median new buffer for the affected banks being substantially higher than the current 2% cap (around 7%, based on yearly losses to risk-weighted assets (RWAs)).

**The magnitude of losses incurred during the global financial crisis also supports the argument for increasing the cap.** In the last financial crisis, bank losses, expressed as a share of RWAs (see Chart 2), were often larger than the 2% absorbency requirement (ESRB Handbook 2014, p. 93). Although in most cases the losses were covered by Pillar 1 capital requirements, many banks still displayed losses higher than the 2% of RWAs (which is currently the maximum O-SII buffer).

**At the same time the ESRB acknowledges that the cap contributes to a level playing field across the EU and reduces any possible side effects to the real economy.** The O-SII buffer cap was introduced in order to limit the range of O-SII buffers applied across the EU, its level being based on political agreement rather than on research or calibration. However, this is at the expense of preventing national authorities from fully addressing financial stability risks in certain

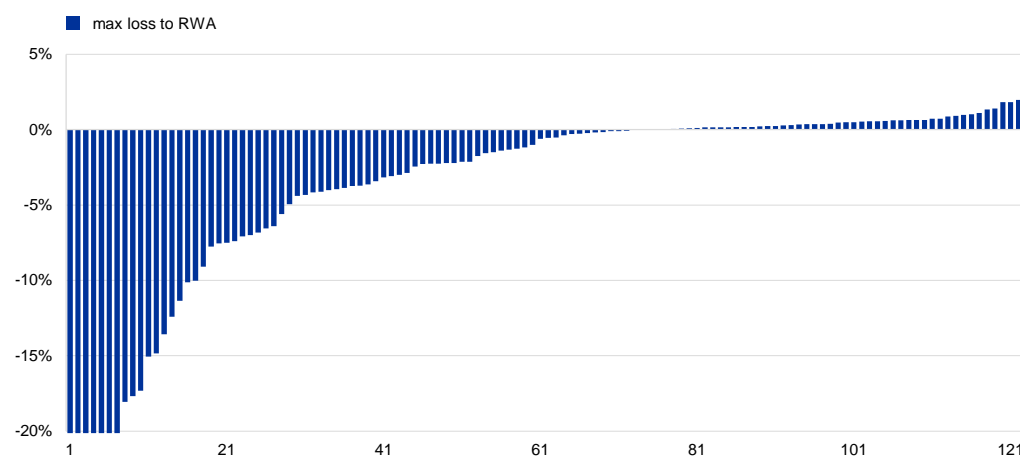
<sup>23</sup> The proportional approach and the equal expected impact approach have been used, as they allow for “unconstrained” estimates of the O-SII buffer.  
<sup>24</sup> Assuming the systemic importance score is equal to 350bps, with the buffer of 0.25% as a reference point.



circumstances, which might increase the impact of the next crisis. These provisions protect the functioning of the internal market by limiting deviations from the harmonised level of minimum capital requirements. They also prevent any unwarranted accumulation of capital buffers that could in the short term have unintended consequences on the supply of credit to the economy, profitability and, in turn, economic growth and financial stability itself. However, the effectiveness of the cap is limited because it is possible to use other instruments to top up the buffers for systemically important institutions.

Chart 2

**Bank losses as a share of risk-weighted assets (2008-12)**



Sources: ECB, based on SNL financials.

Notes: The sample includes 116 banks from the EU28 whose total assets exceeded €30 billion in any year over the period 2008-12. The figure presents the aggregated losses in consecutive years for a bank (or, where there were no losses, the least profitable year) in relation to the bank's risk-weighted assets at the beginning of the period when losses were first incurred.

**Against this background, the ESRB proposes increasing the O-SII buffer cap to 3% and allowing authorities to set O-SII buffers exceeding 3%, subject to approval by the European Commission.** A cap at this level would broadly address the current needs of a large majority of EU Member States and enable authorities to address current and future O-SII risks by means of the dedicated instrument. At the same time, in countries where an O-SII buffer higher than 3% might be needed, the national authorities would be able to address this with a single instrument, subject to an approval process. Moreover, it could further conceptually align the O-SII framework with the G-SIB and D-SIB frameworks, for example by creating space for the national authorities to leave the last bucket empty and deter banks from increasing their systemic importance. In order to safeguard the Single Market and the level playing field, a complete removal of the cap is not desirable and the approval of the Commission should be required when authorities would like to apply buffers in excess of 3%.

**It should be highlighted that the cap represents a maximum level of O-SII buffer that national authorities could require, as opposed to a level that the most systemically important O-SII in every single jurisdiction is expected to hold.** Raising the cap will allow authorities that need higher values of the O-SII buffer to fully address the risks and use the dedicated instrument for that purpose. However, as with the current framework, it is expected that national authorities would only require O-SII buffers at levels which are sufficient to mitigate the systemic risks that those



institutions could pose at national or EU level. This is supported by evidence that a significant number of countries calibrated the highest O-SII buffer well below the current cap of 2%. For example, an O-SII buffer close to the level of the cap might be justified in a concentrated banking system with a dominant player, while the highest O-SII buffer could be set at substantially lower levels for institutions in a less concentrated banking sector, for example in markets that have several dominant players. Therefore, there is no reason to expect that countries would be pressured, directly or indirectly, into increasing their O-SII buffer rates beyond levels which sufficiently cover the risk of their O-SIIs.

**Moreover, the increase in the O-SII buffer cap should be pursued as part of a package of other changes and the legislation should provide for regular reviews of the framework.** An increase in discretion implied by raising the O-SII buffer cap should be balanced with appropriate harmonisation of the design and calibration of the O-SII buffer across the EU in order to ensure a proper functioning of the Single Market and the single rulebook. The ESRB also sees merit in a further review of the 3% threshold, beyond which approval of the Commission is needed, as more experience of the framework is gradually gained. This will also allow new legislation to be assessed and taken into account, including the final set-up for requirements related to the recovery and resolution framework in the EU.<sup>25</sup>

### **Substantial increase in the additional O-SII buffer cap for subsidiaries**

**The introduction of an additional O-SII buffer cap for subsidiaries in the EU legislative framework in 2013 strongly reflected the geographical pattern of cross-border banking linkages among the European banks.** Besides the general cap of 2%, the O-SII buffer rate for subsidiaries of EU G-SIIs or O-SIIs (at the ultimate EU parent level) is subject to an additional cap. Their O-SII buffer rate cap is the higher of either 1% or the G-SII or O-SII buffer rate applicable to the group at the highest EU consolidated level. However, there is no additional cap if the parent group is not designated as either a G-SII or an O-SII. Several EU banks have substantial cross-border intra-EU exposures and ownership links. The scale of activity of EU cross-border banks can differ substantially in different locations. There are cases where a subsidiary is identified as a systemically important bank in the host country, while the parent company is not identified as systemic in the home country. There are also strong ownership linkages among EU O-SIIs, with both the parent groups and their subsidiaries often identified as systemically important banks in their countries of incorporation (see Chart 3).

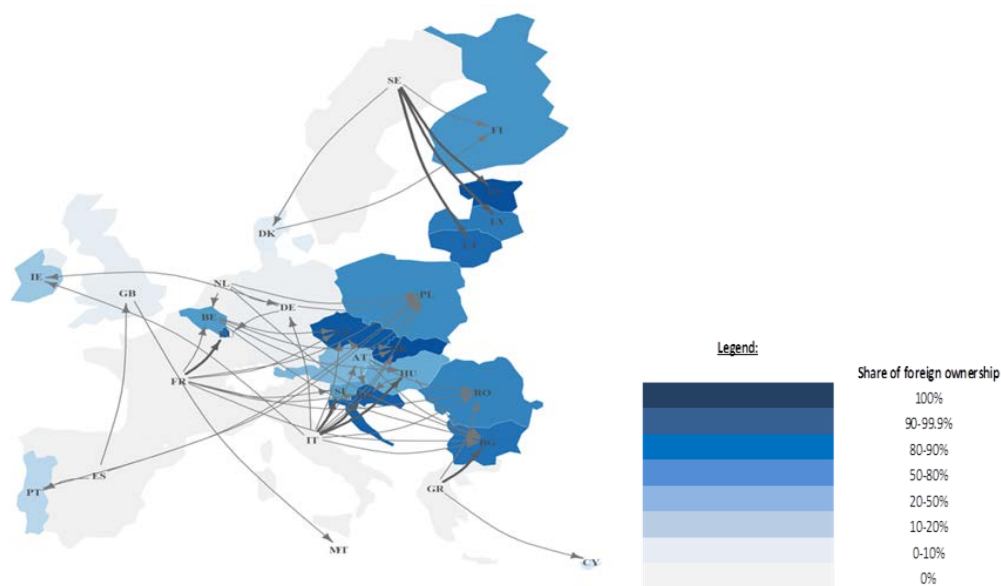
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<sup>25</sup> For example, the TLAC requirement for G-SIBs excludes capital buffers, while the discussion on the MREL requirement for EU banks is currently under revision, and highly likely to result in an outcome that capital buffers would also be excluded from the recapitalisation amount.



Chart 3

**Share of O-SIIs with a foreign parent and cross-border ownership link in 2016**



Source: A Review of Macroprudential Policy in the EU in 2016, ESRB, April 2017.

Notes: The arrows between countries indicate the link between the home country of systemically important institutions (SIIs) that control SIIs in another country (host country). The thickness of the arrow is proportional to the number of such links.

**The cap on subsidiaries is aimed at facilitating financial integration in the EU and avoiding ring-fencing of capital at the subsidiary level.**

Distortions could arise if banking groups are subject to very different capital requirements at the consolidated and subsidiary level.<sup>26</sup> If subsidiaries are subject to a higher O-SII buffer than that for their parent, this could create an incentive for parent institutions (or holding companies) to raise debt externally, in order to invest in the equity capital of their subsidiaries, thereby enabling their subsidiaries to meet their higher O-SII buffers. This process – known as “double leverage” – can weaken the resilience of parent institutions / holding companies, who in order to service their external debt rely in part on dividend income from their subsidiaries which in turn can lead to undue pressure on subsidiaries to upstream dividends. Thus, the additional cap should limit the inefficient allocation of capital and prevent undesired competition between EU home and host supervisors with regard to the allocation of capital for existing cross-border banking groups. Furthermore, it is perceived that different buffer levels across the EU could constitute an obstacle to cross-border bank acquisitions and could inhibit the development of pan-European banking groups. Nevertheless, these issues remain of relevance for non-EU subsidiaries and for groups which are not identified as systemically important, as the additional cap does not apply to them.

