AFME Position paper on limitations to Capital Buffer usage during the Covid-19 pandemic

Initial industry views on the reasons why banks did not draw on capital buffers during the Covid-19 pandemic and changes which could address them.

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Executive Summary

This paper explores the impact of the measures taken by regulators to mitigate the impact of the Covid-19 pandemic in relation to releasing capital buffers. We look at the reasons why, despite the regulatory relief, banks did not draw on their capital buffers and put forward suggestions as to how this could be addressed. Primarily we recommend increasing buffer usability by reducing stigma from breaching MDA triggers through a rebalancing of the Capital Conservation buffer and the Countercyclical Capital buffer (see Part 3). This should be complemented with clear supervisory communication and a more transparent, rules-based MDA framework.

Part 1: Background

On 20 March 2020 the ECB announced several measures to ensure that its directly supervised banks could continue to fulfil their role in funding the real economy as the negative economic effects of the Covid-19 became apparent.

The most significant of these announcements was the freeing up of capital and liquidity buffers. These had been built up by banks since CRD IV was introduced and were designed to allow banks to withstand stressed situations like the Covid-19 pandemic. Specifically, since March 2020 European banks have been allowed to operate temporarily below the level of capital defined by the Pillar 2 Guidance (P2G), the Capital Conservation Buffer (CCoB) and the liquidity coverage ratio (LCR). In addition, it was the ECB's view that these temporary measures should be enhanced through the relaxation of the Countercyclical Capital Buffer (CCyB) by the national macroprudential authorities. These measures will now remain in place until at least the end of 2022. Banks were also allowed to partially use capital instruments that did not qualify as Common Equity Tier 1 (CET1) capital, by advancing the provisions in CRD V to use Additional Tier 1 or Tier 2 instruments, to meet the Pillar 2 Requirements (P2R).

Overall, the ECB calculated that up to €120 billion of bank capital linked to buffers was freed up, which could then be used to absorb losses resulting from the crisis or earmarked to finance up to €1.8 trillion in new loans to households and businesses. Yet despite these extraordinary announcements, only 9 EU banks dipped into their capital buffers in 2020 and this was due to structural issues rather than directly linked to credit losses because of the pandemic.

The ECB has suggested that banks' reluctance to use the buffers or be seen as the first to use the buffers, stems largely from fear of external ratings downgrades, while the BCBS recently noted that it remains "unclear

whether this reluctance to use capital buffers reflects banks' uncertainty regarding potential future losses or the wider market stigma that may result if a bank were to operate in its buffers".[1]

This issue is closely related to a breach of the buffers which would result in triggering the Maximum Distributable Amount (MDA) restrictions. These require regulators to automatically restrict earnings distribution (both to holders of AT1 instruments and to equity shareholders) and variable remuneration if a bank's total capital falls below the sum of its Pillar 1, Pillar 2 and CRD buffer requirements. The negative consequences resulting from the use of buffers has led to concern that banks might opt to deleverage instead of supporting additional lending with potential adverse effects on the recovery.

Most banks maintained capital ratios well above their minimum requirements and buffers during the pandemic (see Figure 1). As acknowledged by BCBS and BoE, in some jurisdictions this was partially due to authorities reducing capital requirements and buffers and imposing restrictions on capital distributions via dividend payments and share buybacks. It was also the result of extensive fiscal and monetary support provided to borrowers which helped reduce the level of losses that might otherwise have been suffered by banks.[2] Hence, in Europe the ECB considered that the exceptional suspension on distributions on a system-wide basis was justified to mitigate the risk from collective deleveraging by banks to maintain or increase their capital ratios and avoid dipping into their buffers in stress periods. It was also intended to avoid the stigma associated with one bank dipping into its buffer and being subject to MDA restrictions on its own. However, in so doing, the ECB has noted that imposing such blanket restrictions on dividend distributions can have drawbacks, most notably that investors may be reluctant to invest in banks which are subject to restrictions and, in consequence, the ability of banks to raise capital in the longer term could be impaired.[3]

Figure 1. Total capital ratio of ECB supervised banks and its components by reference period (EUR billions; percentages)[4]

Indicator	Q4 2019	Q1 2020	Q2 2020	Q3 2020	Q4 2020	Q1 2021
CET1 amount	1,228.10	1,201.99	1,229.30	1,224.64	1,275.11	1,279.51
Tier 1 amount	1,325.71	1,304.06	1,332.28	1,329.40	1,383.51	1,385.38
Total capital amount	1,528.64	1,509.01	1,540.58	1,533.94	1,592.27	1,597.49
Total risk exposure amount	8,218.13	8,335.31	8,257.79	8,056.14	8,146.44	8,261.15
CET1 ratio (%)	*14.9%*	*14.4%*	*14.9%*	*15.2%*	*15.7%*	*15.5%*
Tier 1 ratio (%)	*16.1%*	*15.7%*	*16.1%*	*16.5%*	*17.0%*	*16.8%*
Total capital ratio (%)	*18.6%*	*18.1%*	*18.7%*	*19.0%*	*19.6%*	*19.3%*

