



EUROPEAN CENTRAL BANK

EUROSYSTEM

## **Annex 2: Enhancing macroprudential space in the banking union**

Report from the Drafting Team of the  
Steering Committee of the  
Macroprudential Forum

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# Executive summary

## Motivation and background of the report

*This report discusses the case for, and specific policy options aimed at, operationalising an increase in macroprudential policy space – in the form of a higher amount of releasable capital buffers – in the banking union. The objective is to inform the macroprudential policy strategy of the European Central Bank (ECB), as well as the review of the European Union (EU) macroprudential framework, which is expected to be launched by the European Commission in 2022, without interfering with the implementation of Basel III.*

*The banking system has proved to be resilient and continued to perform its fundamental functions throughout the coronavirus (COVID-19) pandemic, in part due to the extraordinary fiscal, monetary and prudential support measures put in place. To date, no significant losses have occurred within the banking sector and banks have continued to provide credit and other critical services to the real economy. Macroprudential policy has helped stabilise the provision of key services by providing capital relief to the banking sector. Nonetheless, and although prudential measures were taken promptly and decisively by authorities around Europe and the globe, the recent experience with the pandemic has raised questions about (i) whether there is sufficient releasable capital in place to address future systemic shocks, and (ii) whether the ability of macroprudential authorities to respond in a coordinated and predictable manner under very adverse circumstances (particularly when systemic risk materialises in the form of a large and disruptive systemic shock that hits (large parts of) the banking union simultaneously) should be further strengthened.*

*Noting that any reform should be confined to the strictly necessary and least costly or intrusive adjustments, this report develops and analyses specific policy options that could enhance macroprudential authorities' ability to address large and disruptive systemic shocks by increasing the amount of releasable capital buffers in the banking union. Capital buffers are a key element of the Basel framework and are designed to be usable by banks to absorb losses while maintaining provision of key services to the real economy in a downturn. Although downward portfolio adjustments by individual banks have not constrained credit supply on the aggregate level, some micro-level analysis of the pandemic suggests that current bank capital buffers may not be fully usable for these purposes. The potential reluctance of banks to use the buffers when needed has exacerbated a debate on the case for a greater amount of releasable capital buffers. When released, such buffers allow banks to operate with lower capital ratios without breaching a regulatory threshold, thus addressing some possible impediments to buffer use and helping to avoid potential procyclical adjustments arising from harmful deleveraging.*

*The policy options in the report are designed to further strengthen the current macroprudential framework, which includes releasable capital buffers mainly to address cyclical systemic risk arising from excessive credit growth. As illustrated by*

*the pandemic, having releasable macroprudential buffers available might be beneficial, independent of country-specific financial or economic cycles, in addressing large and disruptive systemic shocks that may go beyond the unwinding of domestic imbalances and may hit (large parts of) the banking union simultaneously. In particular, the possibility of disruptive shocks such as the one induced by the pandemic creates uncertainty for the financial system, where it is not possible to precisely define the expected nature or magnitude of such shocks before they materialise. When such systemic shocks hit, the availability of releasable capital buffers can enhance financial system resilience by improving banks' ability to absorb losses while maintaining provision of key financial services to the real economy, in line with the objectives of the capital buffer framework.*

## Approach and criteria for assessment

*The policy options in the report are assessed against five broad criteria. For some of these – notably capital neutrality and European governance – views in the Drafting Team differ on how they should be interpreted and whether meeting them is desirable. Meeting all criteria simultaneously is in any case challenging or even impossible. The report thoroughly and transparently evaluates the benefits and challenges of each option against the criteria. It does not aim to rank the options and does not weight the relative importance of the different criteria, but rather leaves this to the EU legislator. The specific criteria used for the assessment are as follows.*

- **Financial system resilience:** *Policy options should help to enhance financial system resilience, particularly when large, disruptive systemic shocks materialise. In a broad sense, system resilience is the financial system's ability to withstand shocks and absorb losses while maintaining the provision of key economic services in a stress episode. In a narrower sense, its focus is also the level of bank solvency in times of systemic stress, noting that when the solvency of (systemic) institutions is called into question, this can have broad-based systemic and contagion effects.*
- **Basel compliance:** *Compliance with the Basel standard is essential for maintaining international coordination and cooperation and a level playing field. Deviations from the Basel standard could undermine the EU's credibility in the Basel Committee on Banking Supervision (BCBS) and erode creditor confidence in the soundness of the regulatory framework in which EU banks operate.*
- **Capital neutrality:** *The report assesses whether policy options increase macroprudential space in a capital neutral manner. One view is that rebalancing from existing structural buffers towards releasable buffers within the macroprudential framework would recognise that overall requirements ahead of the pandemic were generally considered broadly adequate, with existing buffers already providing cover for the possibility of large, disruptive systemic shocks. According to this view, capital buffers are already meant to be used in a stress episode and their release would be a means to facilitate this use. Moreover, imposing additional requirements could be challenging in the context of*

*implementing the finalised Basel III standards and dependent on the macro-financial environment in banking union countries. Another view is that rebalancing from existing structural buffers to releasable buffers would reduce resilience to prevailing structural systemic risks, and that large and disruptive systemic shocks constitute a new source of risk that had not been fully captured by pre-pandemic capital requirements and buffers and should thus be mitigated through additional capital. According to this view, the change in the composition of Pillar 2 requirements (P2R) during the pandemic has already provided room for increasing overall buffer requirements after the pandemic (although with significant heterogeneity across banks and countries), and – more generally – several banking union countries may have scope to increase current requirements without generating significant, unintended procyclical effects.*

- **European governance:** *While not a precondition for creating macroprudential policy space, a more centralised governance structure or stronger coordination framework could – under certain conditions – enhance policy effectiveness by ensuring a further harmonised and coordinated use of a new tool for banks operating in the banking union. It could help to further promote a timely, forceful, consistent and across-the-board policy response to future, large, disruptive systemic shocks that hit (large parts of) the banking union simultaneously, and it would help to ensure that capital buffers are rebuilt in a timely manner after a release. It thus helps to avoid fragmented use of the tool in the banking union. At the same time, the centralised governance structure would have to consider the role of cross-country heterogeneity with respect to starting points, national macroprudential approaches and the (often asymmetric) impact of systemic shocks. Improved European governance could come in various forms, including explicit decision-making at the centralised level or softer forms, such as recommendation powers, common methodologies or re-emphasising the coordinating tasks of the European Systemic Risk Board (ESRB). At the same time, and due among other things to the existing non-synchronous financial cycles across banking union countries, it is important for national authorities to maintain their ability to address country-specific risks and imbalances and to avoid a new tool overly constraining the effectiveness of national macroprudential policy.*
- **Simplicity:** *Given an already complex regulatory framework with multiple, parallel requirements and regulatory trigger points, the options should achieve the policy objective with the minimal level of additional complexity.*

## Standalone assessment of the three policy options under consideration

*The report considers three standalone policy options and benchmarks them against the criteria.*

**The first policy option** *is to enable the full or partial release of the capital conservation buffer (CCoB), followed by a rebuild to return to the initial (or higher)*



level. The buffer would be released only in exceptional circumstances and under very adverse economic conditions, to address large and disruptive systemic shocks that hit (large parts of) the banking union simultaneously. The release of the buffer could be coupled with a form of system-wide (dividend) distribution restrictions (similar to the supervisory recommendation during the pandemic), to safeguard against possible unwarranted distributions and ensure Basel compliance.

**The second policy option** is a positive neutral rate for the countercyclical capital buffer (CCyB). This option can be practically achieved in different ways. One way would be to create a positive neutral CCyB that is managed at the central level and available to address large and disruptive systemic shocks that hit (large parts of) the banking union simultaneously. More releasable capital can also be created with the CCyB by stimulating more active use of the buffer at the national level and by the ECB (possibly complemented by softer forms of centralisation or more active use of the ECB's top-up powers), e.g. by broadening the scope of cyclical risk assessment. A final way to create macroprudential space with the CCyB would be to introduce an explicit positive neutral rate on top of current cyclical risk assessments at the national level.

**The third policy option** is the introduction of a core rate for the systemic risk buffer (SyRB). As in the other options, the core rate would be released only under very adverse economic conditions, to address large and disruptive systemic shocks that hit (large parts of) the banking union simultaneously. This could be in line with the revised objective and purpose of the SyRB in the revised Capital Requirements Directive (CRD V)<sup>1</sup>, namely, to address macroprudential or systemic risks not covered elsewhere in the regulatory framework.

**Financial system resilience:** Table 1 provides an overview of the assessment of the three policy options. All three policy options could help address possible impediments to buffer usability, thereby (under certain conditions) enhancing financial system resilience in the broad sense by enabling banks to better absorb losses while maintaining their key service position in a stress episode. Compared with the other two options, a release of the CCoB would reduce bank capital requirements in crisis times relative to the status quo, possibly leading to initially stronger declines in capital ratios (even in the presence of distribution restrictions), which could reduce resilience later in the crisis. Moreover, effective usability of the released capital is more constrained under the CCoB option, due to overlaps with leverage ratio (LR) requirements and the minimum requirement for own funds and eligible liabilities (MREL). However, the wedge in effective usability between the options becomes less pronounced for smaller magnitudes of the released buffer and in the medium term when considering the effects of the final Basel III reforms on the calculation of capital requirements.

**Basel compliance:** Views differ in the Drafting Team on Basel compliance of the CCoB and CCyB options, with the CCoB option raising greater concerns. One view is

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<sup>1</sup> Directive (EU) No 878/2019 of the European Parliament and of the Council of 20 May 2019 amending Directive No 2013/36/EU as regards exempted entities, financial holding companies, mixed financial holding companies, remuneration, supervisory measures and powers and capital conservation measures (OJ L 150, 7.6.2019, p. 253).

*that a release of the CCoB would only be Basel-compliant if coupled with a form of system-wide distribution restrictions (which could in turn raise level playing field concerns). Another view is that the compliance assessment is not clear-cut, even without system-wide distribution restrictions (noting that facilitating the use of buffers is in the spirit of the Basel III reform and that the EU framework is more conservative than the Basel framework on stacking capital requirements and buffers). With respect to the CCyB option, one view is that a positive neutral rate is likely to be compliant with the Basel framework, which only sets minimum standards. Another view is that the standard does not currently foresee a positive neutral rate and that using the CCyB for a purpose other than that foreseen in the standard – prevention and absorption of shocks resulting from the accumulation of credit imbalances – may impair the compliance assessment. Unlike the CCoB and the CCyB, the SyRB is a European-specific instrument, so introducing a core SyRB rate would not raise the issue of Basel compliance (although this option, as with the others, could affect the international level playing field if not mirrored by authorities in other countries).*

**Capital neutrality:** *Abstracting from a potential reshuffling from other types of buffers or requirements (for which, having considered microprudential P2R and other macroprudential buffers, there is no natural candidate and in any case no agreement within the group), the only policy option that can immediately enhance macroprudential space (in the form of releasable buffers) at the time of implementation without increasing overall requirements is to enable a release of the CCoB. If the desire is to avoid lower average capital requirements over longer horizons, the CCoB would have to be increased beyond 2.5% in the medium term (or the option would have to be coupled with a positive neutral CCyB or core SyRB), to account for the fact that capital requirements could be reduced during, and in the aftermath of, a future, large, disruptive systemic shock. The implementation of a positive neutral component for the CCyB and the introduction of a core rate for the SyRB would imply additional capital at implementation and over a longer term. As discussed above, one view is that such an increase in requirements is desirable and that several banking union countries have scope for it without generating significant, unintended procyclical effects.*

**European governance:** *Strong centralised governance with explicit decision-making at the central level seems particularly relevant under the CCoB option, to the extent that it can ensure consistent and contemporaneous use of the tool across the banking union and impose credible safeguards and rules against premature release and for timely rebuilding of the currently non-releasable buffer (which, due to its non-releasable nature, can be considered as strongly centralised at present). The CCoB option, unlike the other options, could also particularly suit governance arrangements involving centralised decision-making, since the ECB and national authorities would each be responsible for their respective tools, which would avoid blurred responsibilities and, for example, facilitate the repeal of previous ECB decisions. The need for explicit centralised decision-making is arguably less pronounced for the CCyB and SyRB options, since both buffers come on top of current buffer requirements and are already releasable in the current framework. Different governance arrangements are possible for a positive neutral rate of the CCyB, including centralised decision-making for the positive neutral component or options*



*that rely mainly on national powers for building up and releasing the instrument (possibly coupled with softer forms of centralisation, such as common methodologies and recommendations). The same applies to the SyRB, for which different implementation arrangements with varying degrees of centralisation are also possible. The creation of a strong, centrally coordinated framework may also be of particular relevance for this option, since otherwise the possibility to apply the buffer to subsets of exposures and/or banks could lead to a fragmented approach across the banking union.*

**Simplicity:** *In terms of simplicity, one argument is that the existence of distinct releasable buffers with related but separate policy objectives would help to maintain the clarity and coherence of the buffer framework. This would speak in favour of keeping the CCyB focused on cyclical risks and leaving it to either the CCoB or the SyRB to address large and disruptive systemic shocks that go beyond the unwinding of domestic imbalances. Another argument is that it could be simpler to extend the scope of an existing releasable buffer rather than introduce an additional releasable buffer, which would speak in favour of either the CCyB or the SyRB option. For the SyRB option, it needs to be considered that, unlike the CCoB and CCyB options, it interacts with the other systemically important institutions (O-SII) buffer and has a more complex activation procedure if it reaches a level above the 5% threshold (SyRB + O-SII).*

## Cross-cutting design considerations and possibility of mixing the options

*In any policy option, it is essential to have a clear framework for building up and releasing the buffer(s) to ensure policy effectiveness and increase the predictability of changes in capital requirements. Ensuring that releasable buffers are restored in a timely manner is important for guaranteeing they are available again if a new systemic shock materialises.*

*For both the build-up and release of the buffer, the framework must consider the role of cross-country heterogeneity with respect to starting points, national macroprudential approaches and the (possibly asymmetric) impact of systemic shocks. The framework must also consider the possibility of different speeds of rebuilding the buffer after a crisis, depending on the (ex post) country-specific impact of the shock and the situation of the banks and/or financial conditions more broadly, while ensuring resilience and a level playing field. A new buffer at central level (be it with central decision-making or via softer forms of centralised governance) would need to be large enough to ensure policy effectiveness while maintaining sufficient macroprudential policy space at the national level.*

*In sum, discussions in the Drafting Team have shown that – while there is broad agreement on the usefulness of increasing the amount of releasable buffers – preferences on the policy options are very scattered across members. Different members attach different weights to the importance of individual criteria, with no option emerging as a single most preferred one. Against this background, the report*

*thoroughly discusses the advantages and disadvantages of the three policy options, reflecting a balance of views in the Drafting Team, but does not establish a hierarchy of the options or recommend one specific option in view of the EU macroprudential review. Moreover, some members consider the present framework to be flexible enough to create more macroprudential space, seeing no clear evidence that the ECB's top-up competency is currently not a sufficient power.*

*Considering the different views in the Drafting Team on many elements of the work, a possible way forward could be to investigate how elements of the various policy options could be combined to find more common ground, while also accounting for the various concerns that have been raised. Mixed options could increase the flexibility of the framework, allowing authorities to address different risks in a more tailored way. They could be designed to increase macroprudential space more than any individual option on its own, and such that the mix of tools effectively deals with cross-country heterogeneity should an asymmetric or asynchronous systemic shock hit (large parts of) the banking union or should risk only materialise in some countries. Section 5 of the report discusses the possibility of mixing the options. There is no consensus in the Drafting Team that a mixed option would be preferable to any of the individual options, as members' preferences are also scattered in this respect. Nevertheless, the possibility of mixing different options increases the degrees of freedom to a certain extent and could hence be a fruitful avenue for further work and consideration.*

**Table 1**  
Overview of individual policy options

Criteria	Releasable CCoB	Positive neutral CCyB	Core SyRB
<b>Financial system resilience</b>	<ul style="list-style-type: none"> <li>Enables banks to absorb losses while maintaining key service provision</li> <li>Impact on solvency depends on second-round effects</li> <li>Parallel requirements constrain effective usability</li> </ul>	<ul style="list-style-type: none"> <li>Enables banks to absorb losses while maintaining key service provision</li> <li>Enhances ex ante solvency in a crisis</li> <li>Parallel requirements constrain effective usability (but less than with CCoB)</li> </ul>	<ul style="list-style-type: none"> <li>Enables banks to absorb losses while maintaining key service provision</li> <li>Enhances ex ante solvency in a crisis</li> <li>Parallel requirements constrain effective usability (but less than with CCoB)</li> </ul>
<b>Compliance with Basel standards</b>	<ul style="list-style-type: none"> <li>Possibly non-compliant (but assessment not clear-cut and rests with the BCBS)</li> <li>Coupling with a form of system-wide (dividend) distribution restrictions could ensure compliance</li> </ul>	<ul style="list-style-type: none"> <li>Arguably compliant and already in use in some countries</li> <li>Some uncertainty since positive neutral rate not foreseen in the standard and using the buffer for a different purpose than that intended could affect the compliance assessment</li> </ul>	<ul style="list-style-type: none"> <li>EU tool, so no issue with compliance</li> </ul>
<b>Capital neutrality</b>	<ul style="list-style-type: none"> <li>Capital neutral at implementation</li> <li>Possible long-term decline in average requirements (unless the buffer is rebuilt to a higher level than the initial one)</li> </ul>	<ul style="list-style-type: none"> <li>Increases requirements at implementation and over a longer term</li> </ul>	<ul style="list-style-type: none"> <li>Increases requirements at implementation and over a longer term</li> </ul>
<b>European governance</b>	<ul style="list-style-type: none"> <li>Requires strong centralised governance with explicit decision-making at central level and is well-suited for such governance arrangements</li> </ul>	<ul style="list-style-type: none"> <li>Different arrangements possible</li> </ul>	<ul style="list-style-type: none"> <li>Different arrangements possible (a strong, centrally coordinated framework may be required)</li> </ul>
<b>Simplicity</b>	<ul style="list-style-type: none"> <li>Different buffers for different risks</li> <li>Dual role for the CCoB if only partially releasable could reduce clarity and transparency</li> </ul>	<ul style="list-style-type: none"> <li>Expanding scope of an existing releasable buffer could be straightforward</li> <li>Combining cyclical and semi-structural instruments under the same buffer could reduce clarity and transparency</li> <li>Possible implications for the reciprocity framework</li> </ul>	<ul style="list-style-type: none"> <li>Different buffers for different risks</li> <li>Interaction with O-SII buffers in relation to activation thresholds</li> </ul>

Notes: The assessment does not weight the criteria and does not aim to rank the options. It evaluates whether an option meets a criterion or not, without passing judgement on whether meeting the criterion is desirable. (On the latter, there are different views for some criteria; see text.)

