



Annex 3: Methods for Setting Capital Buffers

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1. Introduction

This document elaborates on the setting of capital buffers and refers to Chapter 3.4 in *Common criteria and methodologies for SREP (Almenn viðmið og aðferðafræði vegna könnunar- og matsferlis hjá fjármálafyrirtækjum)*.

Capital buffers are intended to counter systemic risk in the financial system, enhance institutions' resilience against loan losses and mitigate the impact of financial cycles on the real economy. There are four capital buffers:

- Capital conservation buffer
- Capital buffer for systemically important institutions (O-SII)
- Systemic risk buffer
- Countercyclical capital buffer

According to Article 86(a) of Act No 161/2002, institutions must hold capital buffers in accordance with Articles 86(b)–(e) of the same Act.

The capital buffer rates are available on the FME's website.¹

2. Capital conservation buffer

According to Article 86(e) of Act No 161/2002, institutions must maintain Common Equity Tier 1 (CET1) capital to meet the requirements for capital conservation buffer equal to 2.5%² of their total risk exposure amount, on an individual and consolidated basis, cf. Article 84(e) of the same Act. The objective of the buffer is to conserve institutions' capital.

Securities companies and management companies of UCITS are exempt from this requirement if they meet the following criteria:

- a) Fewer than 250 employees.
- b) The annual turnover does not exceed the equivalent of EUR 50 million in ISK.
- c) Total assets according to published annual accounts do not exceed the equivalent of EUR 43 million in ISK.

3. Capital buffer for systemically important institutions (O-SII)

According to Article 86(c) of Act No 161/2002, the FME shall annually impose a capital buffer rate for systemically important institutions on an individual, sub-consolidated or consolidated basis. The buffer rate may range up to 2% of their total risk exposure amount, and the requirement must be met by CET1 capital.

¹ See: <https://en.fme.is/supervision/financial-stability/capital-buffers/>.

² Cf. however, temporary provision XIII of Act No 161/2002.

The FME sets the rate based on a recommendation from the Financial Stability Council (FSC). The FSC also determines which institutions are systemically important, cf. point c of Article 4(2) of Act No 66/2014, using the following criteria, which are based on EBA Guidelines:³

- (a) Size
- (b) Importance for the economy of the Union or the relevant Member State
- (c) The significance of cross-border activities
- (d) The interconnectedness of the institution or group and the financial system

The O-SII buffer must be reviewed by the FSC every year.

4. Systemic risk buffer

In accordance with Article 86(b) of Act No 161/2002, the FME can require institutions to maintain a systemic risk buffer on an individual, sub-consolidated or consolidated basis based on recommendations from the FSC. The requirement must be met by CET1 capital and is calculated as a percentage of the total risk exposure amount. The FSC's recommendations shall be based on analysis provided by the Systemic Risk Committee (SRC).

The purpose of the systemic risk buffer is to prevent or restrict the effects stemming from systemic risk related to the structure and long-term tendencies in the real economy and the financial system.

The systemic risk buffer shall apply to all institutions, or one or more subsets of those institutions, as decided by the FME and shall be set no lower than 1% and then increased in gradual or accelerated steps of 0.5 percentage points. The requirement to maintain the buffer can vary depending on the type of institution. The systemic risk buffer may apply to domestic exposures as well as exposures in other countries. The FME may recognise systemic risk buffers imposed by other countries for exposures in those countries.⁴

The systemic risk buffer must be reviewed by the FSC at least every two years.

When the systemic risk buffer only applies to domestic exposures, the effective risk buffer rate is calculated by multiplying the proportion of the domestic credit exposure by the domestic systemic risk buffer rate. To calculate the domestic systemic risk buffer rate and reciprocated risk buffers in other countries, refer to the method used to calculate the institution-specific countercyclical capital buffer in Chapter 5 of this Annex.

Example: If the proportion of domestic credit exposure is 80% of the total credit exposure of the institution and the domestic systemic risk buffer rate is 3%, then the effective buffer rate is 2.4% (80% * 3%) which is then multiplied by the total risk exposure amount to obtain the capital requirement for the buffer.