In July 2021 both the ECB and the PRA lifted restrictions on distributions. From now, supervisors of banks subject to ECB supervision will return to pre-pandemic way of assessing banks' capital and dividend plans. Nonetheless banks are urged to remain prudent and not underestimate credit risk when they decide on dividends. In this context, it should also be noted that the recently published EBA stress test results clearly demonstrated the ability of nearly all banks to maintain fully adequate capital ratios even in the event of

[1] Early lessons from the Covid-19 pandemic on the Basel reforms (bis.org)
[2] Early lessons from the Covid-19 pandemic on the Basel reforms (bis.org) (page 2).
[3] https://www.ecb.europa.eu/pub/financial-stability/macroprudential-bulletin/html/index.en.html
[4] Source: ECB. Notes: Significant institutions at the highest level of consolidation for which common reporting (COREP) and financial reporting (FINREP) are available. Specifically, there are 112 in the first and second quarter of 2020, 110 in the third quarter of 2020, 112 in the fourth quarter of 2020 and 114 in the first quarter of 2021. The number of entities per reference period reflects changes resulting from amendments to the list of SIs following assessments by ECB Banking Supervision, which generally occur on an annual basis, and mergers and acquisitions. 1) CET1 stands for Common Equity Tier 1. 2) Total capital, Tier 1 and CET1 follow the transitional provisions laid down in Articles 465 to 491 of Regulation (EU) No 575/2013 on prudential requirements for credit institutions and investment firms (CRR).

exceptionally harsh macroeconomic scenarios materialising. Thus, the ability of banks to withstand stress events[5] - and the fact banks hold an absolute level of capital above the level at which capital requirements have a diminishing effect in reducing the probability of an economic crisis arising[6] - suggests that there is scope to revisit and improve the existing buffer framework.

The following parts of this paper aims to assess what future policy measures should be considered in light of the procyclical interaction between the capital buffer and MDA framework which Covid-19 has brought to light. We urge both global and EU regulators to take the considerations and recommendations of this paper into account in any future revisions to the global or EU framework (e.g. as part of the Commission's review by mid-2022).

Part2: Overview of impediments to banks' buffer usability:

There are several drivers in the current framework that have the potential to limit the usability of buffers:

1) **The role of market pressures to avoid the erosion of capital buffers and the stigma associated with breaching MDA thresholds** (which in the event of such breaches leads to restrictions on the remuneration of equity and other instruments (shares and AT1 instruments) when operating below the combined buffer). The payment of dividends is seen as a signal to the market that a business is profitable, or even if it is not there is still capacity to pay out dividends from capital retentions rather than current earnings. As a result, banks may be reluctant to cut their dividend payments, particularly if they view losses as temporary for fear of the impact on their share and debt ratings and ultimately their funding costs.[7] Even a reduction in surplus capital in excess of combined buffer requirements may trigger market concerns in relation to distribution capacity and especially where the reduction results in a bank's capital ratios falling to below its previously communicated target capital range. One of the reasons a reduction in surplus capital in excess of buffers causes concern is because of the risk that MDA restrictions would follow if capital consumption continued that trend. Banks may also wish to maintain high levels of capital to be able to take advantage of potential M&A opportunities that may arise at times of crisis.[8]
2) **Uncertainty regarding the timeline for rebuilding buffers**. The lack of clear timelines can result in uncertainty regarding capital planning and the extent to which banks can continue to support the economy through increased lending and start paying dividends again, thereby avoiding any further stigma. Banks will be concerned by the impact on rebuilding the buffers when they have increased lending during the period of buffer flexibility. From a market/investor perspective the long-term perspective on what banks will be required to hold also plays an important role, especially regarding sufficient predictability on future rates of the CCyB. For instance, the UK FPC has indicated that any decision to increase the CCyB will be taken in 2022 with a one-year period before the increase is effective and the baseline will be 2%. Hence, market transparency and predictability can be improved via more releasable buffers.
3) **Lack of alignment between regulators and supervisors.** While buffer flexibility may encourage banks to operate below their capital levels to provide more financing to the economy, supervisors continue to require entities to strengthen their capital ratios (for instance, while flexibility on buffer

[5] Results of the EBA stress test 2021 can be viewed here.
[6] BIS study showing the level at which capital levels have a diminishing return on the impact of reducing an economic crisis: https://www.bis.org/bcbs/publ/wp37.htm
[7] See conclusions https://www.ecb.europa.eu/pub/financial-stability/macroprudential-bulletin/html/ecb.mpbu202106_1~b620729a65.en.html
[8] Berger, A.N. and C.H.S. Bouwman (2013), "How does capital affect bank performance during financial crises?", Journal of Financial Economics, Vol. 109 (1), July 2013

usage was granted in respect of EU on buffers, this was not implemented uniformly across EU competent authorities.