# 1 Introduction

**Throughout the unprecedented global economic downturn triggered by the pandemic, the banking system has overall proven to be resilient and continued performing its fundamental functions, with banks continuing to provide credit and other critical services and no significant losses occurring within the banking sector.**

Extraordinary fiscal and monetary support measures were introduced during the pandemic, significantly mitigating pandemic-related shocks across the economy and preventing spillovers to the financial system.<sup>2</sup> In addition, prudential relief measures also supported banks in serving the economy and addressing operational challenges. For example, macroprudential policy – in line with its objective – helped stabilise the provision of key services by providing capital relief to the banking sector.<sup>3</sup> In some cases, however, authorities had to resort to measures that were not necessarily designed for this purpose, given a lack of capital buffers that were explicitly releasable.<sup>4</sup>

**The COVID-19 crisis has illustrated that large and disruptive systemic shocks may emanate from risks that go beyond the build-up of domestic imbalances.**<sup>5</sup>

These shocks do not necessarily relate to cyclical developments and may hit the economy and the financial system at different stages of the financial or economic cycle. Such large-scale shocks are rare events and, by definition, particularly difficult to predict *ex ante*, yet they are very relevant from a financial stability perspective – they can easily spread across the financial sector and significantly disrupt the financial intermediation function, which can then feed back into real activity. Macroprudential policy can play a role in addressing such shocks as it has both a preventive (*ex ante*) and a shock-absorbing (*ex post*) dimension. On the preventive side, macroprudential policy aims to address the build-up of systemic risk, market imperfections and externalities by ensuring a resilient financial sector. When systemic shocks materialise, a resilient banking sector and a responsive buffer framework are a necessary precondition to limiting their impact and helping stabilise the financial system.<sup>6</sup> The more macroprudential policy succeeds in ensuring a resilient financial system, and the more the system absorbs rather than amplifies shocks, the less monetary and fiscal policy will have to resort to extraordinary measures. This can help avoid potential undesired side effects of such measures, including in terms of financial

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<sup>2</sup> See ESRB (2020) for an overview of policy measures in response to the COVID-19 pandemic.

<sup>3</sup> One of the key dimensions of macroprudential policy is stabilising the provision of key services by the banking sector in the follow-up to a shock. For instance, in relation to regular cyclical shocks, the CCyB aims to “ensure that the banking sector in aggregate has the capital on hand to help maintain the flow of credit in the economy without its solvency being questioned, when the broader financial system experiences stress after a period of excess credit growth” (see BCBS (2010b)).

<sup>4</sup> For example, several macroprudential authorities in the banking union released structural buffers or delayed their phase-in (see Box 1 for further discussion). Moreover, ECB Banking Supervision pre-empted a legislative change to the composition of P2R. While this was a microprudential decision, it provided banks with capital relief in the sense spelled out above.

<sup>5</sup> Possible examples could include shocks related to natural disasters, climate change, adverse geopolitical events, technological disruptions or health emergencies.

<sup>6</sup> As further explained in Section 2.1, a core objective of the capital buffer framework is enabling banks to absorb losses while maintaining provision of key services to the real economy in a downturn.

stability. The macroprudential reaction to the large and disruptive shock induced by the pandemic is consistent with this role of macroprudential policy, since macroprudential authorities actively reacted to the shock by releasing different types of available capital buffers (see Box 1 for further discussion).

**Building on the experience with the COVID-19 crisis, this report presents policy options that could enhance macroprudential authorities' ability to act countercyclically in a coordinated and predictable manner when (a large part of) the banking union simultaneously faces a large and disruptive systemic shock.**

There are different ways to enable macroprudential authorities to react to such instances, all of which enhance macroprudential policy space by increasing the amount of effectively releasable capital buffers. This could be done by increasing the share of releasable capital buffers in total capital requirements without increasing total capital requirements, or by including additional buffers on top of existing minimum requirements, thereby increasing overall capital requirements. Either way could make macroprudential policy more reactive and thereby support the stability of the financial system going forward. Specifically, buffers that can be released in the event of severe and disruptive shocks that go beyond the unwinding of domestic imbalances could enhance financial system resilience by enabling banks to better absorb losses while maintaining provision of key financial services to the real economy. Against this background, and while it is challenging to draw definite conclusions about the functioning of the current framework given the extraordinary fiscal and monetary support measures in the COVID-19 crisis and the fact that its current revision in the form of the CRD V has not yet been fully transposed in all EU Member States<sup>7</sup>, the report discusses a number of policy options that may provide room for further targeted improvement.

**The report focuses on developing a range of policy options that could increase macroprudential space in the banking union and will inform both the ECB's macroprudential policy strategy and the European Commission's forthcoming review of the EU macroprudential framework.**<sup>8</sup>

Macroprudential responsibilities in the Single Supervisory Mechanism (SSM) area are shared among multiple national institutions and the ECB. While national macroprudential authorities deal with local financial stability risks, the ECB has top-up powers to set higher buffer requirements than national authorities, if needed. This unique institutional set-up was established because financial cycles in the Monetary Union are typically not fully synchronised across countries. Targeting country-specific developments can be more effective and appropriate than area-wide measures in reacting to asynchronous financial cycles. Nonetheless, and although prudential measures were taken promptly and decisively by authorities around the globe, the recent experience with the pandemic has raised questions about (i) whether there is sufficient releasable capital in place to address future systemic shocks, and (ii) whether the ability of macroprudential authorities to act countercyclically in a coordinated and predictable manner (including in response to

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<sup>7</sup> See European Commission (2021) for the transposition status of the CRD V.

<sup>8</sup> It is expected that eventual proposals on regulatory changes will only be put forward by the European Commission after implementation of Basel III is finalised.

large and disruptive systemic shocks to the European economy as a whole) should be further strengthened.<sup>9</sup>

**This report is structured as follows.** Section 2 highlights the main objectives of the Basel III capital buffer framework, discusses the issue of buffer usability and the role of releasable capital buffers, and explains the limited build-up of macroprudential policy space in specific jurisdictions and at the banking union level before the COVID-19 pandemic. Section 3 discusses objectives and key aspects to be considered in designing policy options to create macroprudential space and elaborates on five criteria against which the policy options outlined in the report are benchmarked. Section 4 presents the three main options for operationalising the increase of macroprudential space in the banking union, i.e. by introducing (i) a releasable CCoB, (ii) a positive neutral rate for the CCyB, and (iii) a core rate for the releasable SyRB.<sup>10</sup> Section 5 discusses a number of aspects that cut across the policy options and touches on the possibility of mixing different types of instruments to address all relevant risks. Finally, Section 6 summarises the main takeaways from the discussion on the policy options and derives corresponding conclusions and/or recommendations in view of the forthcoming review of the macroprudential framework in the EU.

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<sup>9</sup> See Box 1 for further discussion. Further coordination would follow the example of microprudential supervision in the SSM area during the COVID-19 crisis. Faced with the shock of the pandemic, microprudential supervisors allowed banks to operate below Pillar 2 Guidance (P2G), which was a centrally coordinated and simultaneously implemented move across the banking union within the flexibility provided in the framework.

<sup>10</sup> The report consistently refers to a “core SyRB” rather than a “positive neutral SyRB”. This is because “neutral” is a reference to credit or economic conditions being neither elevated nor depressed, which might not be fully appropriate for a buffer that is explicitly not designed to tackle cyclical risks (which are supposed to be addressed by the CCyB).



## 2 Structural and releasable capital buffers in the current framework and lessons from the COVID-19 crisis

### 2.1 Objectives of the Basel III capital buffer framework

**The capital buffer framework is an essential component of the Basel III standard and features several important design elements.** Under the Basel framework, banks are expected to maintain buffers above the minimum risk-based capital requirements, with capital conservation requirements applying to banks that do not maintain such buffers. The buffer framework comprises the CCoB, the CCyB, buffers for global and domestic systemically important banks (SIBs) and the SyRB in the EU.<sup>11</sup> The various buffers are subsumed in the combined buffer requirement (CBR), and automatic restrictions on distributions – aimed at preventing imprudent distributions when a bank’s situation deteriorates – kick in whenever a bank is operating below the CBR (restrictions are imposed on the maximum distributable amount (MDA)). At the same time, the Basel standard specifies that banks can conduct normal business activities when their capital levels fall into the conservation range as they experience losses, since the constraints imposed only relate to distributions, not their operations.

**Capital buffers aim to enable banks to absorb losses while maintaining provision of key services to the real economy in a downturn.** In a newsletter published in October 2019, the BCBS specified that “[w]hile each of [the] buffers seek to mitigate specific risks, they share similar design features and are all underpinned by the following objectives:

- *absorbing losses in times of stress by having an additional overlay of capital that is above minimum requirements and that can be drawn down; and*
- *helping to maintain the provision of key financial services to the real economy in a downturn by reducing incentives for banks to deleverage abruptly and excessively.*

*The Committee continues to be of the view that banks and market participants should view the capital buffers set out in the Basel III framework as usable in order to absorb losses and maintain lending to the real economy.<sup>12</sup> While banks operating in the buffer range are explicitly not deemed to be in breach of their minimum regulatory*

<sup>11</sup> According to the Basel framework, the CCoB is designed to ensure that banks build up capital buffers outside periods of stress that can be drawn down as losses are incurred, so that banks can continue to conduct business as normal. The CCyB should be built up when credit growth is excessive and is leading to the build-up of system-wide risk, and should be released when this system-wide risk crystallises or dissipates. Buffers of global and domestic SIBs aim to ensure that such banks have a higher share of their balance sheets funded by instruments that increase their going-concern resilience, and the SyRB aims to address macroprudential or systemic risks that are not covered elsewhere in the European legislation.

<sup>12</sup> See BCBS (2019b).

capital requirements as a result of using their buffers, they are still subject to the automatic distribution restriction mechanism set out in the Basel III framework, which aims to avoid the imprudent depletion of capital in a stress episode.

**Discussions on the capital buffer framework and its objectives featured prominently during the crisis triggered by the COVID-19 pandemic.** In June 2020, the BCBS reiterated its previous guidance on buffers, recalling the two objectives mentioned above and noting that the “Committee views a measured drawdown of banks’ Basel III buffers to meet these objectives as both anticipated and appropriate in the current period of stress.”<sup>13</sup> This communication by the BCBS came against the background of continued public discussion on capital buffer usability, with different views on whether banks would be willing to use the buffer when needed.

## 2.2 Buffer usability in the COVID-19 pandemic

**Several micro-level analyses of the pandemic suggest that current bank capital buffers may not be fully usable to absorb losses while avoiding excessive deleveraging.** While unprecedented policy action in response to the pandemic supported banks’ capital ratios and the supply of credit, analyses by the Financial Stability Committee’s Macroprudential Analysis and Macroprudential Policy Groups’ Expert Group (EG) show that proximity to the CBR is associated with lower credit supply and stronger risk weight density reductions during the pandemic.<sup>14</sup> Similarly, a BCBS report on early lessons from the COVID-19 pandemic finds global evidence that banks with less capital headroom (i.e. banks closer to the CBR) tended to lend less during the pandemic than those with more capital headroom<sup>15</sup>; a recent staff working paper from the Federal Reserve Board provides similar evidence for small and medium-sized enterprises (SMEs) in the United States.<sup>16</sup> While the extensive fiscal, monetary and prudential support measures mentioned above make it difficult to draw definite macro conclusions, the BCBS states that this evidence “suggests that banks may have been hesitant to use their regulatory capital buffers had it been necessary.” Although the results are consistent, a number of econometric caveats apply. For instance, while loan-level data strengthen the econometric identification, they limit the

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<sup>13</sup> See BCBS (2020).

<sup>14</sup> See the report on buffer usability by the Macroprudential Analysis and Macroprudential Policy Groups Expert Group on banks’ responses to the crisis and policy effectiveness (2021). The analysis compares loan growth between banks closer to the CBR (distance-to-CBR below 300 basis points) and banks further from the CBR (distance-to-CBR 300+ basis points). The estimates suggest that the former feature an acceleration of loan growth to NFCs that is about 2.7% lower than that of the latter, at the beginning of the pandemic. Regarding risk weights, the analysis also found that their reduction by banks with a lower distance-to-CBR was accompanied by an increase of banks’ central bank reserves and of their sovereign bond holdings. Finally, the analysis also finds that (i) provisioning practices did not significantly differ between the two groups of banks, and that (ii) a reduction of the CBR would not increase bank funding costs significantly, as long as it were not associated with a rating downgrade.

<sup>15</sup> See BCBS (2021). The report notes in its executive summary that it is “difficult to draw conclusions regarding banks’ willingness to use capital buffers. Though some evidence suggests that banks may have been hesitant to use their regulatory capital buffers had it been necessary.” It “finds that some features of the Basel reforms, including the functioning of capital and liquidity buffers, [...] may warrant further consideration”, while “it does not seek to draw firm conclusions regarding the need for potential revisions to the reforms.”

<sup>16</sup> See Berrospide, Gupta and Seay (2021).

analyses to euro area non-financial corporates (NFCs) only, i.e. discarding the effect of bank distance to the CBR on households.<sup>17</sup>

**Several factors could explain banks' reluctance to make use of the buffers, although evidence on possible drivers is inconclusive to date.** First, possible market stigma or funding pressures associated with the breach of a regulatory threshold or a decline in capital ratios potentially resulting in a rating downgrade may disincentivise banks from using their buffers. So far, however, analyses by the EG have not highlighted significant market pressure on banks during the COVID-19 crisis, although the extraordinary policy measures in place also condition this reaction of financial markets.<sup>18</sup> Second, fear of automatic restrictions on distributions and Additional Tier 1 coupon payments may prevent banks from using the buffers.<sup>19</sup> Third, despite supervisory flexibility in response to the pandemic and corresponding supervisory communication, banks might still be unwilling to dip into the CBR, in order to avoid closer supervisory scrutiny. Fourth, banks could be reluctant to enter the buffer range because of low expected profitability, including on new lending, as it is costly for banks with low profitability to rebuild their buffers. This factor could play out heterogeneously across banks and countries, since expected profitability can vary in the cross-section. Finally, binding parallel requirements, such as the LR and/or MREL, can hinder the effective use of risk-based capital buffers. As noted in an ESRB report on the overlap between capital buffers and minimum regulatory requirements, *“the regulatory framework is multi-restrictive by construction”*, with each of the constraints *“being important to contribute to the resilience of the banking system”*.<sup>20</sup> Nevertheless, the report finds that aggregate buffer usability might already be limited since the LR became binding in mid-2021 and that usability may further decline once the MREL is phased in from 2022 to 2024. While the number of affected banks and jurisdictions will depend on banks' portfolio adjustments, limited buffer usability will not be a transitional phenomenon, as the overlap stems from allowing banks to use the same capital for both the buffers and the minimum requirements.

### **Downward portfolio adjustments by individual banks have not induced broad-based credit supply constraints at the aggregate level, also due to the**

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<sup>17</sup> While lessons can be learnt about the functioning of the framework during the pandemic, views from members differ on whether the pandemic can be considered a real test for the framework, also due to the extensive support measures mentioned above. Moreover, standard econometric caveats apply to the EG's findings, although these findings are robust across econometric techniques, specifications and approaches; they use different data, which allow for better identification of the effects of proximity to CBR on outcome variables, controlling for banks specific features, credit demand and the impact of other policies, including fiscal policies. Some methods (difference-in-differences and propensity score matching) are aimed at isolating the effect of proximity to CBR from other bank-specific factors that may have affected the outcome variables during the pandemic (e.g. differences in solvency, asset quality, profitability). Other methods (based on loan-level data and bank-firm credit relationships) ensure that unwillingness to use the CBR is not determined by differences in credit demand. In addition, all analyses control for the impact of other policies, including guarantees, moratoria and monetary policy, either at the bank level or at the level of individual loans subject to guarantees or moratoria. This allows the effect of banks' distance to the CBR on the outcome variables to be disentangled from the effect of the pandemic fiscal support packages and monetary policy measures.

<sup>18</sup> For a discussion on this aspect, see also Andreeva, Bochmann and Couaillier (2020) and Schmitz, Nellessen, Posch and Strobl (2021).

<sup>19</sup> While dividend distribution restrictions enacted during the pandemic made this channel less relevant in the past, banks may still be reluctant to dip into the CBR, in order to avoid automatic restrictions on other types of instruments (such as Additional Tier 1 instruments) or automatic restrictions in the future.

<sup>20</sup> See ESRB (2021).

