11.01.2016

Briefing note on the setting of the capital buffers for systemic institutions and the countercyclical capital buffer for 2016

The Banco de España has approved the creation of capital buffers for systemic institutions and has set the countercyclical capital buffer for 2016 at 0 %, as explained in the press release of 28 December 2015. The purpose of this note is to provide more detailed information on the decisions taken by the Banco de España relating to these capital buffers, and on the analysis on which those decisions were based.

Systemically important institutions

Systemically important institutions can give rise to risks for financial stability. Failure of a systemic institution, or the mere expectation of failure, could have negative effects on an unpredictable scale on the rest of the financial system and, ultimately, on the real economy. This risk gives rise to a negative externality, since the institutions do not adequately reflect their systemic nature in their decision-making. In addition, moral hazard can arise insofar as these institutions expect to be bailed out by states if they find themselves in difficulty. Insofar as systemic institutions assume that the authorities have implicit guarantees in place for them, market discipline may be impaired and excessive risk-taking encouraged, exacerbating the threats to and distortions in the global financial system.

This situation merits special supervisory treatment, which has led to the creation of specific capital buffers for global systemically important institutions (G-SIIs) and for other systemically important institutions (O-SIIs).[1] These buffers seek to lessen the likelihood of systemic institutions failing, in an attempt to make expected losses equal for banking system institutions, countering the greater impact in the event of failure at systemic institutions with a lesser likelihood of occurrence. Note that the higher capital requirement also contributes to levelling out competitive conditions between banks when it comes to their funding. Thus, the additional capital acts as a surcharge on the systemic institution to offset its lower cost of funding.

The Banco de España has approved the list of G-SIIs and O-SIIs, in force since 1 January 2016, with effect only in 2016. In accordance with Article 66 of Royal Decree 84/2015, the Banco de España will review the list of G-SIIs and O-SIIs annually.

1 Names coined in Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 (CRD IV).

Global systemically important institutions (G-SIIs)

The Spanish institutions identified as G-SIIs for 2016 are shown in Table 1.

Table 1. G-SIIs for 2016

	Score	Sub-category
Santander	196	1
BBVA	92	1

In keeping with the terms of Law 10/2014, the identification of G-SIIs has taken into account the following five criteria: (a) group size; (b) the interconnectedness of the group with the financial system; (c) the possibility of replacing the services or the financial infrastructure that the group provides; (d) the complexity of the group; and (e) the group's cross-border activity. Specifically, the methodology used for identifying G-SIIs draws on that prepared by the Basel Committee on Banking Supervision,[2] which takes into account the above-mentioned aspects by means of 12 indicators that are aggregated to obtain a final score (in which each of the five aforementioned criteria has a weight of 20 %). By using this methodology, the Banco de España complies with the commitments assumed on the Financial Stability Board, in which the Banco de España participates, and which gave rise to publication by the FSB of an international list of global systemically important institutions in 2014.[3] Accordingly, the decision taken by the Banco de España is consistent with the period of 14 months, set by the Financial Stability Board, between the identification of G-SIIs and the date of entry into force of the capital buffers.

According to the G-SII identification methodology, those institutions with a score of more than 130 points will be automatically identified as G-SIIs, as in the case of Banco Santander. In addition, when it deems appropriate, the Banco de España may reclassify any other institution as a G-SII, even if its score is below the threshold of 130 points. This was the case of BBVA, which was identified as a G-SII in 2014 on the basis of the supervisory judgement of the Banco de España, despite the fact its score was lower than the minimum threshold of 130 points established in the Basel Committee on Banking Supervision's methodology for automatic identification as a G-SII.

Lastly, the Tenth Transitional Provision of Law 10/2014 stipulates that in 2016 only 25 % of the full G-SII buffer will be applicable. Thus, given that the two institutions identified as G-SIIs in Spain belong to the first sub-category, in 2016 they should maintain common equity tier 1 capital elements for an amount of 0.25 % of total risk exposure on a consolidated basis.

[2] See BCBS, "Global systemically important banks: updated assessment methodology and the higher loss absorbency requirement", July 2013.
[3] See FSB, "2014 Update of List of Global Systemically Important Banks (G-SIBs)", November 2014.

Other systemically important institutions (O-SIIs)

The Spanish institutions identified as O-SIIs for 2016 are listed in Table 2, which also shows their scores.