4) **Other regulatory/prudential requirements that are not as risk-based** (such as the leverage ratio and resolution requirements). These could also be binding, at least temporarily. The Bank of England's most recent consultation on the Leverage Ratio[9] does not attach MDA restrictions to the Leverage buffers to avoid complexity and encourage buffer usability, thereby demonstrating the importance of these restrictions in terms of overall usability of buffers.[10]

Aside from these, another key driver of why banks' chose not to or did not need to draw on capital buffers during the Covid-19 pandemic is the unprecedented support from governments. Further, as demonstrated by the recently published EBA risk dashboard, while loans under EBA eligible moratoria declined further in Q1 2021, the NPL ratio also declined despite a slight rise in NPL volumes as this was outstripped by overall loan growth.[11] With banks' CET1 ratios well above minimum requirements at present and a large average distance to MDA triggers, there is little incentive for banks to draw on their buffers.

In addition to aspects of the current framework that could limit buffer usability, forthcoming measures as part of the final revisions to the Basel III package are likely have an impact, most notably the Output Floor which will increase average capital requirements. Regulators should therefore particularly mindful of the interactions when implementing this in the forthcoming CRR3 – see our recommendations here.

One further EU specific aspect of the buffer framework which should also be considered is the way in which the O-SII buffer operates. Although the EBA has defined common criteria for setting the O-SII buffer (e.g. size, importance, complexity, interconnectedness), national discretions result in a diverse range of O-SII buffers across the European countries. Consequently, the national buffer setting is perceived as untransparent, for instance in the scoring criteria, some national authorities take national parameters (e.g. GDP%) into account, which puts banks in a relatively smaller country at a disadvantage. This should be reviewed in the context of creating a coherent capital buffer regime that works uniformly across the EU.

Part 3: Possible policy action that could address impediments to usability of buffers:

Given the challenges to the usability of buffers exposed in the existing framework, a key policy recommendation would be to review and where necessary revise the functioning of buffers at Basel and national level. We set out below several areas which would help improve the current functioning of the buffer framework and address the interconnection with the MDA framework which has proven an impediment to using buffers.

Addressing the balance of the buffer framework

As recognised by the BCBS, buffers may need to be more releasable, but this should not lead to creating more buffers on existing ones nor increasing the overall size of the buffers, rather, rebalancing the existing micro and macro buffers that are already in place.

Notably we would recommend reviewing the small relative weight of counter-cyclical components within the overall buffer mix. The CCyB, which is the only buffer specifically designed to be released at low points in the

[9] https://www.bankofengland.co.uk/prudential-regulation/publication/2021/june/changes-to-the-uk-leverage-ratio-framework

[11] EBA risk dashboard, see pg. 3

cycle, accounted for just 0.1% of risk-weighted assets in the euro area at the start of the pandemic and had not been activated in most EU jurisdictions.[12] The systemic risk buffer (SyRB) has also only been activated in a limited number of jurisdictions. The CCoB, on the other hand, is set by law at 2.5% and its use would automatically trigger MDA restrictions. Equally, this is the case for the global and local systemic risk buffers (GSIB and DSIB). Hence, if the CCyB were larger and the CCoB smaller, this would provide more headroom over MDA restrictions, even if the overall size of the combined buffer is kept the same.

Basel and national regulators should therefore consider lowering the CCoB, and other systemic buffers and use this capital difference to meet a target level for the CCyB in normal times without increasing the overall amount of buffers or changing the basis on which a breach of the correspondingly lower CCoB led to the suspension of distributions. While the benefit of such a capital rebalancing would increase the amount of capital that could automatically be released in a stressed environment and alleviate the stigma issue which could result from a capital release generated from a reduced CCoB, such a switch could raise a number of issues. Amendments might need to be made to the way national regulators released the CCyB to ensure that this was done on a uniform basis using consistent criteria and avoid macro distortions from the release of the buffer in some jurisdictions but not others. Another way of achieving this might be to vest authority for releasing the CCYB (and rebuilding it) in the hands of a body such as the ECB or ESRB (in coordination with national authorities) in times of stress. This need not mean that the CCyB be adjusted by an equal amount in every territory, but it could allow a uniform set of criteria to be applied when determining any change to the buffer. Furthermore, this could be supported by putting in place a transparent framework for how and when the release would be expected to be made, which would in turn address concerns around market transparency and predictability.