### **substantial fiscal and monetary support measures that have been implemented.**

However, a scenario-based analysis by the EG shows that should such adjustments become more widespread, they could induce adverse feedback loops, with negative effects on lending, economic growth and ultimately financial stability. It suggests that the systemic impact of buffer usability constraints in adverse scenarios crucially depends on the possibility for credit substitution across banks in the system, which is likely to vary across countries as it depends on structural and cyclical conditions. Aggregate effects are likely to be limited if the system has large room for credit substitution (i.e. if a part of the banking system maintains sufficient capital margins above the CBR and firms can easily move across banks and other financial intermediaries)<sup>21</sup>, whereas aggregate deleveraging can be significant and thus induce material costs in terms of economic growth in a scenario of significant and widespread losses and limited credit substitution (i.e. when firms have to rely on existing relationships with banks). In addition, model-based analysis suggests that broad-based use of capital buffers by banks can improve economic outcomes – specifically, higher lending during a downturn, with positive effects on gross domestic product (GDP) and lower credit losses – while the resilience of the banking system is not compromised.<sup>22</sup> Finally, an unwillingness to use buffers could also hinder timely loss recognition and possible debt restructuring and thus lead to forbearance. While debt restructuring is currently still at low levels in the euro area, without any signs of increasing, the EG has thus far not identified any statistically significant relationships between banks' provisioning practices and distance to CBR.

## **2.3 Releasable buffers and factors that prevented their build-up ahead of the crisis**

**The experience from the COVID-19 crisis has intensified debate on the case for releasable capital and/or an appropriate balance between structural and releasable buffers in the capital framework.** When released, releasable buffers allow banks to operate with lower capital ratios without breaching the CBR, thus addressing some impediments to buffer use and helping to avoid potential procyclical adjustments.<sup>23</sup> Indeed, the EG's findings suggest that releases of the CBR and P2R had positive effects on credit supply by increasing lending and lowering interest rates. In a similar manner, the BCBS report on early lessons from the COVID-19 pandemic provides global evidence that releases of the CCyB and other capital requirements

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<sup>21</sup> The potential substitution of bank credit by other sources of funding (e.g. leasing, factoring, market-based funding, internal funding) might attenuate the negative feedback loop of lower bank loan supply. However, their availability differs across Member States and across the size of NFCs (see, for example, Albertazzi, Becker and Boucinha (2021); Becker and Ivashina (2014); Adelino, Ferreira, Giannetti and Pires (2020); Peydro, Polo and Sette (2020); and Sabato, Altmann and Andreeva (2021)).

<sup>22</sup> See Borsuk, Budnik and Volk (2020). The analysis illustrates the effect of usable (non-released) capital buffers on lending and resilience. It leaves aside the question of specific policies, other than effective communication, that can bring about this outcome (e.g. by minimising stigma effects in relation to the use of the buffers).

<sup>23</sup> Specifically, capital releases increase the distance to the MDA trigger point and can thus help to address impediments relating to market stigma, distribution restrictions and concerns about supervisory scrutiny. Buffer releases are not effective in addressing impediments relating to parallel requirements, since the latter remain unchanged and may constrain effective usability after the policy change.

had a positive effect on lending during the pandemic. Finally, historical evidence, based on both a euro area sample and a sample of advanced and emerging economies from around the world in the pre-COVID-19 period, also shows that the release of countercyclical capital requirements can be effective in reducing the left tail of GDP growth distribution, with minor costs to median GDP growth.<sup>24</sup> Importantly, to avoid a negative impact on post-shock resilience, such buffer releases have to be coupled with a strong commitment and a clear framework for rebuilding them after the crisis is over (see Section 5.1 for further discussion).

**Despite the potential benefits of releasable capital buffers, thus far the bulk of the buffer requirements in the banking union have been structural rather than releasable.** The main releasable buffer within the current framework is the CCyB. However, ahead of the COVID-19 crisis, the CCyB made up only 0.1% of risk-weighted assets in the banking union, and this figure was partly attributable to positive CCyB rates set by non-euro area authorities. Besides the CCyB, several authorities also (partly) released the SyRB in response to the pandemic shock. However, the SyRB had not been used widely in the euro area before the pandemic, and those countries that had implemented a SyRB had often not promoted it as a releasable buffer at the time of implementation.

**The lack of releasable capital and the resulting distribution between structural and releasable instruments in the pre-COVID-19 environment was driven by several factors.** Factors explaining the limited build-up of releasable capital buffers included inter alia (i) the design of the current framework, which may be particularly geared towards experiences gained from the global financial crisis, with releasable buffers mainly foreseen to address cyclical systemic risks associated with exuberant aggregate credit developments; and (ii) the fact that many countries in the banking union were still recovering from the global financial crisis and its aftermath, which reduced the scope and the need to introduce countercyclical policies. It could also be argued that inaction bias may have played a role – both on the side of national authorities and on the side of the ECB.<sup>25</sup> As cyclical developments differed across countries, such inaction bias – if existent – has likely played out heterogeneously across countries. At the same time, a number of other, more structural capital requirements emanating from the post-global financial crisis reform agenda were phased in in the recent period (e.g. including stricter minimum requirements and structural buffers), substantially increasing overall capital requirements. While the phase-in of these requirements contributed to the banking system's resilience through the current crisis insofar as the public and market participants could be confident that banks' solvency was not in doubt, it also contributed to a possible imbalance between structural and releasable instruments.

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<sup>24</sup> See Galán (2020).

<sup>25</sup> An assessment of a possible inaction bias at national level would require a thorough analysis on a case-by-case basis and is outside the scope of this report. In relation to the ECB, while there has thus far not been a formal top-up decision on macroprudential measures, national authorities and the ECB regularly discuss macroprudential matters, and in several cases such discussions may have induced national authorities to take action before a formal ECB top-up decision needed to be applied. Thus, assessing the functioning of the top-up framework is also a complex task that would require analysing previous decisions on macroprudential measures on a case-by-case basis and is, as such, beyond the scope of this report.

**All this being said, this report acknowledges that the framework did not account for the possibility that releasable buffers could also be useful for addressing large and disruptive shocks that are unrelated to domestic cyclical developments.** Although some authorities had started to become more active and had implemented positive (albeit rather small) CCyB rates to address cyclical systemic risk shortly before the pandemic, the overall build-up of macroprudential countercyclical capacity by national authorities and the ECB in the banking union remained relatively small, especially in relation to the magnitude of the shock induced by the pandemic. A key reason for this apparent mismatch was the specific nature of the shock – a shock that was large and disruptive and went beyond the unwinding of domestic imbalances. The current macroprudential framework neglected the possibility that having releasable macroprudential buffers might help, regardless of the position in the financial cycle, address shocks that may hit the financial system and negatively affect financial intermediation at any stage of the cycle. Acknowledging that macroprudential policy on its own cannot address an extraordinary shock such as that induced by the pandemic, the crisis has highlighted the merit of revisiting the role of releasable buffers in the current framework.



## 3 Objectives and key aspects for the creation of macroprudential space

### 3.1 Objectives of the report

**This report develops specific policy options (in Section 4) to achieve an overarching objective of enhancing macroprudential authorities' ability to address large, disruptive systemic shocks that go beyond the unwinding of domestic imbalances and may hit (large parts of) the banking union simultaneously.** The COVID-19 crisis has illustrated that the availability of releasable capital buffers may help, regardless of a Member State's current position in the financial cycle, address systemic shocks that relate to risks that go beyond domestic imbalances and that may hit the economy and the financial system at different stages of the financial or economic cycle. When such shocks hit, the availability of releasable capital buffers can enhance financial system resilience by enabling banks to better absorb losses while maintaining provision of key financial services to the real economy. This role for macroprudential policy reflects the general objectives of the capital buffer framework (see Section 2.1) and mirrors – for a different type of systemic shock – one of the CCyB's key objectives in relation to cyclical shocks.<sup>26</sup> However, initially lower solvency when banks use buffers can also reduce resilience later in a crisis. Hence, the pros and cons of each policy option need to be thoroughly assessed. In any case, it is essential that releasable buffers be rebuilt in a timely and appropriate manner, to ensure that the capital is available again in the event of a new systemic shock, be it cyclical or non-cyclical.

### 3.2 Key principles and criteria for the assessment

**Policy options to create macroprudential space are likely to have benefits and drawbacks, both of which are thoroughly discussed later in this report. To structure the assessment, the report benchmarks policy options for creating macroprudential space in the SSM area against five broad criteria (Table 1).** The criteria need to be operationalised for the purpose of the report and have, in some cases, multiple dimensions (see, for example, the discussion on capital neutrality below). Moreover, as there are tensions between some of the criteria, meeting all of them simultaneously will most likely be impossible. The report flags such tensions when assessing the various options against the criteria. Importantly, the assessment's objective is not to rank the policy options, but to describe consistently and transparently the features of each option. The report does not weight the relative importance of the different criteria either, but rather leaves this to the EU legislator.

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<sup>26</sup> See BCBS (2010b): the CCyB aims to “ensure that the banking sector in aggregate has the capital on hand to help maintain the flow of credit in the economy without its solvency being questioned, when the broader financial system experiences stress after a period of excess credit growth”.

**Table 2****Criteria for identifying benefits and challenges of proposed policy options**

Criteria	Definitions
<b>Financial system resilience</b>	Broad definition of resilience encompassing loss absorption while maintaining provision of financial services
	Narrow definition of resilience focusing on solvency
<b>Compliance with Basel standards</b>	Maintain compliance with the Basel standard and assess implications for the international level playing field (also in the context of Basel III implementation)
<b>Capital neutrality</b>	Temporal (point in time (different benchmarking dates possible) vs over a long-term horizon)
	Cross-sectional (individual bank vs national banking system vs banking union)
<b>European governance</b>	Centralisation via legislative changes with respect to the ECB's powers
	Centralisation via application and repeal of ECB top-up decisions within the existing framework
	Softer forms of centralisation (recommendation, common methodology), possibly including enhanced role for ECB top-up powers or re-emphasising the ESRB's coordinating role
	Maintain existing national macroprudential competences and accommodate the role for national authorities within a European governance process
<b>Simplicity</b>	Avoid additional unwarranted complexity in the framework, while maintaining or enhancing transparency and clarity of the buffer framework

**Financial system resilience****Creating macroprudential space should help to enhance financial system resilience, particularly when large, disruptive systemic shocks materialise that go beyond the unwinding of domestic imbalances.**

In a broad sense and consistent with the objectives of the buffer framework designed by the BCBS, resilience is the financial system's ability to withstand shocks and absorb losses while maintaining provision of key economic services in a stress episode. A situation in which banks act in this manner can have a positive impact on GDP and lead to fewer credit losses, potentially inducing a net positive or neutral effect on bank solvency while improving economic outcomes. The strength of this mechanism hinges on banks' behaviour and can be weakened if banks distribute capital when solvency is falling or use capital for non-productive uses (e.g. assume additional risks in purely speculative activities).<sup>27</sup> Moreover, initially lower solvency when banks use capital can also have downsides in terms of lower market confidence and uncertainty about the nature and duration of the shock, and can potentially increase the likelihood of bank failures and subsequent contagion effects in left-tail events (see below for further discussion). Therefore, a narrow and arguably more microprudential definition of resilience focuses on bank solvency in times of systemic stress.

**To ensure financial system resilience in the medium term, it is essential that releasable buffers be restored in a timely manner so that they are available again in the event of a new systemic shock.** At the same time, the reconstitution of

<sup>27</sup> The Basel framework addresses this possibility via implementation of automatic restrictions on distributions when banks operate within the CBR. On the one hand, these restrictions address lessons from the global financial crisis, when a number of banks continued to make large distributions even though their individual financial condition and the outlook for the sector were deteriorating. On the other hand, distribution restrictions can represent an impediment to buffer use and may thus prevent banks from making use of the capital altogether (see discussion in Section 2.2).

buffers should not be too abrupt, as that would blunt the beneficial incentive effects of their release. Regardless of the specific policy option chosen, a clear framework for build-up and release of the buffer that balances these opposing effects is thus essential for enhancing policy effectiveness and ensuring financial system resilience over a longer horizon (see further discussion in Section 5.1).

**It is worth noting that financial system resilience does not necessarily imply the resilience of each individual bank.** It is possible that particularly weak institutions with already low capital ratios would have a higher probability of breaching regulatory minimum requirements following a release of buffers after a systemic shock, to the extent that the buffer release makes it more likely that they erode the capital headroom above the minimum requirements (although banks could still remain cautious about getting very close to the regulatory minimum). Given their idiosyncratic nature, such cases should be addressed by the microprudential supervisor on an individual basis. Nevertheless, as the direct and indirect costs of bank failure or resolution may have a systemic dimension (e.g. in the case of a SIB), appropriately calibrated structural buffers remain essential from a financial stability perspective. Against this background, policy options should also consider the need to maintain sufficient buffers against prevailing structural systemic risks.

## Basel compliance

**Compliance with the Basel standard is essential for maintaining international coordination and cooperation and a level playing field.** Deviations from the Basel standard could undermine the EU's credibility in eyes of the BCBS and put SSM area banks at a competitive disadvantage to international peers by eroding creditor confidence in the soundness of the regulatory framework in which EU banks operate, including in the context of Basel III implementation. The report points out where policy options could conflict with the standard, acknowledging that the ultimate compliance assessment rests with the BCBS and is determined in the Regulatory Consistency Assessment Programme (RCAP, which is currently being reviewed by the BCBS). The report also investigates internal EU options that are not identical to, but arguably compliant with, the Basel standard, and it also considers their effects on the international level playing field.

**While the benchmarking of policy options focuses on the current Basel standard, it is worth noting that the topics of buffer usability and macroprudential space feature prominently in the BCBS's ongoing evaluation work.** The need to consider whether sufficient releasable capital is in place to address future systemic shocks is flagged as one of the key aspects in the BCBS' recent COVID-19 evaluation report from July 2021.<sup>28</sup> While the report emphasises that the Basel reforms have achieved their broad objective of strengthening the resilience of the banking system and does not seek to draw firm conclusions on the need for potential revisions to the reforms, it notes that some aspects – including the

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<sup>28</sup> See BCBS (2021).

functioning of the capital buffer framework – may warrant further consideration. It is hence possible that the conclusions of the evaluation work might ultimately lead to a targeted adjustment of the buffer framework by the BCBS.

## Capital neutrality

### **Rebalancing from existing structural buffers towards releasable buffers within the macroprudential framework would be one way to enhance macroprudential space without increasing overall capital requirements.**

One view is that such rebalancing would recognise that overall requirements ahead of the pandemic were generally considered as broadly adequate.<sup>29</sup> According to this view, existing Basel capital buffers already account for the possibility of large and disruptive systemic shocks (in line with the general rationale of the Basel framework that capital should be used to cover for unexpected losses), since they were calibrated to enable “*a bank to withstand a significant downturn period and remain above regulatory minimum capital level[s]*” (where the standard does not specify the type of shock that induces the downturn).<sup>30</sup> Moreover, existing structural buffers are already meant to be used in a crisis (subject to distribution restrictions), and the release of the buffers would be a means to facilitate their use, according to this view. A new releasable buffer would be activated and fully in place most of the time (given the rarity of the trigger event and if swift rebuilding is ensured) and would need to be sufficiently large, reflecting the severity of the shocks to be faced. Against this background, rebalancing would be a way to avoid substantial quasi-permanent increases in capital requirements. Such quasi-permanent increases in capital requirements for rare events could reduce national authorities’ scope of action and could also be challenging in some banking union countries in the years ahead. The latter is because the impact of the pandemic and the implementation of the finalised Basel III standards are likely to induce pressure on capital ratios and, in the case of the former, potentially also on profits. Thus, to avoid generating possible procyclical effects, additional requirements may not be suitable for near-term creation of macroprudential space in all banking union countries and should be considered only when the pandemic has passed and Basel III has been implemented.

**At the same time, rebalancing can also have downsides, as it could reduce resilience against prevailing structural systemic risks when buffers are released and could be seen as an easing of current requirements.** According to this view, large and disruptive systemic shocks represent a new driver of systemic risk and as such motivate an increase in overall requirements beyond current levels. Such an increase in requirements would be a way to create more macroprudential space

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<sup>29</sup> For perceived adequacy of requirements and political will to avoid further significant increases in requirements, see Council of the EU (2016); BCBS (2017); and G20 (2017). As noted in BCBS (2019a), the original BCBS study on the long-term economic impact (LEI) found the optimal Tier 1 capital ratio to be in a range of 10%-15%, whereas estimates in later studies are either similar or higher. As noted in the study, “*The range is fairly wide across studies, and often within studies, reflecting the considerable uncertainties involved in optimal capital levels and the myriad alternative assumptions and calibrations authors used to mitigate the uncertainties*”.

<sup>30</sup> See BCBS (2010a).

since constraints on effective usability of released capital stemming from parallel requirements would be less pronounced under this option. According to this view, the one-off decline in the Common Equity Tier 1 component of the P2R (P2R CET1) capital requirements in the pandemic may have already provided some room for increasing overall requirements in the post-pandemic era (although the decline featured significant heterogeneity across banks).<sup>31</sup> Moreover, several banking union countries could have scope to increase current requirements with the aim of enhancing macroprudential space without generating significant, unintended procyclical effects.

Taking note of these differential views, the report assesses whether the various options under consideration are capital neutral or not.