Table 2. O-SIIs for 2016[4]

Institutions	Score
Santander	3,829
BBVA	1,921
Criteria CaixaHolding	761
BFA	613
Popular	376
Sabadell	373

In identifying O-SIIs, the Banco de España has applied the guidelines of the European Banking Authority (EBA) on the identification of O-SIIs (EBA/GL/2014/10). These guidelines propose a scoring system for the degree of systemic importance of institutions by means of the aggregation of a set of 10 indicators that reflect the size, importance, complexity and degree of interconnectedness of the institutions. Those with scores of over 350 basis points should be automatically identified as O-SIIs. The methodology indicates the variables to be used to calculate the scores, the values of which are determined on a consolidated basis drawing on FINREP statements. The recommended variables have been used where possible; where not possible,[5] the most accurate alternative among the other information sources available to the Banco de España has been used. The data finally obtained are the best available approximation to the EBA guidelines and, moreover, they ensure a uniform coverage of all Spanish financial system institutions. Following the methodology, the highest level of consolidation is considered. Table 2 shows the scores obtained by the institutions that exceed the minimum threshold of 350 basis points set by the EBA guidelines, and which are those finally identified as O-SIIs. In the case of Spain, the methodology used clearly separates the O-SIIs from the other institutions, as the score of the closest institution to those identified in Table 2 is considerably lower.

The capital buffers approved by the Banco de España, shown in Table 3, have been set as common equity T1 capital elements relative to the total risk exposure on a consolidated basis. The calculation is based on a simple conversion mechanism for the capital buffer scores, which maintains consistency both with the differences among O-SII scores and with the G-SII buffers. Given that the Tenth Transitional Provision of Law 10/2014 envisages a four-year phasing-in period for the G-SII buffer, it has been decided that there are identical reasons for applying this same period in setting the O-SII buffer. Hence, for

4 Following EBA methodology, the highest level of consolidation is considered in the scoring. In this respect, the cases of Caixabank and Bankia, where the consolidation perimeter includes their respective parents, Criteria CaixaHolding and BFA, are noteworthy.
5 FINREP statements are consolidated statements that not all institutions are obliged to report. Moreover, even institutions that report FINREP data are not obliged to report non-domestic exposures if they are below 10% of their total exposures.

2016 a requirement of only 25 % of this buffer has been approved, as reflected in the final column of Table 3.

Table 3. Capital buffers for O-SIIs

Institutions	Final buffer	2016 buffer
Santander	1.00 %	0.25 %
BBVA	0.50 %	0.125 %
Caixabank	0.25 %	0.0625 %
Bankia	0.25 %	0.0625 %
Popular	0 %	0 %
Sabadell	0 %	0 %

Combined capital buffer

For instances in which the same institution is classified as a G-SII and an O-SII, Article 65 of Royal Decree 84/2015 stipulates that the Banco de España shall determine the rules for the combined application of G-SII, O-SII and systemic risk buffers. It is envisaged that this will be done through a Circular that is currently in preparation. On this occasion, the Banco de España has taken into account Directive 2013/36/EU of the European Parliament and of the Council (CRD IV), Article 131 of which states that when a requirement is made of an institution for both an O-SII and a G-SII buffer, the higher of the two shall be applied. In accordance with this criteria, the combined buffer approved for 2016 is that indicated in Table 4.

Table 4. Combined G-SII and O-SII capital buffer for 2016

Institutions	Capital buffer
Santander	0.25 %
BBVA	0.25 %
Caixabank	0.0625 %
Bankia	0.0625 %
Popular	0 %
Sabadell	0 %

Countercyclical capital buffer (CCB)

The CCB seeks to mitigate or prevent cyclical risks caused by excessive growth in aggregate credit. Thus the CCB is designed to build up capital buffers in expansionary periods, with a dual aim: to strengthen the solvency of the banking system and to smooth the credit cycle. Pursuant to Article 61 of Royal Decree 84/2015, the Banco de España

must set the CCB rate for credit exposures in Spain on a quarterly basis, taking into account the Basel Committee on Banking Supervision's initial benchmark indicator (the deviation of the credit-to-GDP ratio from its long-term trend, the "credit-to-GDP gap"),[6] the recommendations and guidelines issued by the European Systemic Risk Board (ESRB) and any other variables deemed relevant by the Banco de España.