Increasing the proportion of capital held in the CCyB and shifting the decision making over this capital away from banks would allow greater flexibility and speed of response during any future crisis, and it would reduce the issue of stigma. It would transfer the responsibility for this from the banks' managements to the macro prudential authorities or the ECB depending on which bodies were charged with operating this buffer.

One challenge, should this proposal be taken up, is the calculation of how the CCoB is redistributed to the CCyB as the former is based on an internationally agreed level, while the latter is left to national supervisors and could therefore lead to inconsistent application. A simple way of calculating this would be to transfer an amount from the CCoB to the CCYB which corresponded to a certain % of RWAs. Nonetheless, there are still other aspects of the regulatory framework which interact with these buffers such as the MREL requirement which entails a Market Confidence Charge which is equal to the Combined Buffer Requirement less the CcyB.

As an alternative to this proposal, a temporary freeze of buffers could be introduced, and authorities allowed discretion to reduce CCoB in exceptional circumstances, and/or transfer part of the CCoB into the CCyB and/or SyRB so that the buffers can be used as an effective counter-cyclical tool. Another proposal would be to develop dynamic buffers so that the required level can change according to the cyclical situation of the economy. Policy makers could also consider redistributing the CCoB into the P2G, meaning it would no longer be relevant for MDA purposes, however this would lack transparency and not necessarily support market confidence in bank buffer levels as it is not disclosed.

[12] Behn, M., Rancoita, E., Rodriguez d'Acri, C. (2020), "Macroprudential capital buffers - objectives and usability", ECB Macroprudential Bulletin, Issue 11, October 2020.

In conclusion, industry supports a wider rebalancing of the structural buffers towards cyclical buffers, and encourages regulators to address any related issues, so that the change becomes practicable and consistent with the wider framework. Changes to the MDA framework should also be subject to an after-crisis empirical analysis by the Commission when conducting their macroprudential review. A wider review by BCBS would also be welcomed to ensure that a rebalancing will have a net benefit on buffers usability and credit lending in a crisis.

Clear communication between Supervisors and Banks

Supervisors should be clear and explicit in their communications to enable banks to use buffers and avoid adverse market reactions. This is important where a reduction in surplus capital in excess of the combined buffer requirement triggers market concerns in relation to distribution capacity, and especially where the reduction resulted in a bank's capital ratios falling to below its previously communicated target capital range. In this instance it is important for regulators to communicate to the market that the reduction of the capital requirements is acceptable and provides capacity to absorb idiosyncratic or systemic shocks, that their usage does not necessitate solvency concerns, and that the requirement will not be reversed in the short term but, rather, once there are adequate macroeconomic circumstances. Such communications should help allay unjustified concerns of the market.

Another aspect which requires clear communication regards guidance on the minimum timeframe for capital rebuild, which should reflect on the new lending which banks have undertaken to avoid limiting credit to the economy at a time when it is most needed.

Reducing stigma from breaching MDA triggers

As part of the measures to support and encourage buffer usability and mitigate banks being unduly impacted by stigma from breaching MDA restrictions during the pandemic, the ECB and other regulators introduced a blanket ban on dividend distribution. Overall we consider it best to avoid suspending dividend payments ahead of any breach in MDA to limit undue impact on bank share ratings and uncertainty over future actions (the capital saved during the pandemic was minor in the context of banks' overall capital resources, and while some dividend restraint may have been appropriate, the formal cancellation of dividends added little to lending capacity and reduced market values by a multiple of the capital saved).

Instead, we consider this issue could be more efficiently solved either by rebalancing the buffers as suggested above (whereby if the capital requirement is transferred from the CCoB to the CCyB/SyRB, and, in exceptional circumstances, the CCyB/SyRB is lowered, the distance from the MDA trigger would be commensurately increased, thus allowing banks to continue with their dividend payment), or alternatively/ in addition introducing a rule-based and transparent approach with regard to MDA triggers. This would include:

(i) Avoiding retroactivity – MDA triggered in year N should not apply to profits generated in year N-1; (the trigger of the MDA should only impact the dividend accruing from the date of the breach and not the dividend to be paid related to results accrued before the breach);

(ii) Establish a link between distribution policy and lending, for instance if a bank continues to achieve a minimum/target regulatory specified amount of lending, consequently, even if it

breached its MDA requirement it could maintain its distribution policy subject to minimum levels of capital (or a variant thereof);

(iii) To avoid a cliff edge effect, if a bank breaches MDA triggers, then it should be able to continue paying out dividends consistent with the historic dividend amounts (depending on the level of breach) or up to a certain percentage of RWAs whichever is the higher /lower.

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