<sup>26</sup> Ramirez (2017). Handbook of Basel III capital: Enhancing bank capital in practice, Wiley.



**Views on whether ring-fencing of capital within subsidiaries is actually taking place depend on the different ways in which ring-fencing is understood.**<sup>27</sup>

Apart from referring to structural reforms in the banking sector, the term “ring-fencing” is also used in the context of restrictions related to the cross-border operations of multinational banking groups. In particular, the restrictions can relate to transferring capital and/or liquidity across borders within one group. In this context it is useful to distinguish between: (i) minimum prudential requirements and capital buffers required to be held by subsidiaries of international banking groups in accordance with internationally agreed (Basel) standards; and (ii) measures arising from jurisdiction-specific requirements in excess of such harmonised standards. In the EU, some of the latter actions might be considered illegal to the extent that they go beyond maximum-harmonising EU legislation. The European Commission (2014) in this respect mentions that “restrictions to the free movement of capital are prohibited by the Treaty unless duly justified and proportionate”.

**Therefore, it is difficult to objectively measure ring-fencing, as the definition of what is a justified and proportionate measure is fairly subjective.**

The European Commission acknowledges<sup>28</sup> that it is difficult to distinguish clearly between legal and illegal actions and instead tends to divide national measures into those that are justified (“validly required by the situation of the individual institution targeted by the supervisory requirement”) and questionable (excessively protecting national taxpayers). Thus the different perceptions on ring-fencing stem from diverging views on what is a justified and proportionate measure. Cerutti and Schmieder (2014) estimate the simulated impact of ring-fencing on parent banks’ Tier 1 capital ratio to be between 0.9% and 2.4% compared with a baseline scenario where all capital buffers in excess of regulatory minima could be transferred.<sup>29</sup> Yet, because of the strengthened capital base of most internationally active banks, there would be less of an impact of ring-fencing today. The authors deduce that “the establishment of a credible framework for the resolution of cross-border banking groups would help to avoid unilateral and likely more costly solutions (in terms of capital requirements)” which “could reduce the incentives for and the incidence of ring-fencing by the host country authorities”.

**The calibration of the O-SII buffer at group level does not take into account the systemic presence of the group in other EU Member States.**

The identification of O-SIIs and the current setting of the O-SII buffer is based on national reference frameworks.<sup>30</sup> While the reference system of the home country is adequate for capturing the impact of a failure of an O-SII group at consolidated level in that particular jurisdiction, it does not capture the importance of its subsidiaries for the host

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<sup>27</sup> See Cerutti and Schmieder (2014), “Ring-fencing and consolidated banks’ stress tests”, *Journal of Financial Stability*, Vol. 11, and D’Hulster and Otker-Robe (2015), “Ring-fencing cross-border banks: An effective supervisory response?”, *Journal of Banking Regulation* for a discussion of ring-fencing in the context of capital requirements.

<sup>28</sup> European Commission (2014), **Legal Obstacles to the Free Movement of Funds between Institutions within a Single Liquidity Sub-Group**, COM(2014) 327 final

<sup>29</sup> These estimates are based on the publicly available data from the 2011 EBA stress tests. In the baseline scenario it is assumed that income and capital in excess of regulatory minima could be moved across the group. In the partial ring-fencing scenario, only income could be moved, but not capital while in a full ring-fencing scenario, neither income nor capital could be moved. The results represent the estimated additional Tier 1 capital needed by the groups to withstand the adverse scenario in case ring-fencing by host supervisors is applied.

<sup>30</sup> Although the computation of indicators is carried out at the highest level of consolidation, with four of them dealing with the cross-border dimension of banking groups (cross-jurisdictional liabilities and claims and private sector deposits and loans in the EU), their value is assessed only within the home jurisdiction and not within any host jurisdiction.



economies. There is no theoretical justification to link the importance of a bank in one market (e.g. home market) to the buffer in another location. It could be argued that the O-SII buffer at the consolidated level already partly covers the risk posed by subsidiaries (as it is based on the consolidated systemic importance indicators). However, this argument ignores the fact that in such a case the subsidiary's importance is measured against the home banking system (which is often much larger) and not the host banking system.<sup>31</sup> Holding the capital at subsidiary level can also compensate for potential moral hazard connected with the implicit guarantees that systemically important subsidiaries may enjoy and deter them from increasing their systemic importance. Furthermore, group O-SII buffers are being phased in based on their potential impact on the home markets, even if this phasing-in does not take into account the financial stability implications for the O-SII subsidiaries.

**Experience has shown that the SRB is being used to top up the O-SII buffer in several host EU Member States, since the O-SII buffer, because it is capped, does not seem to adequately address the risk resulting from O-SIIs incorporated in these jurisdictions.** In some cases, the parent institution might not be very systemically important in the home country while its subsidiary could be a dominant institution in a host country. In such cases, the cap on subsidiaries has been perceived as restrictive and thus a higher O-SII buffer in the host country rather than in the home country would be warranted. Generally, this link becomes even more severe if the O-SII buffer on a parent bank is calibrated in line with the G-SII buffer, as has occasionally been the case. The potential levels of the O-SII buffers might, therefore, not be sufficient to fully address the systemic risk posed by O-SII subsidiaries. This could create additional costs during a period of crisis. Consequently, some host authorities require identified O-SIIs to hold an SRB of up to 3% instead or in addition to the O-SII buffer, further exacerbating the overlap between the two structural instruments.

**The cap on subsidiaries distorts the overall O-SII buffer framework within the host countries and consequently the systemic risk of O-SIIs might not be fully addressed.** According to the BCBS framework for D-SIBs, banks within the same jurisdiction should be treated in a consistent, coherent and non-discriminatory manner regardless of who owns them. As a result, the same buffer rate has to be applied to two banks of similar systemic importance regardless of their ownership. As a consequence, the O-SII buffer cap on the subsidiary would not only impact the O-SII buffer of the subsidiary of an EU parent institution, but would also impact the level of the O-SII buffer for all other O-SIIs (e.g. domestic and non-EU subsidiaries) in the host country in order to maintain a level playing field. This either prevents host authorities from adequately addressing the systemic risks of these O-SIIs, or will distort the level playing field among O-SIIs in host countries. Moreover, the host authority may be required to continuously reset O-SII buffers for local O-SIIs in response to changes in their ownership or changes in their parent O-SII buffers, something that may be particularly challenging in cases where the O-SIIs' parents of one country are located in multiple home jurisdictions.

**Moreover, the host authorities have a different level of flexibility, conditional on the SII-buffer levels set at the consolidated level (see Chart 4).** If the parent company is not considered

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<sup>31</sup> For example, the systemic importance of the parent group is the same if it has a high systemic presence in one other Member State or if it has a diversified portfolio split across the entire EU without any systemic presence in any other EU Member State.

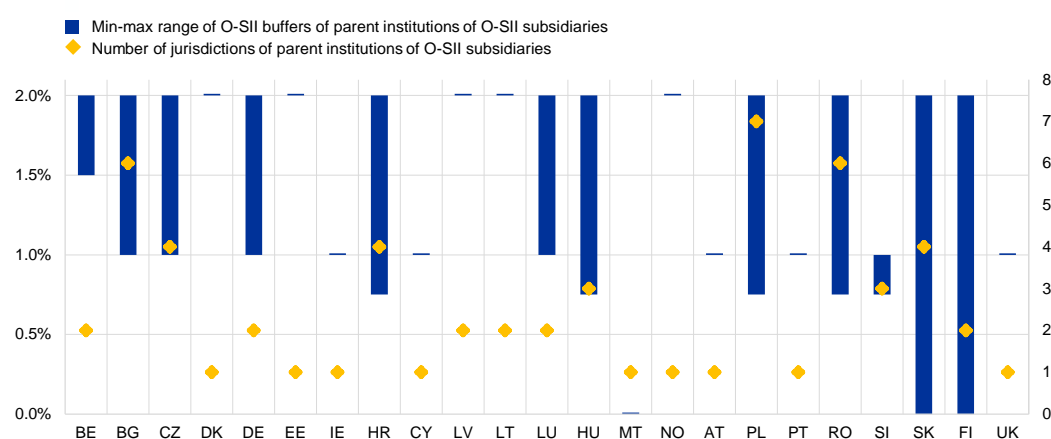




systemic by the home authority, the host authority has full flexibility to set the O-SII buffer at higher levels up to the current cap of 2%. Where the parent company is systemic but the SII-buffers are set below 1%, the host authority has some flexibility to go beyond the SII buffer set by the home authority, up to the level of 1%. On the other hand, there is no flexibility when the SII buffer of the parent company is set at levels equal to or higher than 1%. The ESRB is of the view that such a difference should be avoided. Moreover, given the distortion to the overall O-SII buffer-setting inside the host country, the ESRB would like to advocate higher flexibility for host authorities when setting the O-SII buffer for subsidiaries of EU cross-border groups.

**Chart 4**  
**O-SII buffers of parent institutions of O-SII subsidiaries**

(percentages, numbers)



Source: ESRB.

Notes: The O-SII buffer range is displayed on the left-hand side axis while the number of jurisdictions is displayed on the right-hand side axis. Data refer to end-2016. The O-SII buffer-setting in a host country may be distorted if a single O-SII is bound by the cap on subsidiaries.