**From a temporal perspective, capital neutrality can be defined at the time of implementation or over a long-term horizon.** Capital neutrality at implementation means that a new releasable buffer does not increase overall capital requirements when it is implemented. While the time of implementation is the simplest benchmark date, other dates could in principle also be considered (e.g. pre-pandemic capital requirements or the date when Basel III is fully implemented). By definition, neutrality at implementation means that overall capital requirements may drop below levels prevailing at that time following the subsequent release of the buffer after a possible large and disruptive shock in the future. Neutrality over a longer horizon means that long-term average requirements remain the same as before the policy change. That is, overall requirements with a new releasable buffer may go above (during the build-up phase) or below (for the duration of the release phase) overall requirements prevailing at implementation but fluctuate around the same average value as before the policy change. Importantly, an increase in overall requirements during the build-up phase would not automatically translate into an increase in requirements at implementation, as the build-up could be done gradually.

**From a cross-sectional perspective, capital neutrality can be considered at different levels of aggregation, such as (i) individual bank level, (ii) country level, and (iii) banking union level.** Options that enable the release of current structural requirements (such as the CCoB) are capital neutral on all three dimensions at implementation, but not over the long-term horizon (unless they are coupled with the possibility to increase their current rate over the medium term). For options that consider a reshuffling from current requirements to releasable buffers (such as the CCyB or the SyRB), different levels of aggregation are likely to have different implications. Neutrality at individual bank level would imply that overall capital requirements of each bank are unaffected by the policy change and is likely the hardest to achieve. By contrast, neutrality at the banking union level is likely to be the least restrictive but could create some asymmetries across countries and banks, with a (possibly unwarranted) tightening of capital requirements in some parts of the banking union and a (possibly unwarranted) loosening in others. Capital neutrality at the country level represents an intermediate level of aggregation that may correspond

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<sup>31</sup> The P2R CET1 component decreased from 2.1% to 1.2%, owing to the frontloading of CRD V on the P2R composition, as part of the COVID-19 capital relief measures (see ECB (2021b)).

well with the macroprudential nature of a new instrument (noting that within a country, heterogeneity should be monitored to avoid substantial asymmetric changes at bank level).<sup>32</sup>

## European governance

**A more coordinated and/or centralised European governance structure for a new tool could, under certain conditions, further enhance policy effectiveness by ensuring further harmonised and coordinated use of that tool for SSM area banks.** At the same time, it is important to preserve existing national competencies for macroprudential policy as the means to deal with systemic vulnerabilities at the national level. Therefore, stricter forms of centralised governance should only be considered for a possible new tool in order to address large and disruptive systemic shocks that may hit (large parts of) the banking union simultaneously, not for existing macroprudential tools. While more centralised governance is not a precondition for creating macroprudential space, better coordination or centralisation could – under certain conditions – enhance policy effectiveness by further promoting a timely, forceful, consistent and across-the-board policy reaction and a strong policy signal in response to such shocks (see Box 1 for a discussion of the experience in the pandemic). Furthermore, a more central governance structure could help to avoid fragmented use of the tool in the banking union by promoting uniform and consistent standards applicable to all countries, including in the phase of rebuilding a new tool. This imposes an additional safeguard against the watering down of current requirements (in options with the possibility to lower them), while minimising unevenness and stigma effects. At the same time, centralised governance could also have downsides, as additional coordination may be needed to ensure that macroprudential policy could still effectively address country-specific financial stability risks.

### Box 1

#### Experience with capital buffer releases during the COVID-19 pandemic

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**In response to the shock from the COVID-19 pandemic, prudential authorities took swift action to make around €140 billion of capital more usable to absorb losses and support lending.** On the microprudential side, ECB Banking Supervision allowed banks to operate below P2G and frontloaded new rules on the composition of P2R. These supervisory measures freed up €120 billion of CET1 capital. In addition, ECB Banking Supervision recommended that banks should not pay dividends or buy back shares for 2019 and 2020.<sup>33</sup> The measures announced by national macroprudential authorities since the outbreak of the pandemic have freed up around €20 billion of

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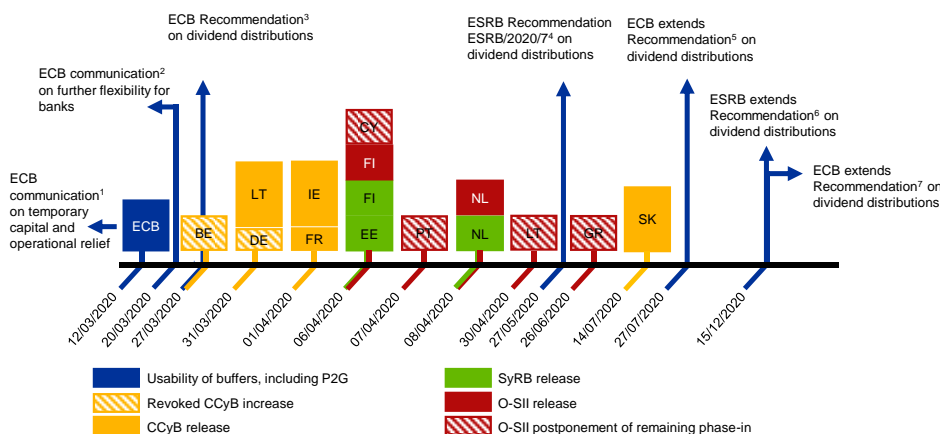
<sup>32</sup> Another possible consideration is the type of capital used to rebalance from (i.e. whether from CET1 into CET1 buffers or from other types of capital into CET1 buffers).

<sup>33</sup> See ECB (2020c). Out of almost €36 billion planned to be paid as dividends, only €8 billion was actually paid, preserving almost €28 billion of capital on banks' balance sheets. See also ECB (2020d) regarding the response from Andrea Enria, Chair of the Supervisory Board, to a letter from Ms Ponsatí Obiols, MEP, on dividend distributions.



CET1 capital.<sup>34</sup> They included full or partial releases of various macroprudential buffers, particularly the CCyB and the SyRB. In some cases, these releases were further supported by simultaneous decreases of O-SII buffers. Some countries revoked or delayed the entry into force of previously announced measures. The macroprudential measures were discussed and coordinated within the relevant structures, for example within the ESRB fora. Moreover, national authorities also needed to coordinate the measures with other institutions within their countries, for example ministries of finance, and in some cases with other European bodies. As a result of these coordination needs, and without passing judgement on this, the macroprudential measures implemented were much more diverse due to the existing ex ante heterogeneity (see **Figure A**). While most measures were taken within a narrow timeframe, i.e. between end-March and early April, they did not occur simultaneously and did not involve common communication on the same day.

**Figure A**  
Micro- and macroprudential policy actions during the COVID-19 pandemic (March to December 2020)



Source: ESRB.

Notes:

1 Press release: ECB Banking Supervision provides temporary capital and operational release in reaction to coronavirus.

2 Press release: ECB Banking Supervision provides further flexibility to banks in reaction to coronavirus.

3 Press release: ECB asks banks not to pay dividends until at least October 2020.

4 Recommendation of the European Systemic Risk Board on restriction of distributions during the COVID-19 pandemic.

5 Press release: ECB extends recommendation not to pay dividends until January 2021 and clarifies timeline to restore buffers.

6 Recommendation of the European Systemic Risk Board amending Recommendation ESRB/2020/7 on restriction of distributions during the COVID-19 pandemic.

7 Press release: ECB asks banks to refrain from or limit dividends until September 2021.

**A more centralised governance structure could take various forms, may require legal changes to the macroprudential framework in the EU and/or the banking union, and therefore requires a thorough legal assessment.** Possible forms of centralisation include explicit decision-making at the central level, or softer forms such as recommendation powers, common methodologies or re-emphasising the ESRB's coordinating tasks. Some of the options for more centralised governance constitute far-reaching changes to the macroprudential framework in terms of institutional set-up. Thus, if the legislator were to agree the need for more centralised governance, amendments to the current legal framework may be necessary. Initial considerations on how such amendments could look are spelled out in Box 2. While further legal changes may also be needed in relation to the respective policy tools under

<sup>34</sup> See ECB (2020b). Euro area banks further benefited from the CCyB reductions in Czech Republic, Denmark, Hong Kong, Iceland, Norway, Sweden and the United Kingdom through mandatory reciprocity.

consideration (CCoB, CCyB and SyRB), Box 2 focuses on legal aspects in relation to centralised governance.

## Box 2

### Legal considerations on centralised governance

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This box examines the extent to which any of the macroprudential buffers under Chapter 4 of Title VII of the Capital Requirements Directive (CRD)<sup>35</sup> can be (re-)set and released across the participating Member States in a uniform manner (for example, by setting a single rate for all participating Member States), in particular by centralising the decision-making about those buffers in the Governing Council of the ECB (a more detailed assessment is included in Annex 1). It also considers what changes to the legislation could be sought to ease centralisation of decision-making. The box does not consider softer forms of centralisation that are also discussed in the main body of the text (such as recommendation powers, common methodologies or re-emphasising the ESRB's coordinating tasks), since such options are likely to be less challenging from a legal perspective.

It should be noted that some of the policy options in this report consider possible changes to the macroprudential rules in the CRD to ease the build-up and release of capital buffer requirements, e.g. releasable CCoB. Any further changes to these rules could affect the exercise of the macroprudential tasks laid down for the ECB in the SSM Regulation<sup>36</sup>. The legal assessment summarised here is, therefore, based on the existing rules and will need to be revisited in the light of any further relevant changes to the CRD. Neither does the assessment consider what changes to the CRD might be necessary to allow for an increase of the share of releasable capital buffers and whether those changes would be compliant with the international standards set by the BCBS.

In summary, and for the reasons set out below (see Annex 1 for the more detailed assessment):

- (a) The ECB can increase the amount of releasable buffers by applying higher requirements and/or more stringent measures, subject to close coordination with national authorities and compliance with the relevant provisions in the CRD. Specifically, the ECB can seek to set a common “base” or “core” rate for a specific buffer across the participating Member States provided that it could be shown that setting such a rate for all participating Member States is aimed at addressing risks that may affect their financial systems similarly.<sup>37</sup>
- (b) The ECB can “release” buffers, either by revoking its decision to apply higher requirements or by applying lower requirements (provided these lower requirements are still above the level set by national authorities). The ECB cannot release buffers set by national authorities.

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<sup>35</sup> 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, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC (OJ L 176, 27.6.2013, p. 338).

<sup>36</sup> Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions (OJ L 287, 29.10.2013, p. 63).

<sup>37</sup> See Annex 1 for a more detailed legal analysis of possible challenges in setting a common “base” or “core” buffer rate for all participating Member States.

- (c) The Governing Council has the right to endorse, object to or amend any proposals from the Supervisory Board to apply higher requirements. It can also initiate the setting of a higher buffer. Central bank governors/presidents from Member States whose national competent authorities have established close cooperation with the ECB and who are not members of the Governing Council could be invited to participate as observers during discussions on buffers to ensure their voice is heard when decisions are made that may affect the Member States concerned.
- (d) In view of some limitations of the ECB's existing powers in this field, changes to the existing legal framework would be necessary if the desire is to completely centralise decision-making on a new tool to address large and disruptive systemic shocks that hit (large parts of) the banking union simultaneously. Those changes could take the form of amendments to existing legislation or of new legislation based on Article 127(6) of the Treaty on the Functioning of the European Union (TFEU)<sup>38</sup>.

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**One possibility to create a more centralised governance structure is to consider changes in legislation with respect to the ECB's powers for setting a specific new tool to address large and disruptive systemic shocks that hit (large parts of) the banking union simultaneously.** Conceivable options include changes to the existing SSM Regulation (which is politically very sensitive and therefore poses severe implementation challenges) or a dedicated regulation based on Article 127(6) of the TFEU (which also brings legal challenges as the ECB's macroprudential competences would be regulated in two separate regulations).<sup>39</sup> More centralised decision-making – for example, through the ECB Governing Council – can help to address large and common shocks affecting lending, growth and financial stability in a fully coordinated and coherent manner. This is of particular relevance in an interconnected single currency area, where negative spillover effects can be particularly strong in adverse economic conditions. At the same time, the centralised governance structure would have to consider how it would deal with situations where only some countries are hit by a large, disruptive systemic shock (see further discussion on this aspect in Section 5). It would also have to be ensured that centralised decision-making for one specific tool does not foster inaction bias by national authorities with other tools. In addition, instruments and responsibilities would have to be clearly allocated to authorities, to address institutional complexity and communication problems with the public and market participants.

**A second conceivable alternative is that the ECB could make more active use of its existing top-up powers under Article 5 of the SSM Regulation to create macroprudential space via top-up decisions and to repeal these top-up**

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<sup>38</sup> Treaty on the Functioning of the European Union (OJ C 202, 7.6.2016).

<sup>39</sup> More specifically, a new Council regulation could confer upon the ECB a power to release a specific capital buffer requirement in light of an SSM-wide systemic shock, whether or not that capital buffer requirement has been set by the ECB or a national authority. The conferral of additional specific macroprudential tasks upon the ECB could also be achieved by, for example, introducing an additional paragraph under Article 5 of the SSM Regulation setting out that in deviation from paragraphs 1 and 2 of Article 5 of the SSM Regulation, the ECB can release a specific capital buffer requirement, including a requirement set by national authorities, to mitigate SSM-wide systemic shocks (see also Annex 1).

### **decisions in the event of a large and disruptive systemic shock that hits (large parts of) the banking union simultaneously.**

- According to Article 5 of the SSM Regulation, *“the ECB may, if deemed necessary, instead of the national competent authorities or national designated authorities of the participating Member State, apply higher requirements for capital buffers than applied by the national competent authorities or national designated authorities of participating Member States.”* Thus, to ensure that all banks in participating Member States build up sufficient levels of releasable buffers in a consistent or uniform way, the ECB could consider setting a common “base” or “core” buffer rate for a specific buffer.<sup>40</sup>
- The ECB cannot set a lower requirement for a capital buffer but it can repeal its previous decisions. However, where a national designated authority (NDA) sets a higher buffer rate than that set by the ECB, it is not possible to lower the buffer by simply repealing the original ECB top-up decision.
- One way to mitigate the ECB’s inability to formally lower the buffer in some circumstances might be for the ECB to enter into appropriate dialogue with the NDAs. Indeed, it is possible to imagine that a centralised releasable buffer would be implemented through a combination of:
  - (i) binding measures, i.e. formally setting the buffer to a non-zero level using the ECB’s macroprudential top-up power and, where possible, formally repealing the top-up decision in the event of a major systemic shock;
  - (ii) collective deliberation within the Governing Council and Supervisory Board, ideally resulting in consensus-based decisions;
  - (iii) centralised public communication by the ECB following the decision in the Governing Council/Supervisory Board;
  - (iv) (potentially) non-binding measures, such as recommendations addressed to national authorities in countries where a formal repeal of the ECB decision would not lower the buffer rate.

### **A third alternative would be to implement softer forms of centralised governance, such as recommendation powers and/or floor methodologies.**

Such options are likely to face less severe legal challenges but may be less effective in ensuring harmonised and timely use of a new tool in the banking union. Specifically, for the build-up phase, such options could comprise a moderate centralisation of governance in the form of enhancing and further operationalising the ECB’s top-up-power, for example, building on the application of common (floor) methodologies.<sup>41</sup> While floor methodologies cannot address the issue of harmonising

<sup>40</sup> See Annex 1 for further discussion. Specifically, the ECB could increase the CCyB rate, the SyRB rate, or in case EU legislation lowers the existing fixed rate of 2.5% for the CCoB and allows national authorities to increase the rate, the CCoB rate.

<sup>41</sup> Existing experiences (e.g. ECB floor methodology for O-SII buffers) could be considered in this context.

the release of the instrument, this could be mitigated or addressed if they are combined with public recommendations from the ECB to national authorities during the release phase. Further involvement of other EU institutions could in principle also be envisioned via (i) ESRB Recommendations, or (ii) centralised competence under the aegis of the European Commission according to Article 459 of the Capital Requirements Regulation (CRR)<sup>42</sup>, which allows for changes to the level of own funds (although the latter would be a rather strict form of centralisation). On the one hand, such options could help to address possible conflicts of interest between microprudential, monetary and macroprudential functions at the central and national levels.<sup>43</sup> On the other hand, exclusively relying on ESRB Recommendations may be less effective in ensuring fully coordinated and timely use of a new tool in the banking union (e.g. when compared with centralised decision-making) and could also induce additional complexity, since the ESRB has a broader composition than the banking union. In addition, the European Commission may not be the best-placed authority for taking regular macroprudential decisions in the banking union, as illustrated, for example, by the fact that Article 459 of the CRR has never been applied.

**While a more centralised governance structure could, under certain conditions, enhance policy effectiveness, maintaining current national competencies is important given the need for national macroprudential policies to address risks and imbalances at country level.** National authorities' existing macroprudential responsibilities can be seen as reflecting cross-country heterogeneity in systemic risks, bank capitalisation and profitability, as well as the possibly uneven expected impact of future crises. It is important for national authorities to maintain control of their current macroprudential tools and space to account for differences in country-specific conditions, including in the future, and to avoid any new tool having a strong limiting impact on national competencies. Moreover, since even a large and disruptive common shock may have significantly heterogeneous implications across countries that depend on pre-existing vulnerabilities and cyclical positions, a central governance mechanism should in any case involve a consultative role for national authorities, to avoid unintended consequences and procyclical effects (see further discussion in Section 5). A related option is to combine a centrally governed releasable buffer with a national releasable buffer so that a combination of a large and disruptive systemic shock at the euro area level and the possibility of such a shock hitting countries with different intensity can be addressed (see Section 5 for further discussion).

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<sup>42</sup> 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 (OJ L 176, 27.6.2013, p. 1).

