

Q&A about the countercyclical capital buffer

The purpose of the Systemic Risk Council is to suggest initiatives to prevent or reduce systemic financial risks that may put all or parts of the economy under pressure. One of the Council's tasks is to assess what is a suitable level for the countercyclical capital buffer

The buffer makes the financial sector more resilient

The buffer is a tool introduced in international regulation after the financial crisis. The buffer is part of an extensive set of reforms designed to make the financial sector more resilient.

What is the countercyclical capital buffer?

The buffer is an equity requirement imposed on banks and mortgage credit institutions. The purpose is for institutions to build up capital during periods in which risks are rising in the financial system. In other words, the purpose is not to contain soaring house prices or excessive lending growth when the economy is expanding, but rather to make institutions more resilient.

The buffer may be released in full or in part when stress occurs in the financial system. Releasing the buffer should prevent banks and mortgage credit institutions from becoming reluctant to provide loans during crises due to insufficient capital. The buffer may be released with immediate effect.

What does the buffer requirement mean in monetary terms?

An increase or a reduction in the countercyclical capital buffer by 0.5 percentage points of the risk-weighted exposures will increase/reduce the overall regulatory equity requirement for Danish banks and mortgage credit institutions by about kr. 7.5 billion. The higher/lower buffer does not entail an expense/income of kr. 7.5 billion, but it means that a larger/smaller share of the institutions' lending activities must be financed by equity rather than debt.

How can institutions meet an increased buffer requirement?

When the buffer requirement increases, a larger share of bank and mortgage credit institution lending must be financed by equity rather than debt. Institutions can, for instance, achieve this by retaining earnings rather than distributing earnings as dividends or share buy-backs. Irrespective of whether earnings are distributed or retained, they accrue to the shareholders as owners of the institution.

When should the buffer be built up?

The buffer should be built up when risks in the financial system are rising. This typically happens during periods when households and companies are optimistic about the economy;

when house prices are increasing; and credit standards are lenient. The Systemic Risk Council continuously assesses developments and sets the buffer rate accordingly.

The Council recommends that the buffer be built up well before considerable stress occurs in the financial system. A timely build-up of the buffer enables the financial sector to adapt to the requirements. An early build-up of the buffer is also essential because a period of 12 months passes from when the Minister for Industry, Business and Financial Affairs publishes buffer rate decisions and until the changes take effect.

Information that provides an early indication of risk build-up is consequently important. For instance, property prices tend to increase before lending in the run-up to financial crises. Moreover, the total debt of Danish households is currently at a very high level. So, while credit growth is currently low, debt accumulation from an already high level will amplify the risks associated with future credit growth.

When should the buffer be released?

The buffer should be released if stress occurs in the financial sector and there is a risk that banks and mortgage credit institutions will tighten their lending to households and companies so much that a credit crunch may occur. The buffer need not necessarily be released in an economic slowdown.

The buffer was released in March 2020 at a time of significant financial market uncertainty due to covid-19. At the same time, lockdowns were implemented in Denmark, and the economy was expected to be severely affected. So, the buffer was released to support lending to companies and households that would be impacted by the lockdowns. The release of the buffer also meant that credit institutions were better able to absorb losses on loans to households and companies impacted by the covid-19 pandemic. Most countries with positive buffer rates in February 2020 decided to release their buffers in full or in part.

Who decides whether to change the buffer?

The Minister for Industry, Business and Financial Affairs decides the buffer rate level based on an assessment by the Systemic Risk Council. At least quarterly, the Council assesses the level of the buffer rate. If the Council finds that the buffer rate should be changed, it will issue a recommendation to the Minister for Industry, Business and Financial Affairs.

Can the Minister refuse to comply with a recommendation from the Systemic Risk Council?

Yes. The Minister must either comply with the recommendation or explain why the recommendation is not complied with.

What is the basis for the Systemic Risk Council's assessment of the buffer rate?

Identifying and measuring risk is a complex process, and future crises are likely to differ from previous ones, although some patterns tend to repeat themselves. Consequently, the Council relies on a broad range of data to assess financial system developments. This means that the buffer rate is not set mechanically on the basis of individual indicators. Other relevant information is also included in the buffer rate assessment, such as other regulatory requirements imposed on institutions.

When does a change of the buffer rate take effect?

It depends on whether the change involves an increase or a release of the buffer.

A period of 12 months elapses from the date the Minister for Industry, Business and Financial Affairs decides to increase the buffer rate until the requirement takes effect. This gives the institutions time to adapt to the higher capital requirement.

The buffer is released with immediate effect after the Minister's decision.

Must foreign banks comply with a Danish buffer?

Yes. Foreign banks with credit exposures in Denmark must also comply with the Danish countercyclical capital buffer requirement. This follows from EU legislation.

Does the buffer rate have a cap?

No. The buffer may be set higher than 2.5 per cent if warranted by the information set. But it is only mandatory for other countries to recognise the Danish buffer rate up to 2.5 per cent.

Do other countries have a buffer?

Yes. Most countries that had built up or announced a future positive buffer rate decided to release their buffers in full or in part in March 2020.

Is the buffer a guarantee against a new financial crisis?

No. The buffer is a tool aimed at preventing banks from reducing their lending too much if a new financial crisis occurs.