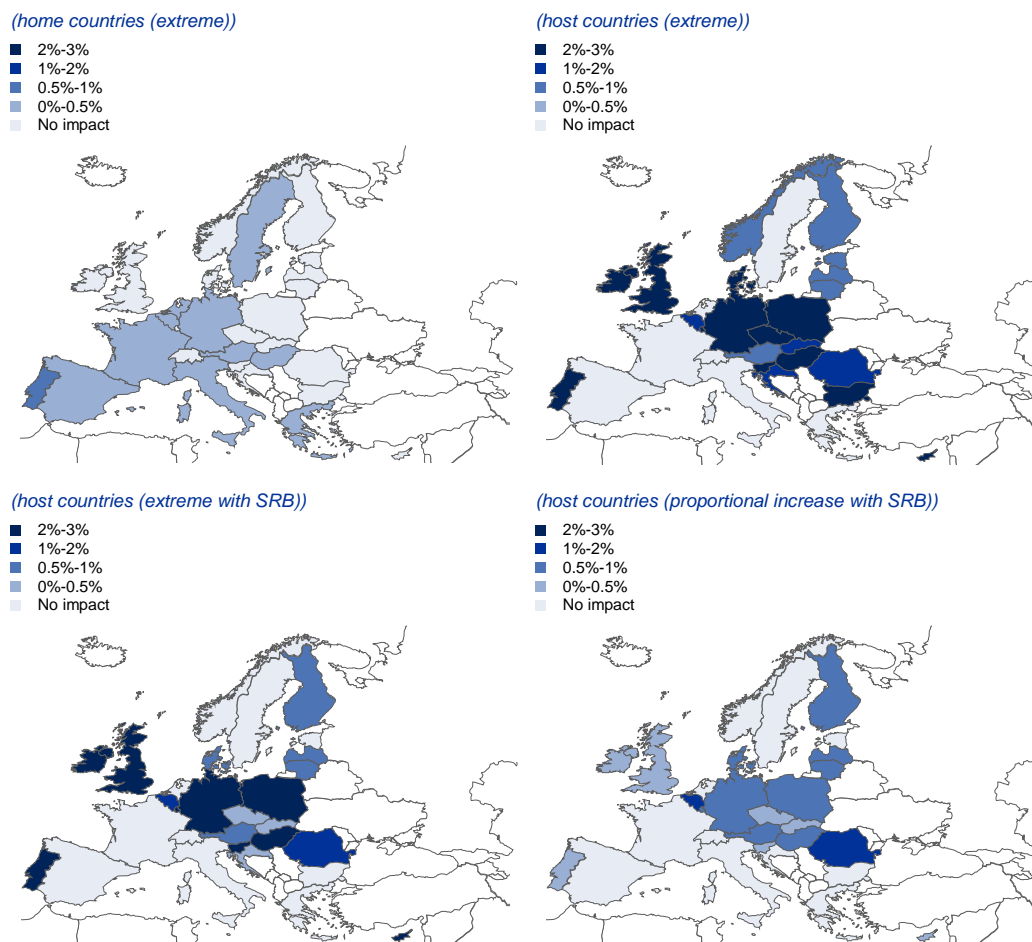
**According to analysis by the ESRB, the potential impact arising from the removal of the additional cap on subsidiaries of parent banks is rather limited, including when the O-SII buffers of subsidiaries are substantially increased.**

The impact on capital requirements is measured in the ESRB simulation as the differences in RWAs of the parent groups and subsidiaries and would be different for parent banks and subsidiaries (see Chart 5). In the most extreme scenario, if all O-SII subsidiaries were to be subject to a 3% O-SII buffer (assuming an increase in the O-SII buffer cap, as proposed in this Opinion), then buffers would increase by around 1% to 3% of RWAs in host countries (see top right-hand chart in Chart 5). Since subsidiaries are usually small relative to the size of parent groups, the increase in capital requirements at the consolidated level would have limited effect – less than 0.6% of consolidated RWAs (see top left-hand chart in Chart 5). However, it should be noted that the actual impact would be smaller, as several of these subsidiaries are subject to an SRB covering the risk of their systemic importance, which would be released once the higher O-SII buffer is introduced (see bottom left-hand chart in Chart 5). Furthermore, not all subsidiaries would be subject to the maximum O-SII buffer of 3% (see bottom right-hand chart in Chart 5), so the net impact would be much smaller. The impact on home countries also decreases significantly in these more plausible scenarios and is below 0.15% of consolidated RWAs of parent groups for each home Member State.



Chart 5

**Increase in capital requirements in response to the removal of the cap for subsidiaries (as a percentage of RWAs)**



Sources: ESRB (2017, Annex 3), notifications, SNL data and ESRB calculations.

Notes: The charts above show the simulated impact under three different scenarios. An extreme scenario assumes that all subsidiaries will increase their O-SII buffers to 3%. Scenarios "with SRB" assume that the increase in the O-SII buffer will be partially offset by decreased SRB buffers covering the SII risks. A proportional increase scenario assumes that subsidiaries with an O-SII score of above 1000 will be subject to a 3% O-SII buffer, and that all other O-SIIs will have their O-SII buffers doubled up to a maximum of 3%. Calculations are based on RWAs of individual banks as at end-2015, taken from the SNL database (in a few cases, data were collected from the individual financial statements of banks).

**Against this background, the ESRB proposes that the O-SII buffer for subsidiaries of EU parent institutions should not exceed the higher of the fully phased-in O-SII or G-SII buffer applicable to the group at consolidated level by more than 2 percentage points.** The ESRB acknowledges that the current design of the additional cap on subsidiaries partially limits the ability of several host authorities to fully address the risks posed by O-SII subsidiaries and may be detrimental to the overall risk coverage and to the objective of ensuring flexibility and simplicity in the design of the macroprudential framework in the EU. The proposed increase in the additional cap for subsidiaries should provide enough flexibility for host authorities to limit the negative distortions of the additional cap to the domestic framework. At the same time, the ESRB reaffirms that it is fully convinced of the



merits of further financial integration in the EU. The ESRB stresses that the ring-fencing of capital decreases the resilience of banking groups and should be avoided. Although there is no authoritative evidence that ring-fencing is actually happening, the ESRB underlines that the additional cap on subsidiaries would limit the potential for ring-fencing of capital, including in the future. Moreover, it is proposed that the cap should be based not on the actual level of the parent O-SII buffer, but on the fully phased-in level. This would ensure that the longer phase-in periods deemed necessary by some authorities would not influence the O-SII buffer framework of other Member States.

**Nevertheless, views on the effects of the additional cap for subsidiaries differ and a significant number of ESRB members support a complete removal of the additional O-SII buffer cap for subsidiaries.** These members are convinced that the additional cap for subsidiaries appears unable to account for differences in the scale of activities of cross-border groups in the EU, leading to a situation where the O-SII buffer cannot on its own address the risks for which it was created. These members highlight that the distortions to the host O-SII buffer framework are large and thus subsidiaries' O-SII buffers should only be subject to the general O-SII buffer cap, as domestic banks are. These members point to the lack of evidence proving the existence of excessive ring-fencing of capital and argue that such actions would decrease the credibility of authorities and are thus not expected to occur.

**Any removal or overly extensive increase in the additional cap on subsidiaries could trigger undesired side effects and may require some innovations being introduced to the existing framework.** A possible side effect of removing or extensively increasing the additional cap on subsidiaries could be that banking groups would transform subsidiaries into branches, which might be detrimental to the financial stability of the host countries.<sup>32</sup> This practice, also known as “branchification”, would imply that a larger proportion of a host banking system would be supervised by the home authority, instead of the host authority. Based on anecdotal evidence, some banking groups have changed the legal status of their foreign exposures from subsidiaries to branches and it could be expected that changes to the macroprudential framework may induce a similar reaction. Against this background, the ESRB would like to propose that an analysis be carried out on what effects a potential removal of the additional cap on subsidiaries would have. The ESRB would also like to advocate that further consideration be given to the issue of significant branches and cross-border lending by the legislator, further analysis of which the ESRB stands ready to support.

#### **Additional guidance in the form of an ESRB recommendation on design and calibration of O-SII buffers**

**The increase in the amount of discretion that national authorities would have would require general principles to be drawn up for calibrating the O-SII buffer; this would contribute to limiting potential negative side effects caused by fragmentation and ring-fencing.** The proposed changes to the O-SII buffer caps described above would lead to the macroprudential authorities enjoying greater discretion. The ESRB is of the view that this increase in flexibility

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<sup>32</sup> This would also be detrimental from the perspective of a home country supervisor, as less information is available at branch level.



should be balanced with further appropriate harmonisation of the calibration of the O-SII buffer across the EU in order to prevent or mitigate systemic risk to financial stability in the EU. This would ensure a proper functioning of the Single Market, while respecting the principle of proportionality. An appropriate way forward would be further harmonising the calibration of O-SII buffers. This would ensure that banks are subject to capital requirements that are commensurate with the systemic risks they pose. It would also mean that banks identical in their systemic importance are subject to similar requirements across Member States.

**It is important to leverage on the experience gained by the ESRB and the EBA with respect to O-SII buffers.** In 2015 the EBA issued guidelines for O-SII identification.<sup>33</sup> The aim of the guidelines was to foster an appropriate degree of convergence when identifying O-SIIs across Member States and making the assessment of O-SIIs more comparable, transparent and comprehensible. The ESRB has issued recommendations on calibration issues in the past.<sup>34</sup> As the ESRB brings together competent and designated authorities, it would be appropriate to leverage on the respective experience for the additional guidance in the form of an ESRB recommendation.

**The ESRB should issue a recommendation on the design and calibration of the O-SII buffers based on the overarching principle of reducing variation in this area across the EU.**

Proposed principles would also ensure a level playing field by respecting a number of safeguards inherent in the need for improving harmonisation, consistency and comparability in the application of the O-SII buffer within the Single Market. This would also help to counteract the issue of ring-fencing of capital. In line with the principle of proportionality and given the diversity of institutions and business models, it is recognised that a certain level of flexibility is warranted, for example to reshuffle indicators' weights (up to a certain limit for comparability and harmonisation reasons) or to introduce additional risk indicators. For example, the principle of assigning a certain percentage of the score to country-specific parameters could also be considered. Each methodology contains some discretionary components and parameters that are set via the supervisory judgement. Since no clear-cut theoretical background is available to back such decisions, the ESRB recommendation should provide information on what best practices national authorities should follow when making their decisions.