³ EBA/GL/2014/10: Guidelines on the criteria to determine the conditions of application of Article 131(3) of Directive 2013/36/EU (CRD) in relation to the assessment of other systemically important institutions (O-SIIs): <https://www.eba.europa.eu/documents/10180/930752/EBA-GL-2014-10+%28Guidelines+on+O-SIIs+Assessment%29.pdf>.

⁴ See: https://www.esrb.europa.eu/national_policy/systemic/html/index.en.html.

5. Countercyclical capital buffer

According to Article 86(d) of Act No 161/2002, the FME can require institutions to maintain a countercyclical capital buffer based on recommendations from the FSC. The requirement must be met by CET1 capital, calculated as a percentage of the total risk exposure amount, and shall be maintained on an individual and consolidated basis. The FSC shall, on a quarterly basis, present a recommendation to the FME on the buffer rate based on analysis performed by the SRC. If the buffer rate is increased, it takes effect no later than 12 months after the decision is made. A shorter lead-time can be applied given extraordinary circumstances in financial markets but must be substantiated.

Securities companies and management companies of UCITS are exempt from this requirement if they meet the following criteria:

- a) Fewer than 250 employees.
- b) The annual turnover does not exceed the equivalent of EUR 50 million in ISK.
- c) Total assets according to published financial statements do not exceed the equivalent of EUR 43 million in ISK.

The countercyclical capital buffer enhances institutions' resilience and can reduce the severity of financial crises. Releasing the buffer during times of stress gives institutions the capacity to lend during a financial-cycle downturn, thereby mitigating its impact on the real economy. When deciding to impose the buffer, indicators of cyclical systemic risk are considered.

The buffer rate is generally set between 0 and 2.5% of the total risk exposure amount but can be set higher under special circumstances. Institutions shall disclose compliance information relating to the stipulated countercyclical capital buffer in accordance with Article 440 of Regulation (EU) No 575/2013, cf. Article 89 of Regulation No 233/2017 and Commission Delegated Regulation (EU) 2015/1555, cf. Rules No 506/2017.

The institution-specific countercyclical capital buffer rate (i.e. the weighted average of countercyclical capital buffer rates in jurisdictions to which the undertaking has private sector credit exposures) applies to the institution-wide total risk exposure amount.

The final institution specific buffer add-on amount is calculated as the weighted average of the countercyclical capital buffer rate applicable in the jurisdiction(s)⁵ in which an institution has private-sector credit exposures (including the institution's home jurisdiction) multiplied by the total risk exposure amount.

The weight for the buffer rate applicable in a given jurisdiction is the credit exposure that relates to private-sector credit exposures allocated to that jurisdiction, divided by the institution's total credit exposure that relates to private sector credit exposures across all jurisdictions.

⁵ See: https://www.esrb.europa.eu/national_policy/ccb/applicable/html/index.en.html.

Private sector credit exposures subject to the market risk capital framework are the risk-weighted equivalent trading-book capital charges for the specific risk, the incremental risk charge, and securitisation.

Example: The countercyclical capital buffer rates in Iceland, the UK, Germany and Norway are 1.25%, 2%, 1% and 1.5% of the total risk exposure amount, respectively. This means, for example, that any loans to UK counterparties, irrespective of the location of the institution providing the loan, will be assigned a buffer requirement of 2%. As a consequence, an institution with 80% of its credit exposure to Icelandic counterparties, 5% of its credit exposures to UK counterparties, 6% to German counterparties and 9% to Norwegian counterparties, will have the following institution specific countercyclical buffer rate:

	Buffer rate (%)	Geographical location of credit exposures
Iceland	1.25	80
UK	2	5
Germany	1	6
Norway	1.5	9
Weighted average	1.295	

The weighted average is 1.295%, which is multiplied by the total risk exposure amount to obtain the capital requirement for the countercyclical capital buffer.