<sup>43</sup> According to Article 26 of the SSM Regulation, the Supervisory Board is responsible for planning and executing the tasks conferred on the ECB, most of which are microprudential supervisory tasks. According to Article 127(1) of the TFEU, the primary objective of the European System of Central Banks is to maintain price stability. The objectives of microprudential supervision and monetary policy could at times conflict with the objectives of macroprudential policy, e.g. in relation to the optimal timing of policy measures, giving rise to potential conflicts of interest. Since the Supervisory Board and Governing Council are constituted by members from national authorities, such potential conflicts of interest apply to these authorities in a similar manner. However, the clear governance structure set out in the SSM Regulation generally accounts for potential conflicts of interest by ensuring that potential trade-offs and unintended consequences of decisions in the different policy domains are properly accounted for in the decision-making process (see, for example, Constâncio et al. (2019)).

## Simplicity

**Given an already complex regulatory framework, with multiple parallel requirements and regulatory trigger points, policy options for creating macroprudential space should be as simple as possible.** While some degree of additional complexity might be unavoidable given the multiple challenges in designing any of the policy options, simplicity should be considered, in particular with respect to governance of the instrument (including the separation of responsibility between authorities), as well as the clarity and transparency of the capital buffer framework. Importantly, a larger share of buffers that are (ex ante) defined as releasable in nature provides more predictability to changes in capital requirements in stress scenarios and enhances the credibility and efficacy of the prudential framework, when compared with a situation where authorities have to resort to discretionary adjustments of buffers that are (ex ante) not releasable. A possible way to meet this criterion could be to build – as much as possible – on already existing tools, competences and coordination fora.



## 4 Options to operationalise the creation of macroprudential space in the SSM area

**The following section describes three policy options for creating macroprudential space in the banking union.** Each option is benchmarked against the criteria discussed in Section 3.2. The discussion does not weight the criteria and does not aim to rank the options. Therefore, the purpose of any cross-references between the options is to avoid unnecessary repetitions when describing the interplay between option features and benchmarking criteria.

### 4.1 Releasable CCoB

#### 4.1.1 Description of the option

**The current 2.5% CCoB could be made partly or fully releasable in response to a large, common and disruptive systemic shock, accompanied by a subsequent rebuild to return to the initial (or a higher) level.**<sup>44</sup> The CCoB is applied to the total risk exposure and thus affects all the exposures of banks in the same manner. The release of the CCoB would be considered only under very adverse economic conditions to address large, disruptive systemic shocks that go beyond the unwinding of domestic imbalances and may hit (large parts of) the banking union simultaneously. The subsequent rebuild of the CCoB to return to the initial level would be a necessary condition to ensure financial stability in the SSM area over the medium term.

**The option could in principle be coupled with the possibility to increase the CCoB rate above 2.5% over the medium term, thus building up an additional releasable part, and/or with a form of system-wide distribution restrictions.**<sup>45</sup> A CCoB rate above 2.5% – a possibility already allowed under Article 458 of the CRR – would further increase the effectively releasable macroprudential space and reduce concerns about bank solvency and the option's Basel compliance. This would increase capital requirements at implementation (in terms of ultimate target level, the phasing-in of the buffer itself could be gradual and targeted at a future date) but could maintain capital neutrality from a longer-term perspective (in the sense that future

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<sup>44</sup> For example, during the COVID-19 pandemic, the Central Bank of Brazil decided to reduce the CCoB from 2.5% to 1.25% for one year with a step-wise rephasing-in of the full buffer in the subsequent year with the intent of addressing the stigma of buffer use. The CCoB will return to 2.5% in April 2022, as follows: from April 2021 to September 2021, the CCoB will be set at 1.65%; and, from October 2021 to March 22, the CCoB will be set at 2%. The release is combined with a restriction on all discretionary capital payouts that exceed the minimum threshold set by civil and corporate Brazilian legislation, including dividends that have already been announced in the current financial year and share buybacks. The restrictions are applicable to all Brazilian banks, regardless of their respective size or level of excess capital above the minimum requirement.

<sup>45</sup> Alternatively, it could be coupled with a positive neutral rate for the CCyB or a core SyRB; see Sections 4.2, 4.3 and 5.2 for further discussion.

CCoB rates would fluctuate around the current level of 2.5%). Coupling the CCoB release with a form of system-wide distribution restrictions would be a way to ensure that the released capital is not used for distributions (see further down for a discussion on the benefits and drawbacks of coupling a CCoB release with system-wide restrictions).

## 4.1.2 Assessing the option against the criteria

### Enhancing financial system resilience

**A (partial or full) release of the CCoB under extraordinary conditions, coupled with strong conditions for subsequent rebuilding while avoiding distributions, could address usability problems and enhance financial system resilience relative to the status quo.** The CCoB is already meant to be used in an idiosyncratic and/or systemic crisis (subject to distribution restrictions), and a release could facilitate this use.<sup>46</sup> As explained in previous sections, active use of buffers can under certain conditions enhance financial system resilience by enabling banks to better absorb losses while maintaining provision of key financial services to the real economy. Such behaviour can positively affect GDP and lead to fewer credit losses, thus mitigating or even compensating potential negative effects on bank solvency. Nevertheless, a release of the CCoB would reduce bank capital requirements in crisis times relative to the status quo, possibly leading to initially stronger declines in capital ratios, which could imply a higher chance of bank failures in left-tail events with the risk of further contagion. Unless the release is coupled with some form of distribution restrictions (see below for further discussion), it could also facilitate the possibility that banks use the released capital for dividend payments or for acquisitions, own trading or buying external assets, which might be detrimental to financial resilience and create reputational damage.<sup>47</sup> Finally, it would have to be ensured that the buffer is rebuilt at an appropriate time, to avoid the effect of a release on bank solvency extending over a longer-term horizon.

**The effectiveness of a CCoB release could be diminished by the existence of parallel requirements, such as the LR and/or MREL.** The recent report by the ESRB Analytical Task Force (ATF) on the overlap between capital buffers and minimum requirements<sup>48</sup> shows that if the full 2.5% CCoB is made releasable, only 38% of the capital released would be effectively usable, due to overlapping requirements (which is a stronger constraint than for the CCyB/SyRB options). The analysis in Box 3 shows that effective usability of the CCoB would increase to 52% in the medium term when the effects of a faithfully implemented Basel III output floor are

<sup>46</sup> For example, at the onset of the COVID-19 crisis, ECB Banking Supervision explicitly allowed banks to operate below the level of capital defined by the P2G and the CCoB (see ECB (2020a)).

<sup>47</sup> It could be argued that large dividend payments or purchases of external assets are somewhat unlikely after a large and disruptive systemic shock (when profitability is usually dampened), which could mitigate such concerns. It should be noted, however, that losses may materialise with a delay, in which case concerns about premature payouts or purchases could persist.

<sup>48</sup> See ESRB (2021).

taken into account (since the output floor reduces overlaps with other requirements), and would further increase to up to 64% if the magnitude of the released part of the CCoB is reduced (to 0.5%). It should be noted that these numbers reflect banks' "ability" and not necessarily their "willingness" to use buffers.<sup>49</sup> The box further shows that the primary driver of the overlap is the MREL, while the effect of the LR is considerably less pronounced. In this respect, it is worth mentioning that the final overlap will depend on banks' choice of instruments and could become less pronounced if banks increase their reliance on non-capital instruments to meet, in particular, the MREL (financial market access permitting). Taken together, the evidence above could help to inform the possible magnitude of the releasable component of the CCoB. Furthermore, an additional assessment of possible ways to further reduce overlaps between the risk-based buffer framework and other requirements seems warranted.

**The subsequent rebuild following a (partial) CCoB release would be essential for preventing financial system resilience decreasing in the medium term.** As further discussed in Section 5.1, adequate timing and conditions for replenishment must balance several factors. The market impact of the release also needs to be factored in, particularly if the release is coupled with system-wide distribution restrictions (see below for a discussion) or if solvency declines following the release.

## Compliance with international standards

**A release of the CCoB is currently not foreseen in the Basel framework, so the option may be non-compliant with the standard (the ultimate compliance assessment rests with the BCBS and is determined in the RCAP).** One view is that Basel compliance crucially hinges on the application of distribution restrictions when banks fall short of the CBR. According to this view, although the release of the CCoB is intended to encourage banks to use their buffers (in accordance with the guidelines provided by the BCBS), it would be non-compliant with Basel without the distribution restrictions. Hence, enabling a release of the CCoB would require a change of the Basel framework, or would have to be coupled with some form of system-wide distribution restrictions (see next paragraph). Another view is that facilitating the use of buffers, when appropriate, via a release of the CCoB is in the spirit of the Basel III reform and its approach to capital buffers, since buffers were meant to be used in a crisis, while evidence from several studies suggests that banks may not be willing to use their buffers when needed from a macroprudential perspective (see Section 2.2).<sup>50</sup> It is worth noting here that the BCBS and the Financial Stability Board (FSB) recently concluded that the functioning of capital and liquidity buffers may warrant further consideration.<sup>51</sup> According to this alternative view, the compliance assessment is also not clear-cut, as the EU framework is more

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<sup>49</sup> As indicated in Section 3.2, banks might also be unwilling to use the entire released capital in the case of a full CCoB release, to avoid getting very close to the minimum requirement.

<sup>50</sup> For example, in G20 (2009), the G20 Leaders stated that "*where appropriate, capital buffers above the required minima should be allowed to decline to facilitate lending in deteriorating economic conditions*".

<sup>51</sup> See BCBS (2021) and FSB (2021).

conservative than the Basel standard with respect to the stacking of capital requirements (while it is less conservative in other aspects, such as capital requirements for SME exposures or credit valuation adjustment risk). Specifically, it places the P2R below the CBR and also includes the possibility of a SyRB, increasing the MDA threshold beyond levels explicitly foreseen in the Basel framework and adopted in other jurisdictions. While the ultimate assessment rests with the BCBS, it could hence be argued that a release of the CCoB would be compliant with the standard as long as the MDA trigger point remains at least as high as that foreseen by the Basel rules text.<sup>52</sup> In this context, it should also be noted that US supervisory agencies have reserved authority to permit the breach of the Basel capital buffers without restricting distributions in exigent circumstances where the US capital buffer framework is still considered as fully compliant with the Basel standard.<sup>53</sup> Similarly, the Swiss framework does not include automatic distribution restrictions in the event of a buffer breach but is still considered as compliant with the Basel standard. While the Swiss Financial Market Supervisory Authority (FINMA) has the power to restrict dividend payments, share buybacks and discretionary bonus payments, these restrictions do not apply automatically in case of a buffer breach.<sup>54</sup>

**EU internal solutions might be explored that are not identical to but arguably compliant with the Basel standard, while also considering their impact on the international level playing field.** Coupling the CCoB release with some form of system-wide distribution restrictions may be a way to ensure Basel compliance. However system-wide distribution restrictions as a standalone tool have received considerable pushback, and such an option would also have downsides for SSM banks.<sup>55</sup> A system-wide ban on distributions in the case of a CCoB release could be designed to mirror Basel-compliant, institution-specific restrictions in the case of a CCoB breach. This means that a CCoB release coupled with system-wide restrictions could be compliant with the Basel framework. On the one hand, system-wide distribution restrictions would increase the likelihood that the released capital is used

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<sup>52</sup> In the euro area, average P2R defined in terms of CET1 currently stands at around 1% of RWA, meaning that – following the line of argument above – 1% of the CCoB could possibly be released. A complication with this argument is that P2R and SyRB differ across institutions and can be lower than the released part of the CCoB for individual banks, which means that these banks would have an MDA threshold lower than that implied by the Basel standard following a possible release. The RCAP compliance assessment would have to consider the materiality of such individual cases.

<sup>53</sup> The US capital rule specifies that when operating in the buffer range, the “[responsible authority] may permit a supervised institution to make a distribution or discretionary bonus payment upon a request of the supervised institution, if the [authority] determines that the distribution or discretionary bonus payment would not be contrary to the purposes of [the regulation], or to the safety and soundness of the supervised institution. In making such a determination, the [authority] will consider the nature and extent of the request and the particular circumstances giving rise to the request.”

<sup>54</sup> The Swiss RCAP report notes that “FINMA has the power to restrict dividend payments, share buybacks and discretionary bonus payments. However, these restrictions do not apply automatically”, and considers this as a non-material deviation from the Basel standard. The RCAP report also notes that “[g]iven the capital buffers of Swiss banks including the Pillar 2 add-on, today’s minimum capital levels are stricter than Basel III rules”, which is an argument that could be applied in a similar manner to the EU framework, which also stacks the P2R below the CBR.

<sup>55</sup> It is worth noting that EU implementation of the MDA mechanism is stricter than in other jurisdictions and could possibly be softened for the imposition of a system-wide ban on distributions. For example, the amount of earnings that can be considered for the “maximum distributable amount” tends to be smaller in the EU than in other jurisdictions, resulting in tighter restrictions in the case of a buffer breach. Similarly, the scope of staff included in automatic restrictions on bonus payments is broader than in other jurisdictions, as the restriction concerns all staff in the EU but only bonus payments to senior staff in other jurisdictions, such as the United States or Japan.

for lending inside the SSM area and not for other purposes, such as dividend payments, acquisitions or external investments. They would reflect the systemic and exceptional nature of the shock under consideration and prevent capital from flowing out of the banking sector, taking into account that at the onset of the global financial crisis a number of banks continued to make large distributions in the form of dividends, share buy backs and generous compensation payments, even though their individual financial condition and the outlook for the sector were deteriorating. On the other hand, such restrictions could put SSM banks at a competitive disadvantage to international peers (if other authorities do not impose similar restrictions) and possibly induce stigma effects, also leading to questions about the period of time that it is possible to maintain this measure. This may in turn affect banks' incentives to use the released capital in the first place. Moreover, such restrictions could be detrimental to banks' long-term cost of capital and potentially restrict their future access to market funding. One possibility to mitigate potential downsides of system-wide restrictions could be a partial ban to avoid possible "imprudent" behaviour, e.g. in the form of a limit based on a percentage of past pay-out ratios. Another option could be to apply the capital conservation standards enshrined in the Basel standard at an aggregate level, which would arguably also help to ensure Basel compliance, i.e. a release of 1.25% of the CCoB could be coupled with a system-wide restriction or recommendation to conserve at least 60% of earnings, mirroring the idiosyncratic distribution restrictions for banks operating in the second quartile of the CCoB under the Basel standard. Alternatively, Basel compliance would be less of an issue if the releasable buffer is built on top of the existing requirement, i.e. if the rate of the CCoB can be increased beyond 2.5% (already possible under the current Article 458 of the CRR; see further discussion on capital neutrality below).

## Capital neutrality

**Enabling the (full or partial) release of the current CCoB would ensure capital neutrality of the option at implementation as the level of the CCoB would remain at 2.5%.** Abstracting from a potential reshuffling from other types of buffers/requirements (see Box 4), this option is the only one of the three that can immediately enhance macroprudential space at implementation without increasing overall capital requirements.

**To ensure capital neutrality over long horizons, the CCoB would have to be increased beyond 2.5% in the medium term (or the option would have to be coupled with a positive neutral CCyB or core SyRB), to account for the fact that capital requirements could be reduced during and in the aftermath of large, disruptive systemic shocks.** The risk of procyclical adjustments following a potential further increase of the CCoB above 2.5% could be mitigated by appropriate phasing-in periods and by considering it only after the COVID-19 crisis has passed and Basel III has been implemented.

## European governance

**A strong centralised governance structure with explicit decision-making power at the central level is particularly important under this option, to ensure consistent and contemporaneous use of the tool across the banking union and to impose safeguards against premature release and for timely rebuilding of the currently non-releasable buffer.** As explained in Section 3.2, possible options for how such a centralised governance structure could be implemented in the complex European legal framework for macroprudential policy relate to (i) changes in legislation with respect to the ECB's powers, and (ii) making use of the ECB's top-up powers and their possible repeal. Compared with the other options, this option could also be particularly well-suited to governance arrangements involving centralised decision-making, since the ECB and national authorities would each be responsible for their respective tools, which would avoid blurred responsibilities. In any case, further legislative changes in the CRD would be required to enable a release of the CCoB.

**Relative to the status quo, powers of national authorities would not be restricted under this option as the CCoB is currently not releasable, and national buffer decisions could account for cross-country heterogeneity.**

National authorities would retain current competences and responsibilities for the CCyB, the SyRB and other tools, to account for possible cross-country heterogeneity. As further discussed in Section 5.1, the magnitude of the releasable buffer at central level would have to balance the effectiveness of its release (increasing in magnitude) with the need to avoid unduly constraining national policy space. Consideration would have to be given to the interaction of the different buffers and the coordination between authorities to avoid competing buffer decisions or conflicts that could arise when national authorities feel compelled to compensate a centralised buffer release through, for example, a higher CCyB rate.

## Simplicity

**On the one hand, the existence of distinct releasable buffers with related but separate policy objectives could help to maintain the clarity and transparency of the buffer framework.** Specifically, and in line with the Tinbergen principle (one objective, one tool), the framework would allocate separate releasable buffers for different risks – the CCyB for cyclical risks related to credit dynamics, the SyRB for other cyclical risks and structural risks inherent in the banking system and the CCoB for large and disruptive systemic shocks that go beyond the unwinding of domestic imbalances. At the same time, this distinction may not be so clear, for example, because large and disruptive systemic shocks can affect financial sectors heterogeneously, depending on the financial and economic cycle (i.e. structural risks can have a cyclical element). Separately from this discussion, it can be argued that the CCoB is more suitable for addressing pan-European or global systemic shocks than the CCyB, as the CCoB is applied to all exposures (which is also possible for the SyRB), whereas the CCyB only covers domestic exposures. However, if a CCyB is



activated at the banking union level (see Section 4.2), this issue could be mitigated to a large extent.