**Existing calibration methods could serve as a starting point.** In principle, a number of different calibration methods can be used to set the buffer size. However the choice of a calibration method which could be applied across the EU is rather restrictive, in particular because data may not always be available across the EU (e.g. data on loss history). Even though each of them has its strengths and weaknesses, in theory no methodology takes precedence over the other. In the past, the bucketing method has been the one most frequently used, and is currently followed by the ECB as a floor methodology for setting the capital buffers.<sup>35</sup> Given the fact that different methodologies have been applied by EU Member States for calibration of their respective O-SIIs, the ESRB

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<sup>33</sup> EBA guidelines on methods for calculating contributions to deposit guarantee schemes, EBA/GL/2015/10, of 22 September 2015.

<sup>34</sup> Recommendation ESRB/2014/1 on guidance for setting countercyclical capital buffer rates issued according to Article 135 CRD IV.

<sup>35</sup> ECB (2017), ECB Macroprudential Bulletin, Issue 3, June.



recommendation could propose the use of two different calibration methods<sup>36</sup> and leave it at the discretion of national authorities to use yet another method.<sup>37</sup> The choice of approach in calibration should be left to the national authorities, in order to enable them to account for the specific features of the banking sector in each EU Member State, while the alternative method could be used to cross-check the results.

**The buffer size should reflect the risk posed by each SII and setting O-SII buffers at the zero level should be avoided.** Thus, if a credit institution is identified as systemically important, this implies that the institution is associated with a systemic risk, something that should be addressed with an adequate buffer. Notwithstanding this, there might be some specific and exceptional circumstances where the 0% O-SII buffer may be justified, for example where the domestic systemic footprint of the bank is already captured by other measures<sup>38</sup> or for banks that are in the running-down process. Against this background, the introduction of a floor methodology across EU countries could also be considered.

**The O-SII buffers should be calibrated with the domestic economy as a point of reference and independently of the buffer rates applied to G-SIIs.** The measurement of the overall level of systemic importance of an institution may differ, depending on the international or national perspective. The identification of G-SIIs is based on a global reference framework, wherein the systemic impact and G-SII buffer of a global institution is proportional to its share in global markets and financial activities. In contrast, when considering a domestic economy, the same institution may have a significantly larger share in a concentrated financial market and in critical financial activities.<sup>39</sup> While the global reference system is adequate for capturing the international impact (e.g. global financial contagion effects) of a failure of this G-SII, it could play down the importance for a national economy of the same institution or some of its subsidiaries. Therefore, it is reasonable to argue that the calibration of the O-SII buffer should be independent of the buffer rates applied for G-SIIs. The same line of argument can be followed when calculating an O-SII buffer in a host country in circumstances where the parent institution is subject to an O-SII buffer in its home country.

**The calibration of the O-SII buffer should provide incentives for banks not to increase their systemic importance.** A rise in the systemic importance of a bank should be reflected in a higher buffer rate, while other policy tools can also play an important role in mitigating risk. Ideally, some scope should be available for addressing such an increase, for example by leaving the last bucket empty. Although this might not be possible under the current O-SII buffer caps, their increase, as

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<sup>36</sup> The EBA guidelines for setting up contributions to deposit guarantee schemes (EBA/GL/2015/10) could serve as an example, in which the option to choose from two different calibration methods is given to authorities.

<sup>37</sup> The ESRB recommendation on guidance for setting countercyclical capital buffer rates (ESRB/2014/1) could serve as an example.

<sup>38</sup> For example bank subsidiaries with globally integrated business models that are themselves part of wider international banking groups, for which the systemic risks are already properly mitigated with the G-SII buffer, and their domestic activities do not pose significant systemic risk at a non-global level.

<sup>39</sup> In the existing O-SII identification methodology, eight (out of the ten) compulsory indicators are the same as those used in the G-SII identification methodology. In addition, there seems to be some inconsistency in computing the majority of these indicators on a worldwide scope when the objective is to identify the domestic and/or regional systemic footprint.



proposed above, could provide leeway in this respect. For the same reason, a flat buffer rate for all O-SIIs should be avoided, in particular if large differences exist in the systemic importance of banks.

**The proposed guidance should also include additional provisions regarding the disclosure procedure.** A more detailed disclosure would facilitate a full understanding of how the systemic risk stemming from the existence of O-SIIs is mitigated with the buffer. It would also be beneficial if details of the methodology and related justification for their choice were to be released, for example where the proposed guidance allows certain deviations to account for national specificities.

**The calibration of the O-SII buffer should only depend on aspects directly related to the systemic importance of the O-SIIs.** This would avoid overlaps between instruments, increase their effectiveness and make evaluation of the impact of the different instruments possible. Therefore no other aspects, such as microprudential ones, should be considered in the calibration process. In particular, the time dimension of systemic risk should not be taken into account, making the buffer rate independent of the financial cycle. It is acknowledged, however, that during the phase-in process, when the O-SII buffer has yet to be built, how much capacity an O-SII has to comply with the buffer could be taken into account for the duration of the phase-in process.

### Scope of application of the O-SII buffers

**Calculating the O-SII systemic importance scores at the highest consolidation level ensures a conservative approach for identifying all institutions that could endanger financial stability.** With regard to the calculation of the O-SII systemic importance scores, choosing a sub-consolidated or individual level of consolidation might lead to the computation of lower market shares for O-SIIs in a given jurisdiction. In general, there will be a decrease in market share of the lower consolidation level of a banking group as some of its activities are excluded. On the other hand, an increase in the contribution of the domestic entities of a banking group might be observed when assessed at a lower consolidation level, as intra-group transactions no longer offset each other. Nonetheless, the resulting overall systemic importance score will be reduced.<sup>40</sup> The EBA Guidelines on the identification of O-SIIs explicitly require an initial assessment at the highest level of consolidation for achieving the objective of harmonisation across Europe although they allow subsequent applications of the methodology to be carried out at other appropriate levels.

**Applying an O-SII buffer at the highest consolidation level within an institution should ensure enough capital is available should the need arise.** Such an approach is in line with the BCBS principles regarding higher loss absorbency for D-SIBs.<sup>41</sup> The choice of consolidation level of the buffer should be closely linked to the level on which the O-SIIs have been identified. Differences in the levels of consolidation also have an impact with regard to the capital allocation within a systemically relevant institution. In order to ensure that enough capital is available in all parts of the

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<sup>40</sup> It should be noted, however, that intragroup transactions are not externalities; this is why accounting rules require their elimination, contrary to the systemic footprint measurement.

<sup>41</sup> See BCBS (2012), Principle 10.



group, the O-SII buffer should, in general, always be imposed at the highest consolidation level, even if the institution is identified as a G-SII. This could ensure that activities performed in an institution's subsidiaries and affiliates, which may contribute to the institution's systemic significance, are subject to the additional capital requirements.

**In some circumstances, there might be a rationale for not applying the O-SII buffer at the highest level of consolidation and instead setting higher buffer rates at lower levels of consolidation.** Such an approach may in particular be justified in the case of banks that are globally active and that at the same time are identified as G-SIIs. According to CRD IV, the higher of the two buffers (O-SII and G-SII) applies in such cases. Thus, if the bank is subject to the 2% O-SII buffer and 1% G-SII buffer, the global operations of the bank would be subject to the higher buffer (i.e. 2%) rather than the one intended solely by the G-SII buffer. Such a situation may be justified if the country where the parent of an O-SII is hosted may be facing costs that, in the event of insolvency, are substantially greater than the domestic ones because the losses of a foreign subsidiary may have to be borne by the parent. However, in some circumstances, this could result in a disproportionately high buffer for the group as a whole. Another situation where setting a higher buffer rate at lower levels of consolidation could be justified is where some groups contain particular subsidiaries or sub-groups that are both (a) relatively more important for the domestic economy than the rest of its group; and (b) structurally separated from the rest of the group. In these circumstances, it would be reasonable for the competent authorities to hold the systemically important subsidiary (or the sub-group) to a higher standard of loss absorbency than the rest of the group. In such a case, the amount of capital required on a consolidated basis should reflect the sum of the domestic systemic importance of the specific subsidiary (or the sub-group) and the systemic importance (domestic or global) posed by the other entities in the group.

**Furthermore, applying the O-SII buffer simultaneously at a lower consolidation level and at the highest consolidation level may help to enhance the stability of a complex institution with a layered corporate structure.** This could ensure that enough capital is held not only in the group (or sub-group), but also in key institutions in its jurisdiction. Imposing the buffer at multiple consolidation levels, even within a single jurisdiction, can increase the resilience of key parts of the group against financial distress. Applying an O-SII buffer only at the consolidated level would not guarantee that the capital held to meet the buffer would be available to absorb losses from that particular subsidiary. In addition, imposing the O-SII buffer simultaneously at the highest and at the lower consolidation levels could mitigate the risk of (excessive) ring-fencing by the host supervisors.<sup>42</sup> In the case of an entity with particularly large subsidiaries, it is important that the home authority continues to ensure there are sufficient financial resources at the parent level. This could be achieved, for example, through a solo capital requirement that takes into consideration the level of buffers set at subsidiary level by the host authorities. However, it should be noted that the setting of the O-SII buffer at multiple levels of consolidation in the EU adds a layer of complexity and is a limitation on the circulation of capital.

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<sup>42</sup> See, for example, the BCBS framework for D-SIBs, which draws attention to this problem.



## 2 Proposals relating to the SRB

**The SRB, by proving itself as a flexible macroprudential instrument for mitigating risks of a non-cyclical nature, has justified its existence following the first few years of its practical application.** This notwithstanding, some of the limitations of the current legal framework for the SRB, or the fact that it may potentially be transposed in different ways by EU Member States or some of its procedural aspects may present impediments to its effective use and reciprocation. Thus, initial experiences would suggest some legal changes, qualifications and clarifications may be required. The ESRB considers it important that its proposals outlined below maintain or even expand the SRB's flexibility.