The Banco de España has resolved to set the countercyclical buffer rate applicable to credit exposures in Spain at 0 % from 1 January 2016.

The basis for the Banco de España's decision is that all the information analysed shows consistent and sufficiently uniform signs that favour not activating the CCB at present. In particular, at June 2015 the credit-to -GDP gap stood at -58 % (indicator 1 in Table 5), still well short of the benchmark 2 % activation threshold established by the Basel Committee on Banking Supervision. Account was also taken of a set of complementary core indicators: credit intensity, various measures of real estate sector prices, non-financial private sector indebtedness and external imbalances (indicators 2-5 in Table 5), along with other quantitative and qualitative data used for additional information. The indicators all provide mutually consistent data.

All the indicators have been selected and designed exclusively on the basis of their ability to provide information on the creation of systemic risk associated with periods of excessive credit growth. It should be noted that both the credit-to-GDP gap and the real estate sector price indicators used are calculated in terms of deviations from a long-term trend which, owing to the estimation method used (a Hodrick-Prescott statistical filter), shows a high level of inertia.[7] This could give rise to sizeable swings in the indicators, especially in the present context where the levels of these variables have undergone significant correction, following a long period of sharp increases such as that which preceded the recent crisis. Consequently, it is important to note that although they provide useful information to help detect the emergence and build-up of real estate market or credit imbalances, none of the above-mentioned indicators should be interpreted as precise measures of the volume of excessive credit or of over- (or under-) valuation of house prices.[8]

6 "Guidance for national authorities operating the countercyclical capital buffer", Basel Committee on Banking Supervision, December 2010.

7 A one-sided filter that uses only historical data.

8 One way to mitigate the effects of the inertia observed in the long-term trend estimations when applying the Hodrick-Prescott filter is to use an econometric procedure to estimate the trends. The Banco de España also considers this type of econometric estimation, as part of the quantitative and qualitative information it uses to back up and guide its decisions on the activation of the CCB. However, given the uncertainty entailed in the real-time measurement of the relevant parameters, such estimations are mainly used to analyse the robustness of the information provided by the core indicators.

Table 5. Credit-to-GDP gap and complementary core indicators

(%)

	Latest value (June 2015)	Previous quarter	Average since 1970	Minimum since 1970	Maximum since 1970	Standard deviation since 1970	Average 1999-2008 [a]	Minimum since 1999	Maximum since 1999
1) Credit-to-GDP gap [b]	-58.3	-55.8	2.3	-58.3	45.4	19.9	30.9	-58.3	45.4
2) Credit intensity [c]	-7.5	-6.5	10.9	-17.6	35.8	9.9	21.7	-17.6	35.8
3) Real estate sector prices [d]	[-27.3 -20.5]	[-30.3 -23.2]	[-5.4 -2.5]	[-43.0 -33.3]	[22.6 27.8]	[13.4 18.1]	[6.8 13.9]	[-43.0 -33.3]	[21.7 26.6]
4) Non-financial private sector indebtedness [e]	17.2	17.6	18.4	12.0	24.5	2.9	17.8	12.6	24.5
5) External imbalances [f]	0.9	1.4	-2.3	-10.3	3.1	2.9	-6.1	-10.3	2.2

Source: Banco de España.

Notes

(a) In 1999 Spain joined the euro area; 2008 was the last year before the onset of the recent systemic banking crisis in Spain.
(b) The credit-to -GDP gap is calculated as the deviation of the credit-to-GDP ratio from its long-term trend, obtained using a one-sided Hodrick-Prescott filter (smoothing parameter equal to 400,000).
(c) The credit intensity indicator is calculated as the annual change in credit to the non-financial private sector divided by total GDP in the last four quarters.
(d) The price ranges in each column are maximum and minimum values of a set of indicators of changes in real estate sector prices in respect of their long-term trends, obtained using a one-sided Hodrick-Prescott filter (smoothing parameter equal to 400,000 in all cases).
(e) The debt service ratio in the non-financial private sector is used, calculated according to the method described in Drehmann, M. and M. Juselius, “Do debt service costs affect macroeconomic and financial stability?”, BIS Quarterly Review, September 2012.
(f) The indicator of external imbalances is calculated as the current account balance divided by GDP.