**On the other hand, creating multiple releasable buffers or a buffer with a dual purpose could also have downsides in terms of complexity.** If the CCoB were designed to be partially releasable, the buffer would have a dual purpose, functioning both as a buffer that can be drawn down on an institution-specific basis and as a buffer that can be released. Since releasable buffers already exist (e.g. the CCyB and the SyRB), it is debatable whether introducing another releasable buffer is necessary or whether it would not be simpler to broaden the scope of one of the existing buffers. Joint calibration with the other two existing releasable buffers could induce additional complexity. However, and again recalling the Tinbergen principle, it can also be argued that it would be more complex to start using the same releasable buffer for more than one purpose than to introduce more than one releasable buffer. All these considerations are also relevant for the CCyB and SyRB options.

### Box 3

#### Usability of released capital under different policy options

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**The severity of constraints on the usability of the released capital resulting from parallel requirements can inform the degree to which the policy options for creating macroprudential space could effectively support financial system resilience.** Building on the work of the ESRB ATF on buffer overlaps, a quantitative assessment of usability under various calibrations of the size of release indicates that the degree of constraint from parallel requirements such as the LR and MREL varies with the magnitude of the release (Table A). Two general facts are that size matters – the higher the capital requirements in the risk-based stack, the lower the likelihood of potential impediments – and release sequencing matters – the part of the CBR that is released first is the most usable. How severe the impediments are in practice, however, depends on bank balance sheet structure and relative size of the requirements.

**The quantitative assessment is produced with the Usability Simulation Tool (USIT) tool developed in the context of ATF work on buffer overlaps.** The analysis is based on end-2019 bank balance sheet data and fully phased-in capital requirements, including the MREL, for 71 EU banks. The analysis assumes the following: (i) all the MREL shortfalls outstanding in the fourth quarter of 2019 have been closed using the cheapest available funding source, (ii) banks hold a management buffer on top of the MREL stack of 1% of total risk exposure amount (TREA), and (iii) the Basel III output floor is in place. For both the CCoB and CCyB options, several magnitudes of the buffer release are considered, ranging from 1% to 2.5% of the TREA. For the evaluation of CCyB usability, it is assumed that each bank initially holds a CCyB at the level of the considered release magnitude (i.e. the buffer is always fully released – when evaluating a 1% release, for example, it is assumed that all banks hold a CCyB of 1%) on top of a 2.5% CCoB. For the evaluation of CCoB usability, the actual 2.5% CCoB levels are considered, while the CCyB rate is set to 0%: the underlying assumption is that national authorities fully release all available CCyB in the wake of a shock before releasing the CCoB. This assumption is consistent with the need to create additional macroprudential space on top of the existing CCyB in the hands of national authorities.

Under certain conditions, SyRB usability is quantitatively similar to the aforementioned release of CCyB. This requires the core SyRB to be placed on top of the existing SyRB (as suggested in



Section 4.3) and the core SyRB to be released after the CCyB but before any other buffer, including the remainder of the SyRB. Note also that unlike the CCyB, increasing the SyRB might increase the MREL through a market confidence charge, which would reduce excess capital or require additional resources.<sup>56</sup>

**Table A**

Average effective usability of CCoB, CCyB and SyRB releases given parallel requirements (percentage of capital amount released)

Release magnitude	CCoB			CCyB/SyRB*			Usability gaps		
	TOTAL (1)	LR (2)	MREL (3)	TOTAL (4)	LR (5)	MREL (6)	(1)-(4)	(2)-(5)	(3)-(6)
0.5%	64.1	98.4	64.5	71.2	99.4	71.4	-7.1	-1.0	-6.9
1%	60.7	97.3	61.1	71.7	99.4	71.9	-11.1	-2.2	-10.7
1.25%	59.7	95.1	60.4	72.3	99.4	72.4	-12.6	-4.3	-12.0
1.5%	58.2	93.4	59.4	72.7	99.4	72.8	-14.4	-6.0	-13.4
2%	55.5	91.3	57.3	73.2	99.4	73.3	-17.7	-8.2	-16.0
2.5%	51.7	88.1	54.0	73.9	99.4	74.1	-22.2	-11.3	-20.1

Notes: SyRB\* refers to usability of the core SyRB placed on top of existing SyRB requirements (see also Section 4.3). Columns (1)-(6) present average CCoB/CCyB/SyRB\* releasability in percent: 100 means the full released amount translates into excess capital not locked into a parallel minimum requirement, with the release being maximally effective. 0 means the full released amount remains locked into a parallel minimum requirement, with the release not being effective. Total CCoB/CCyB/SyRB\* releasability is determined by the lowest usability across the LR and MREL (more precisely MREL-LR, MREL-RW, MREL-TLOF (where RW = "risk-weighted" and TLOF = "total liabilities and own funds")). For MREL-TLOF, the exercise assumes a subordination requirement expressed as TLOF to be allowed to determine the overall MREL-LR. Average CCoB/CCyB/SyRB\* releasability is calculated as the weighted mean across all banks' individual realisability, where the ratio of each bank's CBR to total CBR is used as weights. Columns (1) and (4) evaluate usability with respect to the most binding minimum requirement, while columns (2) and (5) and (3) and (6) calculate usability only with respect to the LR and MREL respectively.

**Consistent with the ATF results, a CCyB/SyRB release is more usable than a CCoB release, but the gap narrows significantly for smaller magnitudes of the release.** The higher usability of the CCyB/SyRB is primarily related to the stacking order of buffers, as its release implicitly starts from a higher capital requirement given that the CCyB/SyRB is built up and stacked on top of the 2.5% CCoB. The usability gap closes markedly when moving from a full 2.5% release (corresponding to a gap in total usability of some 22 percentage points) to a 0.5% release (where the gap narrows to some 7 percentage points).

**Implementation of the Basel III output floor narrows the usability gap in the medium term.** The output floor increases the usability of the CBR on average, and this effect is particularly emphasised for the CCoB compared to the CCyB/SyRB. The 22 percentage points usability gap in the last row of Table A compares favourably with the 27 percentage points from the computations included in the

<sup>56</sup> The SyRB, unlike the CCyB, is not excluded from the standard formula for a market confidence charge for the MREL expressed in terms of TREA (MREL-TREA). Increasing the SyRB would therefore increase the MREL-TREA, which would not impact buffer usability because the CBR always stacks on top of the MREL-TREA. There is no market confidence charge for the MREL expressed in terms of leverage (MREL-LR), so any increase in the SyRB will not increase the MREL-LR. It should, however, be noted that using the SyRB instead of the CCyB increases the MREL and thus reduces usability of excess capital. Also, banks' potential response to meeting an increased MREL might affect their balance sheet structure, which might in turn affect buffer usability. For example, issuance of additional liabilities might improve buffer usability by reducing the CBR overlap with the MREL-LR (see ESRB (2021) for more detail). Evaluating these implications would be assumption-heavy and their impact on overall buffer usability will likely be negligible. Finally, it is not ruled out that resolution authorities might use their discretion to reduce a market confidence charge by the extent of the releasable SyRB in order to avoid any increase in the MREL. In those circumstances, there will be no difference between increasing the CCyB or the SyRB.

ESRB (2021) report, which abstracts from the Basel III output floor.<sup>57</sup> The results are conditional on full and timely implementation of Basel III and will only apply in the medium term.

**Among the parallel requirements, the MREL is the main constraining factor.** Table A indicates that the releasable buffers are virtually unconstrained by the LR, while the impact on total effective usability comes mainly from the MREL. In this respect, it is worth mentioning that the final overlap with the MREL will depend on banks' choice of instruments and could become less pronounced if banks increase their reliance on less costly, non-capital instruments to meet the requirements (financial market access permitting).

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## 4.2 Positive neutral rate for the CCyB

### 4.2.1 Description of the option

**A positive neutral component of the CCyB could enhance the current CCyB framework by providing an additional layer of buffers at the banking union level that can be released if large and disruptive systemic shocks materialise in a concerted manner.** The CCyB is currently designed to be built up during periods of excessive credit growth and to be released during downturns. As such, it is currently meant to address domestic cyclical risks resulting from excessive credit growth. The current use of the CCyB in most Member States reflects, in the spirit of the Basel guidance, that a CCyB rate of 0% is perceived as adequate in a “normal” risk environment. While CCyB rates are set by national macroprudential authorities to reflect the domestic cyclical risk outlook, they do not account for non-cyclical shocks possibly unrelated to domestic developments.

**Without prejudicing the ability of national macroprudential authorities to build and release the CCyB according to domestic developments in the financial cycle, an additional, positive neutral component of the CCyB could increase resilience to a wider spectrum of systemic shocks (including non-cyclical ones).** One variant of this option would be to implement a positive neutral component that is managed at a centralised level. It would effectively complement the current national CCyB rate with an additional layer of releasable capital whose build-up and release would be based on a common framework and would therefore account for Knightian uncertainty (“unknown unknowns”). The positive neutral component of the CCyB would be released only under very adverse economic conditions to address large and disruptive systemic shocks that hit (large parts of) the banking union simultaneously, and would subsequently have to be rebuilt at least to the level of the positive neutral component within a certain timeframe. Since the CCyB is an exposure-based measure and applies only to domestic relevant exposures, this option

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<sup>57</sup> Calculations based on Table 9 in Section 3.2 of ESRB (2021). The 27 percentage points represent the difference between 38% usability of the CCoB under a 2.5% release assumption and 65% usability for a release of the CCyB of a similar magnitude.

would affect banks that are relatively more active outside the banking union to a lesser extent (given that the CCyB would be built up in the entire banking union but not abroad). Heterogeneous effects of the tool could be justifiable in general, but also specifically if the expected impact of shocks is also heterogeneous.

**Another variant of this option would be to rely mainly on national powers for the build-up and release of the positive neutral rate, possibly complemented by softer forms of centralisation.** Different versions are possible in this variant. First, it could take the form of a proactive increase of the CCyB within the cycle (“more active use”). This version could already be implemented within the current framework. However, under this version, the CCyB would still be perceived as a tool that is primarily used to address cyclical risks. More active use of the CCyB could thus be facilitated by (i) widening the scope of the risk assessment for setting the CCyB, acknowledging measurement uncertainty and increasing CCyB rates earlier on in the cycle (although it could be difficult or impossible to account for the possibility of large, disruptive systemic shocks in a purely cyclical risk assessment); and (ii) potentially by the ECB making more active use of its top-up power. Second, a positive neutral rate for the CCyB could take the form of setting an explicit target for a positive neutral rate above 0%. The CCyB rate from the regular cyclical risk assessment would come on top of the positive neutral rate. Both components would be available for release in the event of a large and disruptive systemic shock (while requiring communication to clarify that they target two different sources of systemic risk). The CCyB would subsequently have to be rebuilt to at least the level of the positive neutral rate within a certain timeframe. This version (in contrast to the other version) would require changes to the legal framework (CRD), and implications in relation to the Basel framework would have to be assessed. For the release phase, both versions could in principle be coupled with softer forms of centralisation, such as recommendations to release the instrument.

#### 4.2.2 Assessing the option against the criteria

##### Enhancing financial system resilience

**A positive neutral component for the CCyB would increase the amount of releasable buffers, thereby improving financial system resilience relative to the status quo and addressing impediments to buffer usability.** The additional buffer would support the ability of banks to continue providing credit and other services to the real economy without their solvency being called into question and would allow for timely provisioning for losses that may materialise with a delay. Overall capital requirements would be at least as high as the current requirements at any stage of the cycle, and average levels would increase (unless the introduction of the positive neutral CCyB is compensated by a reduction in another requirement; see Box 4 and discussion further down).

**Effective usability of a positive neutral CCyB could also be limited by parallel minimum requirements, but less than for the CCoB option, since the overall**

**risk-based requirement under this option would be higher.** For instance, for a sample of large European banks, the ESRB ATF estimated that on aggregate 65% of a 2.5% CCyB would be unconstrained by parallel minimum requirements (LR and MREL), while the figure for a releasable CCoB is only 38% (a wedge of 27 percentage points in terms of effective usability). The analysis in Box 3 shows that the wedge between the two buffers would narrow to 22 percentage points in the medium term, conditional on a faithfully implemented Basel III output floor, and would narrow further to about 7 percentage points when smaller buffer releases are considered (e.g. a 0.5% buffer release).

## Compliance with international standards

**As Basel sets minimum standards, it can be argued that the option is likely to be compliant with the Basel standard, although the standard does not foresee a positive neutral rate and compliance depends on the details of implementation (the ultimate assessment is to be made by the BCBS).** One view is that more active use of the CCyB via implementation of a positive neutral rate is super-equivalent to the Basel framework, which only sets minimum standards. EU authorities would go beyond the Basel standard according to this view. However, this could have an impact on the international level playing field if other countries do not introduce a positive neutral rate for the CCyB as well. Another view is that the CCyB is designed to address cyclical risks, not other risks. According to this view, implementation of a positive neutral component would require an amendment of the BCBS Guidance for national authorities operating the CCyB, which might be difficult to achieve. Moreover, employing the CCyB both as a cyclical and semi-structural buffer and for a different purpose than that foreseen in the Basel framework could be of concern for the governance, transparency and simplicity of the framework and may thus affect the compliance assessment. In either case, as the CCyB applies only to domestic exposures, implications for the reciprocity framework would have to be assessed. The presence of a positive neutral CCyB reduces the space left before the 2.5% threshold for mandatory reciprocity is reached. Hence, a higher threshold or even an abandonment of the threshold might be warranted, which would require agreement at the international level (most notably in the BCBS). Notably, the ESRB recommends applying reciprocity beyond the level of 2.5% for exposures in the EU. Finally, the assessment of compliance with international standards would have to include an assessment of Basel compliance of the possible reduction in another buffer requirement, should the positive neutral component for the CCyB be introduced in a capital neutral manner via a reshuffling from other requirements. This latter part of the assessment is needed only if there is compensation from a reduction in another buffer requirement.

## Capital neutrality

**If added on top of existing buffer requirements, the implementation of a positive neutral component for the CCyB would imply additional capital and higher**

**buffer requirements at implementation and over a longer term.** At the same time, the MDA trigger point would not fall below current levels in the aftermath of future, large and disruptive systemic shocks. As for the other options, an increase in overall requirements could be motivated by the view that large, disruptive systemic shocks constitute a new source of risk that is thus far not captured in the buffer requirement (see discussion in Section 3.2). In contrast, a reshuffling would be capital neutral, assuming that current overall requirements already capture these types of shock, and would comprise the possibility to lower the MDA trigger point below current levels in future crises. As for the other options, it could also be argued that such an increase in requirements would at least in part be compensated by decreases in pre-pandemic capital requirements – at least at the country or banking union level (as the one-off decline in P2R CET1 capital requirements provides some room for higher CET1 buffer requirements, albeit with significant heterogeneity across banks).

**This option could be made capital neutral at implementation if the increase in the CCyB rate is compensated by a corresponding decrease in other capital requirements (see Box 4).**<sup>58</sup> In this case, the option would comprise the possibility to lower the MDA trigger point below current levels. Notably, ensuring capital neutrality at bank level via such reshuffling could be more complex than for the SyRB option (if the latter is applied to total risk-weighted assets; see next section for discussion), since the CCyB is an exposure-based measure.

## European governance

**As noted above, different governance arrangements for a positive neutral level of the CCyB are possible, including, for example:**

- First, a change in governance by which general decision-making (both release and subsequent build-up) on the positive neutral component of the CCyB rate is moved to the centralised level, with the possibility to alter it for (large parts of) the banking union in response to a large and disruptive systemic shock.
- Second, variants that mainly rely on national powers for the build-up and release of the positive neutral rate, possibly complemented by softer forms of centralisation.

As explained in Section 3.1, possible options for how such governance arrangements could be implemented in the complex European legal framework for macroprudential policy relate to (i) changes in legislation; (ii) making use of the ECB's top-up powers and their possible repeal; (iii) softer forms of centralisation, such as recommendation powers, common methodologies or re-emphasising the coordination task of the ESRB in this regard.

**Some form of European coordination may also hold benefits for variants relying mainly on national powers.** First, a positive neutral rate in the “more active use”

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<sup>58</sup> To recall, the Bank of England, in its move to a greater share of releasable capital buffers, partially offset the initial increase in the CCyB by reducing the PRA buffer (see Bank of England (2016a)).

variant could be supported by moderate centralisation of governance in the form of enhancing and further operationalising the ECB's top-up-power for the CCyB. A link could be created between a CCyB target rate based on a risk assessment by the ECB for the SSM area as a benchmark and CCyB rates set on a national level based on national risk assessments. In this case, the ECB would face a lower hurdle to exerting top-up power if national authorities stay well below that level for a prolonged period. This "more active use" option would not require changing changes to the regulatory framework but potentially to how the ECB operationalises its top-up power. Second, a positive neutral rate in the form of an explicit positive target rate enshrined in the legal framework would not necessarily require centralised governance to support the build-up. However, some common guidelines or understanding as to how this buffer component can be released and under which circumstances, and, even more importantly, when it will be replenished afterwards would be helpful. Lack of coordination between national authorities in the release stage could potentially hamper the instrument's effectiveness and tilt the level playing field. At the same time, a coordinated or centralised release can be facilitated by an ECB Recommendation to national authorities to release the macroprudential space at hand (or by re-emphasising the ESRB's coordinating role), although the ultimate policy action would remain with national authorities, so that some heterogeneity could persist. Harmonised replenishment of this buffer component could also be facilitated by the ECB using its top-up power. Finally, national authorities would, of course, be free to move beyond this rate.

**For variants with explicit centralised governance, the centralised positive neutral CCyB and the national CCyB components would both operate on the same buffer.** The option would not constrain current national powers to use the CCyB for addressing cyclical risks. However, the cyclical component would be operated under the same tool as the positive neutral rate. Depending on the precise design of the option, this could lead to additional complexity in terms of governance of the instrument and public communication and potentially reduce the instrument's effectiveness should financial institutions be uncertain about the outlook for buffer requirements.