**The ESRB is of the view that the SRB should be available across the whole of the EU.** The frequent and varied application of the SRB shows its appeal when dealing with systemic risks. The ESRB notes however that a few EU Member States have opted not to transpose the SRB into national law, since this is not mandatory. This means that the national macroprudential authorities in these countries do not have a tool at their disposal for targeting structural risks except for the too-big-to-fail risk. This not only limits their flexibility in addressing structural risks, but also hinders reciprocation of the SRBs introduced by other EU Member States, thus creating the potential for regulatory arbitrage and raising financial stability concerns.<sup>43</sup>

**The proposed amendments are aimed at facilitating a timely and adequate response to systemic risks of a structural nature by clarifying and simplifying the SRB framework while providing safeguards for preserving the Single Market.** While underlining the need for flexibility in the SRB, the ESRB recognises that it needs to be balanced with certain rules and procedures to safeguard the integrity of the Single Market, and it needs to take into account the EU-wide nature of some risks in an integrated market. First, current experience with the use of macroprudential instruments shows that, for a wide range of structural risks, the SRB is the most suitable and the only available macroprudential capital tool. Therefore, mandatory sequencing for its activation (the "pecking order") should be abolished in order to upgrade the SRB to the status of a dedicated instrument to address system-wide structural systemic risks not covered by the CRR. This would place the SRB alongside the countercyclical capital buffer addressing cyclical risks and the SII buffers mitigating the moral hazard risks posed by SIIs. Second, if changes to the O-SII buffer allow the moral hazard risks posed by O-SIIs to be addressed completely through the O-SII buffer, as proposed in the first section of this opinion, then it should be clarified that the scope of the SRB excludes the possibility of targeting the risks covered by the O-SII buffer. Third, the SRB's responsiveness to structural risks should be improved, thereby reducing the potential for regulatory arbitrage. This requires (i) application of the SRB to target specific subsets of exposures, such as sectoral exposures; and (ii) multiple uses of the SRB (multiple SRBs) to be able to address distinct risk sources, if needed. Furthermore, it will increase transparency and hence market acceptance and enable effective reciprocation. Fourth, if several SRB requirements are in place at the same

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<sup>43</sup> This also hinders the ECB's top-up powers that (for the SRB) are restricted to countries that have transposed this instrument, which creates an adverse incentive with regard to the transposition of the instrument.





time, their cumulative application for each affected institution should be subject to EU scrutiny in order to preserve the Single Market. Fifth, notification and approval procedures should be streamlined in order to avoid unnecessary burden. Sixth, a more detailed and transparent mandatory disclosure should increase transparency, facilitate reciprocity and improve public scrutiny of the measures.

## Removal of the mandatory sequencing for activating the SRB

**The current pecking order of instruments in the EU macroprudential framework impairs the flexibility of the SRB and might induce misleading incentives in the decision-making process.** At present, before the SRB is activated, macroprudential authorities need to justify why other tools contained in CRD IV/CRR (excluding Articles 458 and 459 CRR) are insufficient for addressing the identified systemic risks even if some of those instruments are not adequate to address the risks. Moreover, Pillar 2 requirements and risk weights or loss-given-default (LGD) floors may be increased only by competent authorities (Articles 124 and 164 CRR) which may not necessarily be the macroprudential authorities. In such a case the designated authority has to consider instruments which are not even under its own control. This may create an incentive to choose an instrument which is easier to apply but not adequate to address the risk or induce “inaction bias”. For example, if an authority wishes to apply the SRB to increase the resilience of its banking system against real estate risks of a structural nature, a complex sequence of steps should be applied. First, the authority must document that increasing the risk weights or LGD floors will not mitigate the risk. Second, the authority needs to show that the countercyclical capital buffer cannot be applied owing to the sectoral and non-cyclical nature of the problem. It then needs to argue that the solution via Pillar 2 might be impaired because of the difficulties of coordination, in particular if the identity of the macroprudential authority differs from that of the competent authority. The lack of a signalling effect, unless the Pillar 2 requirement is made public, and the administrative burden and time delays when negotiating the issue in supervisory colleges also impairs its effectiveness.<sup>44</sup>

**To ensure a timely and adequate response to systemic risks, the SRB should be upgraded to the status of a dedicated instrument to mitigate system-wide structural systemic risk and the mandatory sequencing for the activation of the SRB should thus be removed.** CRD IV treats the SRB as a residual instrument, which should only be used when more well-defined tools have been analysed and found to be insufficient.<sup>45</sup> The purpose of such a pecking order is to ensure that the dedicated instrument is used to target a specific systemic risk, which should result in macroprudential measures being applied consistently across the Single Market. For a wide range of structural risks the SRB is the only available macroprudential capital tool. The current set-up might therefore serve as an incentive for authorities to use other instruments instead of the SRB, even when the SRB may be the most suitable tool. This may happen if authorities find it easier, less burdensome, quicker and more predictable to use other measures. National authorities should be

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<sup>44</sup> The ESRB acknowledges the Commission legislative proposal of November 2016 that Pillar 2 should not be used to address macroprudential or systemic risks. It also acknowledges the different views of the ESRB members on the issue.

<sup>45</sup> Whether Pillar 2 is a better defined tool than the SRB in terms of flexibility and transparency is debatable.



required to demonstrate why the structural systemic risk is not covered by Pillar 1 requirements, but should not be required to demonstrate that other instruments are insufficient for targeting the identified risk.

### **Enabling authorities to use the SRB to target specific sources of risk**

**Multiple sources of structural systemic risk can only be addressed within the framework in place by means of a complex and risk-insensitive calibration of a single SRB.** There may be different sources of systemic risks of a structural nature that would justify the use of an SRB. The legal provisions of Article 133 of CRD IV are silent on how to target multiple sources of systemic risk and national transposition may differ in this respect. However, the EBA Q&A 2017\_3229 clarified that since the SRB is an exposure (not risk) targeting measure, two SRBs cannot be simultaneously applied to the same set of exposures. Therefore the only possibility for addressing multiple sources of structural systemic risk is through a single SRB based on the total risk exposure (TRE) amount. Generally, the exposure of individual institutions to each systemic risk varies, which requires the authority to calibrate the SRB rate to the specific situation of each institution. In such a case, the buffer rate is calibrated at one point in time and is not sensitive to the changes in the amount of exposures to the targeted risk, which may create space for regulatory arbitrage. As a result, although the underlying structural systemic risks are not expected to change quickly or frequently, authorities are required to frequently recalibrate the SRB rate to reflect the change in the exposure mix of individual institutions. Moreover, due to the summing up of several risks, the resulting SRB would not be transparent and hence not comprehensible, which may undermine the acceptance of the instrument altogether.

**Some Member States already use the SRB to address a multitude of systemic risks in this way.** These countries use the SRB to simultaneously contain risks of systemically important institutions and risks of certain exposures (e.g. foreign exposures, real estate). Methodically, the institutions concerned are subject to a single SRB requirement which covers all risk sources combined. Differences in the SRB level only occur with respect to different risk degrees at individual institutions.

**To illustrate the complexity of the current framework, one could take the example of an authority that has identified two structural systemic risks: (i) a foreign exchange risk of unhedged borrowers with credit in foreign currency; and (ii) a legacy stock of residential real estate loans with high loan-to-value ratios which it would like to address through an SRB.** The two sources of risks are different and the subset of institutions exposed to the two risks need not be identical, which calls for multiple SRBs. However, in the current framework the authority has to calibrate an institution-specific SRB rate for each targeted institution. In such cases, once a decision on an SRB has been taken, institutions could actually increase their exposure to the underlying risks by reshuffling their portfolio of exposures. For instance, they could decrease corporate loans, which will under a standardised approach decrease their overall risk exposure amount and hence their own funds to comply with the SRB requirement despite the fact that their exposure to the targeted risk increased. The authority would then need to regularly check if the SRB rate in effect properly reflects the changing exposure mix of the institutions.

**In order to enable authorities to target the specific sources of systemic risk, it should be clarified that the SRB can also be applied to a subset of (domestic) exposures, in particular**



**to sectoral exposures.** One of the major sources of systemic risk of a structural nature is risks stemming from the real economy. These risks often come from a particular sector within the economy or from a particular subset of exposures (e.g. foreign exchange risks of unhedged borrowers, residential real estate risks, concentration of exposures to a particular economic sector, persistently high levels of indebtedness of the private non-financial sector). To target these risks on a risk-sensitive basis, the SRB should be applicable to sectoral exposures, but also to subsets of exposures based on other characteristics. Regarding the location of exposures which could be targeted by the SRB, it is important to continue allowing it to address structural macroprudential risks stemming from domestic exposures and exposures in third countries as well as clarifying the option to target risks from exposures in a specific Member State. This will facilitate the targeting of specific sources of structural systemic risks from abroad as well as reciprocation.

**Authorities should therefore be allowed to impose more than one SRB when distinct risks are being addressed and set the buffer rate based on the risk exposure amount of the targeted exposures, despite the potential challenges of applying these.** The ideal basis of the SRB calculation should be the risk exposure amount of the targeted exposures. This means that the SRB requirement would be sensitive to the underlying exposure amounts of the targeted risk and prevent regulatory arbitrage that might arise should the SRB remain based on a total risk exposure amount. Together with multiple applications of the SRB, this would enhance the efficiency and transparency of the SRB framework. It would also facilitate reciprocity by allowing the reciprocating authority to target the systemic risk in the same way as the activating authority did. Any challenges that are encountered when applying multiple SRBs would relate, in particular, to the accumulation of distinct capital requirements, the need for a harmonised definition of the targeted subsets of exposures and avoiding the double-counting of risks.

**Adoption of these proposals would also facilitate reciprocation and thus strengthen the Single Market.** Based on the transposition of CRD IV, the current framework might prevent national authorities from reciprocating if they already have an SRB in place. Similarly, authorities might be reluctant to reciprocate if it might hamper the issuance of their own future SRB measures. Allowing for multiple risk-sensitive SRBs would result in more effective – since less prone to regulatory arbitrage – reciprocation by the reciprocating authority. The latter would be able to target the exposures associated with the risk identified by the authority applying the SRB rather than all the exposures potentially concerned by a reciprocity decision.

**Flexibility should enable authorities to address risks in a proactive and forward-looking way.** Although structural systemic risks are expected not to change rapidly, their sources will nevertheless sometimes diminish and new sources might be identified in the future. The macroprudential toolbox should also enable authorities to address these sources of systemic risk in order to achieve their objectives<sup>46</sup>. Allowing the SRB to target several specific sources of structural risk as proposed above would allow authorities to have both appropriate instruments in place to mitigate structural systemic risk and the necessary flexibility to react on an identified risk.

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<sup>46</sup> Recommendation ESRB/2011/3 on the macro-prudential mandate of national authorities (OJ EU 2012/C 41/01), recommendation C4.