**For variants mostly relying on national powers, national competences would remain unchanged.** More active use of the CCyB is already possible within the current framework and therefore would not increase regulatory complexity. An explicit positive neutral rate for the CCyB would require changes to the buffer framework, but its impact on regulatory complexity would depend on the details of implementation.

## Simplicity

**Combining a cyclical and a semi-structural instrument under the same buffer could have downsides in terms of clarity and transparency of the buffer framework.** Specifically, for variants with an explicit positive neutral component, the (semi-structural) positive neutral rate and the (essentially cyclical) CCyB would have different purposes, different build-up and release rules, and (potentially) different governance arrangements. One view is that this would lead to additional complexity in

the joint calibration of the two components, and that communication to the markets and the public at large could be challenging. According to this view, building on the Tinbergen principle, it is arguably more complex to use the same releasable buffer for more than one purpose than to introduce more than one releasable buffer. Another view is that the semi-structural component of the new CCyB could also be perceived as a minimum floor (e.g. 1%), with the cyclical component raising the buffer above its structural component, so that there would be a relatively straightforward distinction between the two elements. Moreover, according to this view, variants making more active use of the CCyB would not have different components for the buffer, as the calibration of the buffer would still be based on cyclical elements (albeit a substantially broadened interpretation of cyclical systemic risk than the current one).

**A positive neutral rate for the CCyB could also have implications for the reciprocity framework of macroprudential measures.** Specifically, the current EU macroprudential framework foresees automatic reciprocity of the CCyB up to 2.5%. Unless implemented in a homogeneous manner across countries, a positive neutral rate independent of cyclical developments could imply that non-domestic institutions face higher capital requirements, depending on host authorities' risk aversion or policy strategy. Moreover, the concept of a positive neutral rate would increase the number of jurisdictions with positive CCyB rates, therefore intensifying the need for institutions to update their overview of applicable CCyB rates.

#### **Box 4**

##### **Options to achieve capital neutrality through buffer rebalancing**

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Options involving the establishment of a positive neutral (or core) rate for the CCyB and the SyRB can be made capital neutral at implementation (if desired) if accompanied by a corresponding decrease in another buffer requirement. As previously mentioned, some room may have already been provided when taking pre-pandemic capital requirements as a benchmark, since the one-off decline in P2R CET1 capital requirements could have provided some room for higher CET1 buffer requirements, albeit with significant heterogeneity across banks.

Abstracting from changes that occurred in the past, several options could – in principle – be considered for achieving capital neutrality at implementation through buffer rebalancing:

##### **1. Using microprudential requirements (P2R or P2G)**

One option to create a positive neutral CCyB or a core SyRB using existing requirements would be to reduce P2R or P2G. For P2G, the reshuffling would not be fully capital neutral in strict terms, as the MDA threshold would increase as a consequence of the reshuffling. Moreover, P2G is non-public and legally non-binding, so it may currently face fewer obstacles to usability than legally binding buffer requirements.

A similar shift from microprudential to macroprudential requirements was implemented in the United Kingdom in 2016, when the “positive neutral” CCyB introduced by the Bank of England's Financial



Policy Committee<sup>59</sup> was accompanied by a corresponding decrease in Pillar 2 supervisory capital buffers by the Bank of England's Prudential Regulation Authority (PRA).<sup>60</sup>

However, in the SSM context, this proposal was already discussed ahead of the pandemic in December 2019 by the MPF, which did not find widespread support. Specifically, several members of the Supervisory Board had voiced substantial concerns about constraining microprudential policy space. Since the average aggregate level of P2R and P2G is rather low (1.2% and 1.4% respectively)<sup>61</sup>, a meaningful shift to a new capital buffer may leave microprudential supervisors with insufficient space to adequately reflect idiosyncratic risks that banks would face in a stress episode – especially for those banks with the lowest P2R/P2G rates.

## 2. Rebalancing from structural buffers (O-SII buffers)

A second option for capital neutral implementation would be to rebalance from O-SII buffers. This option, however, suffers from a number of shortcomings. First, as highlighted in the latest review of the ECB O-SII framework, the level of structural buffers is not sufficient for a few SIBs. Even after the revised O-SII methodology is implemented, some heterogeneity in O-SII buffers would remain unaddressed. Second, it is hard to justify a decrease in O-SII buffers, since the relevance of the underlying structural risks has not changed. Third, while the new releasable buffer should cover the whole banking system, the O-SII buffers are held by just a few very large banks, so a reshuffle between the two buffers would not be capital neutral for many banks. Against this background, increasing releasable buffers by decreasing O-SII buffers may not be warranted.

## 3. Permanently reducing the CCoB

A third option to introduce a positive neutral CCyB or core SyRB in a capital neutral manner would be to permanently reduce the CCoB. However, as the CCoB would effectively decrease below 2.5%, such a reshuffling would face more challenges in terms of Basel compliance than the option to make the CCoB releasable. A targeted adjustment of the buffer framework by the BCBS could in principle help to facilitate implementation of this solution. However, this option is arguably dominated by directly making (part of) the CCoB releasable, as it introduces additional legal, technical and Basel compliance challenges without adding anything from an economic perspective.

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## 4.3 A greater role for the releasable SyRB

### 4.3.1 Description of the option

**A third option would be to enhance the macroprudential framework by introducing a core SyRB rate at the banking union level, available for a release to address large, disruptive systemic shocks that go beyond the unwinding of domestic imbalances.** This could meet the revised objective and purpose of the

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<sup>59</sup> Cf. Bank of England (2016a).

<sup>60</sup> Cf. Bank of England (2016b).

<sup>61</sup> See ECB (2021b).

SyRB in the CRD V, namely, to address macroprudential or systemic risks not covered elsewhere in the regulatory framework.<sup>62</sup> The setting of a SyRB is not mandatory and can be flexibly adjusted according to European legislation, which implies that the buffer can be released when the targeted risk materialises. As for the other options, the core part of the SyRB would be released only under very adverse economic conditions to address large and disruptive systemic shocks that relate to risks that go beyond domestic imbalances and hit (large parts of) the banking union simultaneously. The SyRB can be applied to the total risk exposure or to subsets of exposures. The option could hence be designed so that the core SyRB affects all banks to which it is applied in the same way. As the SyRB is a very flexible tool, introducing a core rate for it may already be possible within the current legal framework, although explicitly recognising this possibility within the CRD may be beneficial.

### 4.3.2 Assessing the option against the criteria

#### Enhancing financial system resilience

**A core SyRB rate that can be released in the event of a systemic shock would increase the share of releasable buffers, thereby addressing impediments to buffer usability and improving financial system resilience relative to the status quo.** Unless introduction of the core SyRB is compensated by a reduction in another requirement (see Box 4 and discussion further down), overall capital requirements would be at least as high as the current requirements at any stage of the cycle, and average levels would increase. The release of the additional buffer would support banks' ability to continue providing credit and other services to the real economy without their solvency being called into question and would also allow for timely provisioning for losses that may materialise with a delay. Similar to the CCyB option, adding a core rate for the SyRB on top of current requirements would limit the likelihood and magnitude of potential impediments to buffer usability stemming from parallel minimum requirements more than a releasable Capital Conservation Buffer (CCoB), since the overall capital requirements under this option would be higher (see Box 3 for further discussion and illustration). Again, the wedge in the ability to effectively use these buffers relative to the CCoB becomes smaller for smaller magnitudes of the buffer release and, conditional on a fully and timely implementation of Basel III, smaller in the medium term when the effects of the output floor are considered. In contrast to the CCyB, an increase in the SyRB might also increase the MREL through a market confidence charge, which would reduce excess capital or require additional resources.

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<sup>62</sup> Following amendments to the CRD, the objective of the SyRB under [Article 133 of the CRD](#) (as amended by CRD V) is "to prevent and mitigate macroprudential or systemic risks not covered by Regulation (EU) No 575/2013 and by Articles 130 and 131 of this Directive, in the meaning of a risk of disruption in the financial system with the potential to have serious negative consequences to the financial system and the real economy in a specific Member State".

## Compliance with international standards

**Unlike the CCoB and the CCyB, which are enshrined in the Basel framework, the SyRB is a European-specific instrument, so introducing a core SyRB rate would not per se raise an issue of Basel compliance.** Moreover, the SyRB has been expressly designed under the CRD V to address residual risks (“macroprudential or systemic risks not covered by Regulation (EU) No 575/2013 and by Articles 130 and 131 of this Directive”). However, introducing such a buffer may have an impact on the international level playing field if authorities in other countries do not introduce a similar additional buffer. Moreover, the assessment of compliance with international standards should also include an evaluation of the Basel compliance of the possible reduction in another buffer requirement when aiming for a capital neutral introduction of a core SyRB. This latter part of the assessment is not needed if there is no compensation from reducing another buffer requirement.

## Capital neutrality

**If added on top of existing buffer requirements, a core SyRB rate would imply additional capital at implementation and over a longer term.**<sup>63</sup> Currently, the use of the SyRB is very limited: as of July 2021, only four SSM countries (Austria, Bulgaria, Croatia, Slovakia) had an SyRB requirement in place. Moreover, since the current buffers are tackling a specific risk, it could be argued that the core SyRB rate should be added to the existing SyRB rate for these countries. Therefore, all else being equal, establishing a core SyRB rate would not be capital neutral relative to buffer requirements in place today. At the same time, the limited use of the SyRB at the starting point also means that differences in the impact at bank level and country level would be limited.

**Since the scope and purpose of the SyRB have recently been revised, assessing capital neutrality relative to current levels might not be fully appropriate.** The CRD established the SyRB as a buffer that can be set at up to 3% of risk-weighted assets (RWAs, or even higher with the Commission’s opinion or approval).<sup>64</sup> Depending on how actively the SyRB is expected to be used in the future, establishing a core SyRB rate might be regarded as not entirely additional to the currently agreed set of requirements that are expected to apply over the cycle/in the long term. Moreover, as for the other options, it could also be argued that such an increase in requirements would at least partially compensate decreases in pre-pandemic capital requirements – at least at the country or banking union level (considering the space provided by the one-off decline in P2R CET1 capital

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<sup>63</sup> Considering the significant recent changes to rules for setting the SyRB that were introduced by the CRD V, the current level of the SyRB use may not be a good guide to how macroprudential authorities might be expected to use it in the future. Therefore, the extent to which its use for macroprudential space would conflict with the principle of capital neutrality depends on the extent to which such usage would overlap with possible future usages of the SyRB by macroprudential authorities. See below.

<sup>64</sup> Additionally, the Commission’s authorisation is also required when the sum of the SyRB and the O-SII/G-SII buffers to which the same institution is subject results in a combined rate higher than 5%.

requirements, from 2.1% to 1.2% on average, albeit with significant heterogeneity across banks).

**Capital neutrality at implementation could in principle be achieved if the increase in the SyRB rate were compensated by a corresponding decrease in another buffer requirement (see Box 3).** In this case, the option would comprise the possibility to lower the MDA trigger point below current levels. In contrast to the CCyB, the SyRB can be applied to the TREA, which implies that a positive neutral SyRB would affect all the exposures (also those outside the euro area) of banks to which it is applied in the same way. This would make a possible capital neutral introduction of a core SyRB via rebalancing from other requirements easier.

## European governance

**Since the SyRB can be applied to subsets of exposures and/or banks, there is a particularly strong need for coordination and/or enforcement of a common approach.** As the SyRB is an instrument with many different potential applications, the creation of a centrally agreed framework is particularly important in this option, to avoid fragmentation in the EU and to ensure that authorities apply the core SyRB in the same manner. One step further would be to set up a centrally governed framework. As explained in Section 3.1, possible options for how such governance arrangements could be implemented in the complex European legal framework for macroprudential policy relate to (i) changes in legislation; (ii) making use of the ECB's top-up powers and their possible repeal; and (iii) softer forms of centralisation, such as recommendation powers or common methodologies.

**For options with explicit centralised decision-making, the centralised core SyRB and the national SyRB components would both operate on the same buffer.** Such variants would not constrain current national powers to use the SyRB for addressing macroprudential or systemic risks. However, the regular component of the SyRB would be operated under the same tool as the core rate. Depending on the precise design of the option, this could lead to additional complexity in governance of the instrument and public communication and potentially reduce the instrument's effectiveness should financial institutions be uncertain about the outlook for buffer requirements. Of course, when setting a core SyRB rate centrally, the ECB would need to consider how the core SyRB rate should interact with SyRB rates set by NDAs (see Box 5). Finally, use of the SyRB among SSM countries has thus far been limited, so governance and communication issues could be contained if this pattern persisted in the future.

## Simplicity

**Having two separate instruments for different risks (the CCyB for cyclical risks related to credit dynamics and the SyRB for residual risks of a cyclical or structural nature, but also for other unforeseeable shocks) could help to maintain the clarity and transparency of the buffer framework.** At the same time,

structural risks can affect countries heterogeneously, depending on the financial cycle (exemplified by how the COVID-19 shock has worked out heterogeneously among countries). As such, the distinction between cyclical and structural risks and the subsequent effects might not be clear-cut. Separately from this discussion, it can be argued that the SyRB (if applied to all exposures, and similar to the CCoB) is more suited to addressing pan-European or global systemic shocks than the CCyB, since the latter only covers domestic exposures. However, activating a CCyB at banking union level (see Section 4.2) could mitigate this issue to a large extent.

**The scope of application of a core SyRB needs to consider its interaction with the O-SII buffer and has a more complex activation procedure if it goes above the 5% threshold (SyRB + O-SII), unlike the CCoB and CCyB options.<sup>65</sup>**

Establishing a core SyRB rate may mean that NDAs need more time to tackle unrelated systemic risks with the SyRB, given the different approval thresholds established in the CRD.<sup>66</sup> One option to reduce the interaction with the O-SII buffer and to maintain national authorities' flexibility within the SyRB framework is to exclude the euro area level core SyRB from the SyRB rate relevant for determining the activation procedures. This, however, would warrant a legislative change.

## Box 5

### Interaction between centrally set core SyRB rates and national SyRB rates

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Ex ante dialogue between the ECB and NDAs would be needed to establish the degree of overlap (in terms of risk coverage) with any existing SyRB rates set in each country. Such dialogue is in any case required by the SSM Regulation before the ECB exercises its power to set higher buffer rates than those set by national authorities (Article 5(2) of the SSM Regulation).

Where an NDA has set a positive SyRB rate for total exposures, the ECB would need to decide whether or not the centrally set core SyRB rate should apply additively to that national SyRB rate. Similarly, where an NDA has set a positive SyRB rate for sectoral exposures, the ECB would need to decide whether or not the centrally set core SyRB rate should apply additively to that SyRB rate. In both cases, this would need to be considered in dialogue with the NDA.

For example, consider a scenario where (a) the ECB decides to establish a 1% core SyRB rate to mitigate the risk of major systemic shocks, and (2) an NDA has set a 2% SyRB for domestic residential property exposures. In this scenario, the ECB would need to decide whether the combined SyRB rate for domestic residential property exposures should be 2% or 3%.

Applying the core SyRB rate in parallel to the sectoral SyRB would leave the buffer requirements for that sectoral exposure unchanged. The effect would be that buffer requirements for exposures previously not covered by the sectoral buffer would come closer to (or to the same level of) the

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<sup>65</sup> The Commission's authorisation is required if the sum of an institution's combined SyRB rate and an institution's G-SII or O-SII buffer rate exceeds 5%.

<sup>66</sup> Where the combined SyRB rate for a given set or subset of exposures is less than 3%, the authority must notify the ESRB one month before publication of the decision. Where the combined SyRB rate for a given set or subset of exposures is between 3% and 5%, the authority must request an opinion of the Commission, which will be issued on a comply or explain basis. Where the combined SyRB rate for a given set or subset of exposures is above 5%, the authority must obtain authorisation from the Commission.

requirements for exposures already subject to the sectoral SyRB. Such an approach would limit the capital impact of the core SyRB rate in jurisdictions that have already applied the SyRB on a sectoral basis.

In contrast, buffer requirements would increase for all exposures if the core SyRB were additive to the existing sectoral requirement. A possible benefit of additive application is that it would ensure that a repeal of the decision in the event of a major systemic shock would necessarily reduce the combined SyRB rate for the given exposures. Also, incentive structures arising from differential treatment (i.e. pricing) of risks from different subsets of exposures would remain intact.

It should be noted that the CRD requires buffer rates to be reviewed at least every two years. This means the process of determining how the core SyRB rate interacts with SyRB rates set by individual NDAs would be an iterative and ongoing process, and not limited to the initial implementation of the core SyRB rate (or its reintroduction after a release).

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## 5 Additional policy considerations

### 5.1 Cross-cutting considerations on instrument design

**While the previous section provided a thorough assessment of the three policy options, there are a number of cross-cutting issues that warrant similar consideration under each option.** Specifically, these issues relate to a clear framework for building up and releasing the new tool, the role of cross-country heterogeneity, the magnitude of the new releasable buffer at central level, the possibility of conditional buffer releases, and the need to coordinate the measure more broadly within the EU.