### **Sufficient safeguards should be in place to maintain the Single Market and single rulebook.**

First, the requirement to target a structural systemic risk, which needs to be clearly identified by the activating authority, mitigates the fear that authorities would use the SRB for micromanaging capital requirement for different exposure types. This requirement can be strengthened by maintaining the minimum required level of an SRB rate, thus further limiting the possibility to target less significant exposure amounts. Second, the cumulative impact of all SRBs in place together with the activated SRB should be relevant when assessing the need for Commission approval as proposed in the section on notification below.

### **Limited application of the SRB to risks stemming from the systemic importance of individual institutions**

#### **There are several reasons why the SRB is applicable to individual institutions in the current framework.**

According to CRD IV, the SRB should be applied to all institutions or to one or more subsets of institutions and different requirements can be applied to different subsets. In principle there is no obstacle to defining a subset of institutions so that each subset consists of only one institution and thus applying the SRB to each individual institution. At present, there are several reasons why this can be warranted: (i) the targeting of SII risks, which can differ from institution to institution; (ii) the application of the SRB to subsets of exposures – in principle each institution's exposures differ and therefore the impact of the SRB to each institution will be different; (iii) the multiple application of the SRB – a combination of risks affects each institution differently; and (iv) the addressing of non-exposure based systemic risks, e.g. the business model, concentration risk or operational risk.

#### **Provided that the O-SII buffer is sufficiently flexible to fully address misaligned incentives and moral hazard risks posed by O-SIIs, the policy purpose of the SRB should be specified to clarify that the SRB should not be used to address O-SII risks.**

A clear delineation of instruments and the use of the dedicated instrument to cover SII risks would improve the transparency and effectiveness of macroprudential policy. Only once the SII buffers are flexible enough to fully cover the SII risks can the legislation exclude from the SRB's scope the risks stemming from misaligned incentives and moral hazard of SIIs. However, the presence of one or more SIIs in a financial system can in principle influence the structure of the financial system, thus creating other long-term structural risks, which go beyond the SII properties of these institutions (e.g. concentration of exposures, common business models, etc.). Authorities should continue to be able to address such sources of structural risks with the SRB.

#### **Assuming that all proposed changes to the framework were implemented, the need for targeting the SRB on individual institutions should be limited to addressing non-exposure based systemic risks of a structural nature.**

The proposed changes address many of the concerns that currently motivate the application of the SRB to individual institutions. If multiple applications of the SRB to subsets of exposures are allowed and are applied on a cumulative basis, including with the SII buffers, there would be little need to directly address individual institutions with the SRB. The SRB should, in most cases, be applied either to all institutions or to subsets of institutions, based on their exposure or contribution to a specific structural systemic risk (e.g. common and concentrated exposures, similar business models, etc.), but not on an individual institution to avoid ring-fencing. In principle a situation where such definition of a subset of institutions is met only by a single institution cannot be avoided. However, this in itself is not a



problem if the systemic risk emanates from a single institution and the risk is not related to the moral hazard targeted by the SII buffers. For reasons of legal certainty and to reduce complexity, it should still be possible for authorities to individually name institutions, to which potentially different SRBs with potentially different rates apply, in the respective legal act to complement the general definition of the SRB's targeted risk. Any explicit prohibition on applying the SRB to individual institutions could impair flexibility when addressing systemic risks and is therefore not warranted.

## **Simplification and clarification of the notification and approval procedure**

### **Notification and approval requirements may currently influence the setting of the SRB level.**

All EU Member States have activated an SRB of not higher than 3%. Information on the considerations regarding the buffer levels is scarce, but this may possibly be due to the more complex notification and approval requirements if the SRB rate exceeds 3% of the total risk exposure amount (according to EBA Q&A 2016\_3037). It is understood, that the notification and approval process is currently required, if a single institution has an SRB rate above the threshold. In some countries an additional Pillar 2 charge is applied for the banks with the SRB, which could be an indication that the 3% threshold represented an impediment to the consistent application of the SRB.

### **While the SRB rate should be based on the risk exposure amount of the targeted exposures, the thresholds should apply to the cumulative impact of all active SRBs expressed as a percentage of the total risk exposure amount.**

In principle, there are three potential definitions to which the thresholds could apply (see Table 1): (i) the SRB rate as a percentage of targeted exposures; (ii) the ratio of the SRB capital requirement to the total risk exposure (TRE) amount for each individual SRB; and (iii) the ratio of the overall cumulative SRB capital requirement to the TRE amount for all active SRBs. In the current SRB application, these three measures hardly differ from one another. Measure (i) depends heavily on the basis to which it applies and thus it is impossible to aggregate these measures. Measure (ii) (threshold applicable to a single SRB application) could potentially lead to the situation where all SRBs are calibrated below the intervention threshold, but the total cumulative impact could be significantly beyond the threshold. Thus, the best basis for the intervention thresholds is the cumulative system-wide impact of all active SRBs, which allows sufficient flexibility for national authorities in the calibration, provides the best comparability of the measures between countries, limits the possibilities of exploitation and is transparent to communicate. At the same time, measure (iii) can lead to situations where the overall impact would be lower than the threshold, but exceeding the threshold for an individual bank. Application of measure (iii) at the individual level of each bank could thus provide an additional safeguard to prevent potential misuse of the SRB for excessive ring-fencing of capital. However, the individual application of measure (iii) is not warranted as it is seen as burdensome and could raise issues of confidentiality.

### **A simple notification and approval process for SRB activation would further facilitate the application of the SRB and increase the effectiveness of macroprudential policy.**

Today, there is a large degree of uncertainty regarding the process of approval from the various European bodies. The process differs based on the location of targeted exposures (domestic, third countries, other Member States), the SRB rate (below 3%, between 3% and 5%, above 5%), whether the measure targets a subsidiary from another Member State or not (EBA mediation or comply/explain procedure) and the length of the process (one or three months). Authorities need to notify the Commission, the ESRB, the EBA, the competent and designated authorities of Member States



concerned and, if the measure targets exposures in third countries, the supervisory authorities of those third countries as well.

Figure 1  
Illustration of the calibration thresholds for the SRB

SRB	Targeted risk	Targeted exposures	SRB rate (% of targeted exposures)*	Impact on Bank X (as % of its TRE amount)**	System-wide impact (as % of TRE amount)***
SRB1	Foreign exchange risk of unhedged borrowers	Exposures of unhedged borrowers	10%	0.5%	2%
SRB2	Excessive indebtedness of households	Household sector exposures	5%	2.5%	2%
<b>Overall impact</b>				<b>3%</b>	<b>4%</b>

Source:ESRB.

Notes: \* The SRB rate is set as a percentage of the targeted exposures. For example, in the case of SRB2, the rate is 5% of exposures to the household sector.

\*\* The bank-specific impact as a percentage of the TRE amount of an individual bank. For example, Bank X is required to hold 2.5 of its TRE amount for SRB2 as exposures to households have a 50% share in its TRE amount.

\*\*\* The system-wide impact as a percentage of the TRE amount of the entire banking sector. For example, the entire banking sector is required to hold 2% of its TRE amount for SRB2, as exposures to households have a 40% share in the TRE amount of the entire banking sector.

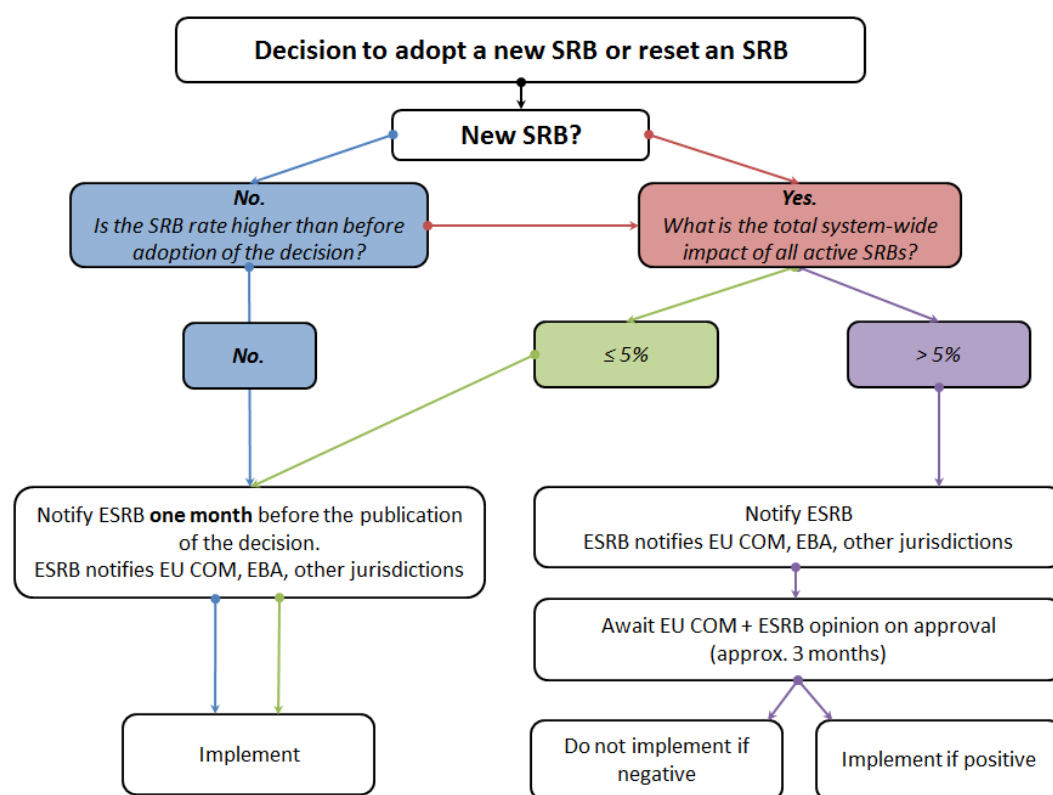
**The notification and approval processes should be streamlined and harmonised at the 5% threshold to allow for the adequate and timely application of the SRB.** Cumbersome activation procedures, involving delays and even rejection of the intended measures, can counteract a swift application and by themselves cause misleading incentives rather than promote a proactive use of macroprudential policy. Harmonisation and simplification of the procedure would improve flexibility of the SRB while maintaining the essential backstop powers for the Commission to preserve the Single Market and the single rulebook. As there is a lack of evidence on the optimal level of capital requirements, the current limit of 5% is proposed as the threshold at which Commission approval would be required. This 5% approval threshold would be based on the total system-wide risk exposure amount of all active SRBs as highlighted above. Measures reciprocating SRBs from other jurisdictions should not be included in the approval threshold. Where another jurisdiction has identified and motivated the use of an SRB calibration, the reciprocating jurisdictions should not have to justify the reciprocation of that measure again. Inclusion of reciprocating SRBs in the threshold could limit domestic use of the SRB and lead to a reluctance to reciprocate SRBs.

**The approval process should not be needed when maintaining or lowering the SRB rate.** Currently, the approval process is needed even if the SRB rate is maintained or lowered from a previously approved higher level. For example, if an authority were to lower the SRB from the approved level of 7% to 5.5%, it would need to go through the entire approval process again. However, were it to lower it to 3%, no approval process would be needed. Requiring approval for the 1.5 p.p. drop to 5.5% but not for a 4 p.p. drop to 2% is illogical and leads to unnecessary bureaucracy. Therefore only measures which tighten the SRB (an SRB targeting a new risk or setting a higher SRB rate than previously set) should need to be made subject to the approval process, but not measures which loosen the SRB. Otherwise authorities could lose the motivation to cancel SRBs at the right time once the underlying systemic risk has diminished. The proposed notification and approval process is presented in Figure 2.



**The available time for providing the ESRB and EBA opinion under Article 133 of CRD IV should be extended to 30 working days.** At present, the time allowed to provide this opinion is one month. However, based on current experience with regard to the issuance of opinions under Article 458 of the CRR, the one-month limit is deemed not to give enough time for a proper assessment to be carried out of the impact of the SRB and to discuss the proposed opinion internally before adoption while also respecting the procedural requirements for the General Board's written approval. An extension to 30 working days would provide sufficient time, particularly in cases where internal opinions differ, and would allow a proper exchange of views on the impact of the SRB.

Figure 2  
Proposed approval process for the SRB



Source: ESRB.

**The ESRB should become the central hub for all notifications regarding structural macroprudential measures<sup>47</sup> in the EU, thus reducing the overall notification burden.**

Currently, one month before the publication of the SRB decision, macroprudential authorities

<sup>47</sup> The role of the ESRB as a central hub for notifications could also cover all macroprudential measures in addition to those that are structural.



should notify the Commission, the ESRB, the EBA and the competent and designated authorities of Member States concerned and third countries. In order to facilitate the notification procedure, the ESRB should become a central hub for notifications and will further distribute the notification to other relevant stakeholders. At the same time, the notification template should be harmonised in order to provide a standardised set of information required for a proper assessment of the SRB by other authorities.

### **Effective reciprocity to prevent regulatory arbitrage**

**The availability of the SRB as a macroprudential instrument in all EU Member States would facilitate reciprocity.** A few EU Member States opted not to transpose the SRB into national law. This situation not only limits their flexibility in addressing structural risks, but also hinders reciprocity of the SRBs introduced by other EU Member States as well as the ECB's top-up powers. Reciprocity is based on the assumption that identified risks should be fully addressed in all EU Member States. By allowing different EU Member States to treat the same risk exposure differently, it is possible that regulatory arbitrage and potential financial stability concerns will emerge.

**Reciprocity should follow the “risk coverage principle”, based on an overriding objective of ensuring that identified risks are fully covered, regardless of the measure being used for reciprocity.** This means that an authority in one EU Member State must clearly identify the risk in issue when requesting a measure to be reciprocated, so that reciprocating authorities in other EU Member States can effectively ensure it has been fully covered. Such considerations are especially important when considering SRB reciprocity, as the instrument's broad scope could make it difficult to target risk accurately. The responsibility lies in the reciprocating authorities to ensure that the risk is addressed as anticipated by the authority requesting the reciprocity.

**The reciprocity of national exposure-based SRB measures should become automatic, albeit with exceptions based on the principle of proportionality.** However, such framework is only possible if the above-mentioned changes to the SRB are implemented. Automatic reciprocity reduces the risks that the same exposure is treated differently and should ensure that systemic risks stemming from certain exposures are adequately addressed throughout the EU. In order to reduce the burden on authorities, SRBs targeting domestic exposures could be subject to automatic reciprocity as is already the case for the countercyclical capital buffer. Authorities in other Member States would have the right either to issue a decision exempting institutions in their jurisdiction from this reciprocity (particularly on the basis of the principle of proportionality), or to comply with reciprocity, if an existing SRB macroprudential measure already addresses the respective systemic risk in accordance with the “risk coverage principle” in that jurisdiction. In particular, institutions with immaterial exposures could be exempted from the SRB either by the activating authority in a harmonised way, or by the reciprocating authority. Where authorities have opted to exempt, or have reciprocated with a different measure / calibration, it is important that the reasons for this are clearly explained and made public in the notification of the reciprocating measure. This will serve to improve understanding of the measure's usage and justify the regulatory assessment of the reciprocating authority as well as reduce the risk of unintended interactions of multiple measures.





**The ESRB has a key role to play in reciprocal requests by checking the initial request before it is sent to the other EU Member States, and monitoring the degree to which the reciprocation request has been complied with.** While there is little historical precedent for how reciprocation requests should be handled in the EU, the ESRB can provide further guidance to assist policymakers in identifying whether a reciprocal measure is needed and, when other measures are already in place, how the reciprocal measure should be calibrated and accumulation handled between different measures.

## Transparency through communication and mandatory disclosure

**Transparency through public disclosure is vital to the SRB as a flexible tool to allow economic agents to make informed decisions in an efficient manner.** Macroprudential decisions, even if institution-specific, are always taken with a system-wide perspective and therefore can potentially have a significant impact on all the agents in the market. In order to take effective mitigating actions, agents need to understand the nature of the systemic risk, its potential magnitude and transmission channels. This is especially true for the SRB, as it can target a large range of systemic risks, which are very different in nature. Publishing the reasoning and analysis behind an activating authority's decision would ensure better understanding of the policy decisions and ultimately lead to a smooth and efficient functioning of the framework and, in the longer run, would guarantee its credibility and effectiveness.

**A mandatory and harmonised disclosure framework would afford systematic transparency, thereby underpinning the effectiveness of the SRB, and could work as a safeguard to preserve the integrity of the Single Market.** Article 133(16) of CRD IV contains basic requirements for the announcement of the setting of the SRB, including a justification of the systemic risk buffer. Extending the scope of disclosure and its harmonisation through guiding principles will improve the understanding of national measures by all stakeholders and also enable the potential cross-border effects and interplay with other measures to be evaluated. This would also facilitate reciprocity by enabling better understanding of whether risks are already captured by domestic measures. Such a transparent framework can also serve as a safeguard for the integrity of the Single Market and protect it from capital ring-fencing.

**However authorities should retain the right not to publish this information if this could jeopardise the stability of the financial system.** It is acknowledged that, in some situations, publication of the detailed analysis of the systemic risks could prompt market reaction and thus aggravate the systemic risk instead of mitigating it. Therefore, the current provisions of Article 133(16) of CRD IV, which allow authorities not to disclose justification for the SRB in case this might jeopardise the stability of the financial system, should be retained.



### 3 Accumulation of structural buffers based on the risk coverage principle

**The accumulation rule of structural buffers hinders the possibility of targeting several structural risks.** If applied on a consolidated basis, only the higher of the G-SII buffer, O-SII buffer and the SRB is currently applicable to an institution.<sup>48</sup> The only exception is when the SRB applies only to domestic exposures, in which case it is cumulative with the higher of the G-SII and O-SII buffers. This limitation is supposed to prevent the combination of structural buffers leading to an excessive accumulation of capital requirements. Thus, one solution for targeting multiple risks in the current framework is to impose the SRB on domestic exposures only. Alternatively, all targeted risks need to be incorporated into a single SRB; however this approach diminishes the transparency of macroprudential policy.

**The ESRB is of the view that capital requirements related to measures that target different systemic risks should be cumulative.** In general, the accumulation of measures should be dependent on the risks targeted by those measures. Measures targeting different risks should be added together, while measures targeting the same risks should not, as long as the risks are fully addressed. This prevents the double-counting of risks, which could lead to negative incentive effects in the system. A particular example is the interaction of the O-SII and SRB buffers. If the proposed delineation of the SII buffers and the SRB is implemented, the two instruments would, by definition, target different risks. It follows that the structural buffers should be made cumulative, where the SRB would always be applied in addition to the maximum of the G-SII and O-SII buffers. The same principle should also apply to the multiple application of the SRB, where in principle each SRB decision should target a specific systemic risk and thus they should be applied in addition to each other. The proposed accumulation rules in combination with other capital requirements are illustrated in Figure 3.

**The changes to the accumulation principle combined with the proposal on the O-SII buffer caps should be taken into account in the calibration of structural buffers.** Indeed, this will result in more effective macroprudential policy, but may have a substantial impact on the level of regulatory capital that an individual bank might be required to hold in the future. This could also imply short-term costs; however, in the longer term, the net benefits would be positive<sup>49</sup>, as, in the long run, higher capital buffers should have only marginal (if any) impact on the real economy.<sup>50</sup> Thus, any costs reflect only short-term adjustments during the transition period, as banks can meet higher requirements by a combination of increasing retained earnings (by reducing dividends or increasing lending spreads) and deleveraging. The main benefits of the buffer come from

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<sup>48</sup> Article 133(4) of CRD IV.

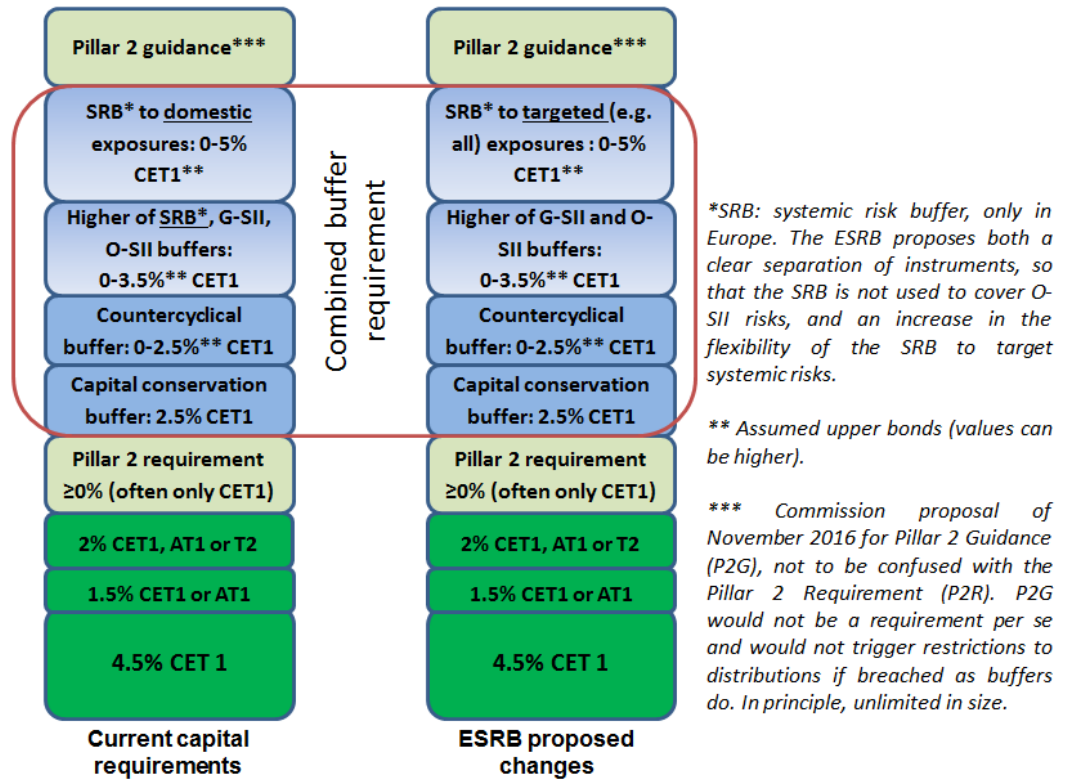
<sup>49</sup> E.g. BCBS (2010), "An assessment of the long-term economic impact of stronger capital and liquidity requirements", BIS Paper, August.

<sup>50</sup> E.g. Admati, A., DeMarzo, P., Hellwig, M. and Pfleiderer, P. (2011), "Fallacies, irrelevant facts, and myths in the discussion of capital regulation: why bank equity is not expensive", Rock Center for Corporate Governance at Stanford University Working Paper No 86.



preventing costly crises, which are difficult to estimate. However, as the research on the optimal level of capital requirements is inconclusive, authorities need to take all these aspects into consideration for the instruments' calibration.

Figure 3  
Current cumulative capital requirements for European banks and ESRB proposed changes



Source:ESRB.



## 4 Establishing cooperation requirements between authorities with respect to macroprudential policy

**To accommodate national specificities, the institutional frameworks of EU Member States encompass potentially three types of institutions with macroprudential tasks:** (i) the national competent authority (NCA, the microprudential supervisor); (ii) the national designated authority (NDA, the authority designated to set the countercyclical capital buffer<sup>51</sup>); and (iii) the national macroprudential authority (NMA, the authority established in response to Recommendation ESRB/2011/3 on the macro-prudential mandate of national authorities). In some countries all three mandates lie within a single institution, in others it may be with three different authorities.

**Due cooperation is required in such a heterogeneous framework to ensure the compatibility of objectives and to limit potential conflicts of interest.** Although the Member States should ensure that the NMA has control over appropriate instruments for achieving its objectives<sup>52</sup>, EU legislation leaves it up to the Member States to decide on who may be allocated the decision-making powers on macroprudential instruments. CRD IV gives the Member States the choice whether the competence to identify G-SIIs and O-SIIs, set the SII buffers and set the SRB is given to the NCA or the NDA. Cooperation can help to reconcile the different policy objectives of NCAs and NDAs and enable a complete risk assessment (including system-wide risks).<sup>53</sup> In particular, coordination agreements should be put in place with regard to the NMA if its identity is separate from that of both the NCA and the NDA.

**Cooperation requirements need to avoid and solve conflicts of interests arising between the objectives of macroprudential policy and microprudential objectives; cooperation requirements should also contribute to the consistency of overall capital requirements and ensure that risks are neither overlooked nor double-counted.** The overall level of capital for an individual institution is composed of the regulatory capital under Basel III, Pillar 2 capital requirements and the combined (macroprudential) buffer requirement. A conflict of interest may arise between the NCA and the NDA about the adequate level of prudential capital requirements for a bank. As shown by the financial crisis, taking care of the solvency of institutions and markets in isolation may not be sufficient to safeguard the stability of the entire financial system. The prevention and mitigation of systemic risk and the stability of the financial system is a prerequisite for the stability of its individual components. Therefore, an adequate process of cooperation between the authorities concerned should be established to sufficiently balance the microprudential and macroprudential views.

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<sup>51</sup> Articles 131(1), 131(3), 133(2), 136(1) of CRD IV.

<sup>52</sup> Recommendation C4 of Recommendation ESRB/2011/3 on the macro-prudential mandate of national authorities.

<sup>53</sup> See ECB, SSM Manual, Chapter 1.3 Macro- and Microprudential Supervision in the SSM.



**Cooperation requirements have to make sure that macroprudential authorities receive all the relevant information and data to pursue their macroprudential policy objectives.** This also includes information from NCAs and institution-specific information upon reasoned request, while at the same time maintaining confidentiality. Potential conflicts should be resolved through a clear procedure with a view to safeguarding financial stability.

**Cooperation requirements are particularly important where the NCA applies Pillar 2 capital requirements with a system-wide stability perspective** (e.g. using Articles 103 or 104(3)(d) of CRD IV). In such cases, it cannot be excluded that the Pillar 2 of given banks covers the same risk targeted by a structural buffer (e.g. an SRB applied to target common and correlated exposures), resulting in risk double-counting for those banks. In particular, any offsetting of microprudential and macroprudential tools (e.g. via the Supervisory Review and Evaluation Process) should be avoided. Therefore, to enhance transparency and avoid any inconsistent use of instruments, the designated authority should be systematically involved and consulted.

**Coordination between the NCAs and NDAs should therefore be mandatory if Pillar 2 measures continue to be used to address systemic risks.**<sup>54</sup> The ESRB acknowledges the Commission's legislative proposal of November 2016 that Pillar 2 should not be used to address macroprudential or systemic risks. However, the ESRB stresses that if the option to use Pillar 2 for macroprudential purposes remains in the final legislative text, a mandatory cooperation requirement between the NCAs and NDAs whenever Pillar 2 measures are applied with a system-wide stability perspective needs to be incorporated into CRD IV. In addition, coordination with NDAs could also be incorporated into the EBA Guidelines on the application of the Supervisory Review and Evaluation Process<sup>55</sup>.

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<sup>54</sup> As a general principle, a clear distinction in responsibilities and powers of authorities is beneficial to an effective macroprudential framework. Nevertheless, the ESRB acknowledges that ESRB members have different views on whether Pillar 2 should continue to be available as a macroprudential tool reflecting their different experiences. On one hand it enhances flexibility of macroprudential policy, on the other hand the difficulties of coordination between authorities when applying Pillar 2 can impair flexibility and a lack of disclosure of Pillar 2 decisions might affect the transmission of policy signals.

<sup>55</sup> EBA/GL/2014/13.



## 5 Abbreviations

### Countries

<b>BE</b>	Belgium	<b>HR</b>	Croatia	<b>PL</b>	Poland
<b>BG</b>	Bulgaria	<b>IT</b>	Italy	<b>PT</b>	Portugal
<b>CZ</b>	Czech Republic	<b>CY</b>	Cyprus	<b>RO</b>	Romania
<b>DK</b>	Denmark	<b>LV</b>	Latvia	<b>SI</b>	Slovenia
<b>DE</b>	Germany	<b>LT</b>	Lithuania	<b>SK</b>	Slovakia
<b>EE</b>	Estonia	<b>LU</b>	Luxembourg	<b>FI</b>	Finland
<b>IE</b>	Ireland	<b>HU</b>	Hungary	<b>SE</b>	Sweden
<b>GR</b>	Greece	<b>MT</b>	Malta	<b>UK</b>	United Kingdom
<b>ES</b>	Spain	<b>NL</b>	Netherlands	<b>NO</b>	Norway
<b>FR</b>	France	<b>AT</b>	Austria	<b>US</b>	United States

### Other

<b>AT1</b>	Additional Tier 1 capital	<b>P2G</b>	Pillar 2 guidance
<b>b.p.</b>	basis point(s)	<b>P2R</b>	Pillar 2 requirement
<b>BCBS</b>	Basel Committee on Banking Supervision	<b>RWA</b>	Risk-Weighted Asset
<b>BIS</b>	Bank for International Settlements	<b>SII</b>	Systemically Important Institutions
<b>CRD IV</b>	Capital Requirements Directive	<b>SRB</b>	Systemic Risk Buffer
<b>CRR</b>	Capital Requirements Regulation	<b>SSM</b>	Single Supervisory Mechanism
<b>D-SIB</b>	Domestic Systemically Important Bank	<b>TLAC</b>	Total loss-absorbing capacity
<b>EBA</b>	European Banking Authority	<b>TRE</b>	Total Risk Exposure
<b>ECB</b>	European Central Bank		
<b>ESRB</b>	European Systemic Risk Board		
<b>EU</b>	European Union		
<b>GDP</b>	Gross Domestic Product		
<b>G-SIB</b>	Global Systemically Important Bank		
<b>G-SII</b>	Global Systemically Important Institution		
<b>IMF</b>	International Monetary Fund		
<b>MREL</b>	Minimum Requirement for Eligible Liabilities		
<b>NCA</b>	National Competent Authority		
<b>NDA</b>	National Designated Authority		
<b>NMA</b>	National Macroprudential Authority		
<b>OMRTF</b>	Task Force on Operationalising Macroprudential Research		
<b>O-SII</b>	Other Systemically Important Institution		
<b>p.p.</b>	Percentage point(s)		



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