**Regardless of the specific policy option, a clear framework for building up and releasing the buffer(s) is essential for ensuring policy effectiveness and will help increase the predictability of changes in capital requirements.** A clear delineation of the conditions, modalities and size of the release of the instrument will reduce regulatory uncertainty and compliance costs for banks and allow for a forceful reaction in the event of the specific targeted shock. In this respect, the framework will also have to include a process to formally determine whether a “large and disruptive systemic shock” has taken place. Adequate timing and conditions for replenishment must balance several factors. On the one hand, the replenishment path needs to be sufficiently smooth to incentivise banks to effectively use the released capital when needed, also accounting for economic uncertainty at the time of release. On the other hand, the buffer needs to be rebuilt sufficiently fast to ensure sufficient macroprudential space in a possible subsequent crisis of similar scope. For options with the possibility to go below current overall requirements, the latter is essential for avoiding a medium-term decrease in financial system resilience in the banking union.<sup>67</sup> Overall, and depending on the degree of coordination or centralisation ultimately implemented, the decisions on a potential build-up and release would need to be based on strict and transparent criteria and could be made by the ECB Governing Council (e.g. following the regular macroprudential decision-making process). Softer forms of centralisation might be pursued via recommendations, common methodologies or the ESRB’s coordinating tasks.<sup>68</sup> If the first option of centralisation is preferred, the voting mechanism would need to foresee a procedure for involving Member States in close cooperation or all SSM participating Member States that are not represented with a voting right in the Governing Council. This is

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<sup>67</sup> There is considerable uncertainty about the costs of lower solvency in terms of output loss. The costs are likely to vary across Member States due to different starting values of solvency and differences in the impact of a banking crisis on GDP. The impact of the global financial crisis on banking union countries differed substantially. Faster replenishment of buffers reduces crisis probability and crisis costs. Permanently lower solvency may also have a negative impact on bank funding costs, which may again differ across countries (e.g. depending on differences in starting levels of solvency, share of wholesale funding, initial ratings as well as potential rating downgrades and alternative funding sources for the real economy (such as market-based finance, leasing and factoring)). Faster replenishment of buffers could help to reduce the impact of solvency on funding costs and the real economy.

<sup>68</sup> Further consideration and a legal assessment may be warranted to analyse whether the current voting procedure (including rotation of voting rights in the Governing Council) is well-suited to achieving a decision on the build-up and release of the centralised tool in the banking union.



less of an issue with the other forms of centralisation. Moreover, under any option, processes would have to be designed to avoid inaction bias.

**The framework for both building up and releasing the buffer will have to consider the role of cross-country heterogeneity with respect to starting points, national macroprudential approaches and the (possibly asymmetric) impact of systemic shocks.** Given that a large and disruptive systemic shock is unlikely to hit all SSM Member States equally, further consideration may be warranted as to whether the buffer should also be releasable for a subset of countries/sectors/banks (see also additional discussion in Section 5.2). While this could allow for a more targeted policy response, it could make the policy options more complex and affect the European and international level playing field. Additionally, while some countries may appear to be initially more affected by such shocks than others, it may be difficult to differentiate which countries will be most severely affected in the medium term. A simultaneous release of the buffer across all countries in response to a large, disruptive systemic shock could send a powerful signal to financial markets, while a partial release could be perceived as a weaker policy signal in view of prevailing uncertainty about the ultimate consequences of the shock. A common release would help prevent reductions in credit supply or disruptions to critical financial services, including in countries that appear less initially affected by the shock. Moreover, giving a centralised body the power to release capital requirements in a subset of countries/sectors/banks may come with a risk of negative stigma effects in these countries/sectors/banks. Operationally, however, a definition of what constitutes a shock hitting “large parts of the banking union simultaneously” needs to be agreed.

**Similarly, further consideration may be warranted as to whether there could be different speeds of rebuilding the buffer after the crisis, depending on the (ex post) country-specific impact of the shock, banks’ situation, and/or financial conditions more broadly.**<sup>69</sup> This would also have to take into account the situation where a centrally induced release may run counter to the speed of recovery/cyclical normalisation in some Member States, where cyclical developments may already signal the need for macroprudential tightening. Specifically, the net benefits and the optimal length of buffer releases are likely to vary across countries. As noted above, these considerations speak in favour of keeping a key role for national authorities or at least embedding a consultative role for national authorities into any central governance framework. In any case, the framework for both the release and subsequent replenishment of the buffer will have to consider the interaction of decision-making at central and national levels.<sup>70</sup>

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<sup>69</sup> Notably, even large and disruptive common shocks may have significantly heterogeneous implications across countries, depending on countries’/banks’ pre-existing vulnerabilities and cyclical positions.

<sup>70</sup> The coordination and cooperation demands could warrant the setting up of an adequate forum for discussion, which could be the existing Financial Stability Committee or a dedicated standing committee. The respective group could work on buffer guidance for build-up and release to facilitate coordination in the banking union. In line with the discussion above, this guidance would have to account for the asynchronous nature of credit cycles across SSM countries when discussing a subsequent centralised build-up of the buffer at the SSM level, especially in terms of (i) the initial capital position of institutions in each country, (ii) the heterogeneous impact of the crisis on those institutions, and (iii) the period of time necessary to stabilise each economy.

**The magnitude of a new buffer (be it with central decision-making or via softer forms of centralised governance) needs to be large enough to ensure policy effectiveness while at the same time accommodating the need to maintain sufficient policy space at the national level.** On the one hand, the buffer should not be too small, so as to ensure that its release in response to large and disruptive systemic shocks at the banking union level can have a meaningful impact. On the other hand, the imposition of the new buffer should not overly constrain the national policy space and should maintain sufficient flexibility to address cross-country heterogeneity (e.g. in terms of starting points and expected impact of shocks, see Section 5.2 for further discussion on this point). Moreover, while a smaller releasable component has the disadvantage of reducing the scope of action of the centralised authority, the replenishment of a larger centralised buffer could more easily collide with national authorities' decision-making process for the build-up of other macroprudential buffers. The interaction between decision-making on releasable buffers at the central and national levels will be discussed further in the next subsection.

**Further assessment of possible complementary measures or conditional buffer releases could be considered under any of the policy options.** As explained earlier, possible downsides of buffer releases in the shape of potentially lower solvency are interdependent with the benefits of the measures, since releasing buffers does not necessarily imply deteriorating solvency positions at the aggregate level, if the benefits in the form of additional productive lending or conservative provisioning are high and ensured. The social benefits of buffer releases could be larger in countries where banks distribute less free capital and/or are closer to their regulatory threshold and where non-financial corporations are more dependent on bank funding. They could be smaller – and even negative – in countries facing excessive credit growth and/or systemic risk induced by residential real estate. Possible ways to enhance social benefits could include complementary measures aimed at preventing imprudent payouts, or “conditional buffer releases” where the (ex post) release is made conditional (ex ante) on certain types of buffer use (e.g. additional productive lending, conservative provisioning, or minimum efforts on debt restructuring and forbearance for viable debtors). While conditional buffer releases are theoretically appealing, they may also have downsides, as they may pose substantial operational challenges and could also have unintended consequences for banks' lending practices.

**Decisions on the release and eventual rebuilding of the buffer would ideally be coordinated, not only in the banking union but across the entire EU.** To safeguard market confidence, it would be desirable to ensure that release and replenishment decisions are aligned within the EU, which would require the involvement of the ESRB and/or other EU institutions and could arguably increase complexity. Specifically, the ESRB with its substructures could provide the necessary coordination fora, in the shape of existing groups or a new standing committee at EU level, for discussing buffer release and replenishment. Given the importance of the Internal Market, it may also be necessary to assess whether the concept of macroprudential space needs to be introduced in other EU countries as well. Finally,

implications for the reciprocity framework and related legal provisions would have to be assessed for each of the policy options.

## 5.2 Possibility of mixing different instruments

**In order to increase the share of releasable buffers available to macroprudential authorities, it might be worth considering the possibility of mixing different types of releasable buffer.** On the one hand, combining more than one releasable buffer would increase the framework's flexibility, allowing authorities to address different risks in a more tailored way. Specifically, combinations of options could help to address difficult procedural issues that may arise if risk only materialises in some members of the banking union, potentially making it difficult to release a common buffer if the respective shock is not "sufficiently widespread". More generally, it could also help to address cross-country heterogeneity in the event of an asymmetric or asynchronous systemic shock hitting (large parts of) the banking union, in response to which there may be no one-size-fits-all approach for releasing and rebuilding (at a later stage) capital buffers. Finally, by increasing the "degrees of freedom", it could also help to achieve agreement on the overall revision of the framework. On the other hand, the complexity of the system could increase.

**A possible mix of instruments could be based on the need to address different sources of systemic risk.** As already indicated, while the pandemic has highlighted the relevance of global or EU/SSM-wide shocks, large, disruptive systemic shocks may also occur at the national level (or at the level of a limited number of individual countries), and common shocks may have a heterogeneous impact across countries. Such cross-country heterogeneity is arguably best addressed at the national level, which could speak in favour of complementing a centrally governed macroprudential space with a national component.

**To deal with shocks that differ in their geographical impact, one possibility could be to combine a centrally governed releasable buffer with a national releasable buffer.** One specific example that was discussed by the Drafting Team but does not constitute a compromise solution or preferred option is to combine a partially releasable CCoB at the centralised level with a positive neutral rate for the CCyB or a core SyRB at the national level. Such a combination of options could provide more flexibility for national authorities than any fully centralised option, while at the same time maintaining some space for coordinated action. With respect to capital neutrality, it would combine a capital neutral element with an element that increases overall requirements. Moreover, it could have benefits in terms of governance, since the ECB and national authorities would each be responsible for their respective tools. Nevertheless, it could increase operational and legal complexity relative to the current framework. Importantly, all considerations stemming from the assessment of the individual options discussed in Section 4 would continue to apply in a combined option. As discussed in that section, different possibilities are conceivable for the precise design of the instruments.

For example, the centralised partial release of the CCoB could be framed as a “systemic risk exemption”, to be considered only under very rare and exceptional circumstances, and it could be coupled or not with the imposition of a form of partial, system-wide (dividend) distribution restrictions. Over the longer term, following the finalisation of Basel III, a more flexible national component could be added in the form of either a positive neutral rate for the CCyB or a core rate for the SyRB. There would be national flexibility to decide on the build-up and release of this component, although some common guidelines or understanding could be helpful. While the Drafting Team has discussed this specific example, there is no consensus that this (or another) mixed option would be preferable to any of the individual options, as members’ preferences are broadly scattered.

## 6 Conclusion

**This report discusses the benefits and drawbacks of three specific policy options aimed at operationalising an increase in macroprudential policy space – in the form of a higher amount of releasable capital buffers – in the banking union.** The policy options relate to (i) enabling the release of the CCoB, (ii) a positive neutral rate for the CCyB, and (iii) a core rate for the SyRB. Each policy option is evaluated based on five broad criteria, including (i) financial system resilience, (ii) Basel compliance, (iii) capital neutrality, (iv) European governance, and (v) simplicity. For some of the criteria, notably capital neutrality and European governance, views in the Drafting Team differ on whether meeting them is desirable.

**The assessment in the report illustrates that no single policy option easily matches all five criteria that are considered, and discussions in the Drafting Team have shown that – while there is broad agreement on the usefulness of increasing the amount of releasable buffers – preferences on the policy options are very scattered across members.** Different members attach different weights to the importance of individual criteria, with no option emerging as the single most preferred one. Against this background, the report thoroughly discusses the advantages and disadvantages of the three policy options, reflecting a balance of views in the Drafting Team, but does not establish a hierarchy of the options or recommend one specific option, in view of the macroprudential review. It does not aim to rank the options or weight the relative importance of the different criteria, but rather leaves this to the EU legislator.

**Considering the lack of consensus in the Drafting Team on many elements of the work, a possible way forward could be to investigate how elements of the various policy options could be combined to find greater agreement, while at the same time accounting for the various concerns that have been raised.** The report discusses the possibility of mixing the options in Section 5. There is no consensus in the Drafting Team that a potential mixed option would be preferable to any of the individual options, as members' preferences are also scattered in this respect. Nevertheless, the possibility of mixing different options increases the degrees of freedom to a certain extent and could hence be a fruitful avenue for further work and consideration.

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# Annex

## Annex 1: Legal considerations on centralised governance

### I. Central governance under the current legal framework

#### A. The “top-up” power

##### 1. General remarks

1. The SSM Regulation confers on the ECB specific tasks relating to the prudential supervision of credit institutions in participating Member States. These tasks include measures taken in pursuance of macroprudential stability. However, in carrying out macroprudential tasks, the ECB exercises a complementary competence. This means that it can only apply higher requirements for macroprudential capital buffers or more stringent measures aimed at addressing systemic or macroprudential risks than those applied by the national authorities. It follows that the ECB cannot lower a capital buffer requirement set by a national authority or apply less stringent requirements. Article 5(2) of the SSM Regulation provides that (our emphasis):

*“The ECB may, if deemed necessary, instead of the national competent authorities or national designated authorities of the participating Member State, **apply higher requirements for capital buffers than applied by the national competent authorities or national designated authorities of participating Member States** to be held by credit institutions at the relevant level in accordance with relevant Union law in addition to own funds requirements referred to in point (d) of Article 4(1) of this Regulation, including countercyclical buffer rates, subject to the conditions set out in paragraphs 4 and 5 of this Article, **and apply more stringent measures aimed at addressing systemic or macroprudential risks** at the level of credit institutions subject to the procedures set out in the Regulation (EU) No 575/2013 and Directive 2013/36/EU in the cases specifically set out in relevant Union law.”*

2. Article 4(3) of the SSM Regulation provides that the ECB, in exercising its tasks as a competent or designated authority, must apply all relevant Union law.<sup>71</sup> This

<sup>71</sup> See also Article 102 of Regulation (EU) No 468/2014 of the European Central Bank of 16 April 2014 establishing the framework for cooperation within the Single Supervisory Mechanism between the European Central Bank and national competent authorities and with national designated authorities (SSM Framework Regulation) (ECB/2014/17) (OJ L 141, 14.5.2014, p. 1). This provision acknowledges that where a directive provides for macroprudential tools, the ECB shall comply with the national law implementing that directive.

means that the ECB must follow the coordination procedures and meet the relevant requirements applicable to setting capital buffers or imposing more stringent measures under Chapter 4 of Title VII of the CRD.<sup>72</sup> For example, under Article 133(1) of the CRD, the SyRB can only be applied “[...] *in order to prevent and mitigate macroprudential or systemic risks not covered by Regulation (EU) No 575/2013 and by Articles 130 and 131 of this Directive, in the meaning of a risk of disruption in the financial system with the potential to have serious negative consequences to the financial system and the real economy in a specific Member State*”. Moreover, in addition to the relevant requirements in the CRD, Article 5(5) of the SSM Regulation requires the ECB to “[...] *take into account the specific situation of the financial system, economic situation and the economic cycle in individual Member States or parts thereof*”.

3. It should be noted the provisions on the division of responsibilities concerning significant institutions and less significant institutions in Article 6 of the SSM Regulation do not apply to the ECB fulfilling its macroprudential mandate. As a result, any action taken by the ECB under Article 5(2) of the SSM Regulation can apply directly to significant institutions and less significant institutions in the participating Member States, as well as to institutions outside the participating Member States in the case of the CCyB rate.

## 2. Releasing the buffer

4. It is a general principle of public law that where legislation confers power on an authority to act, it comprises, unless the contrary intention is indicated, a power, exercisable in the same manner and subject to the same conditions or limitations, to revoke, amend or re-enact any instrument made under the power.
5. As a consequence, where the ECB has exercised its power to impose higher buffer requirements under Article 5(2) of the SSM Regulation, it can lower those requirements by (i) revoking the buffer requirement it has set, or (ii) resetting the buffer requirement at a lower level.
6. It is important to note that the ECB cannot release a buffer requirement set by a national authority. Therefore, any buffer requirement set by national authorities effectively serves as a floor. For example, if a national authority sets a buffer rate at 3%, the ECB can exercise its power to apply a higher buffer of 5%. The ECB could release the buffer by revoking its buffer requirement, in which case the applicable buffer rate would be 3%. Alternatively, the ECB could reset its requirement at a lower level, such as 3.5%. Because the ECB can only set higher buffer requirements, it would not be possible to reset the buffer at a rate below that set by the national authority, i.e. 3%.

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<sup>72</sup> On the coordination procedure, see the recital to the SSM Regulation, which states: “*The provisions in this Regulation on measures aimed at addressing systemic or macroprudential risk are without prejudice to any coordination procedures provided for in other acts of Union law. National competent authorities or national designated authorities and the ECB shall act in respect of any coordination procedure provided for in such acts after having followed the procedures provided for in this Regulation.*”

7. However, it would arguably be possible for the ECB to issue a recommendation (non-binding instrument) to national authorities, inviting them to release their buffer requirements.
8. Against this background and by way of illustration, the following three main scenarios can be distinguished:

**(a) The national authority has not exercised its discretion under the CRD to set a capital buffer requirement.**

The ECB can set a capital buffer requirement (y%) of  $y% > 0%$  in accordance with Article 5(2) of the SSM Regulation and subject to the requirements of the CRD for the specific buffer.

The ECB can release the capital buffer requirement it has set by (i) revoking its decision to set a capital buffer requirement, or (ii) resetting its capital buffer requirement below y% but above 0%.

**(b) The national authority has exercised its discretion under the CRD to set a capital buffer requirement at x%.**

The ECB can set a capital buffer requirement (y%) of  $y% > x%$  in accordance with Article 5(2) of the SSM Regulation and subject to the requirements of the CRD<sup>73</sup> for the specific buffer.

The ECB can release the capital buffer requirement it has set by (i) revoking its decision to set a capital buffer requirement, in which case the applicable capital buffer requirement falls back to x%; or (ii) resetting its capital buffer requirement below y% but above x%.

These two scenarios would be relevant if, for example, the ECB wanted to increase the SyRB rate or the CCyB rate or, in case EU legislation lowers the existing fixed rate of 2.5% for the CCoB and allows national authorities to increase the rate, the CCoB rate.

**(c) The national authority has exercised its discretion under the CRD to set a capital buffer requirement at x%, which is the maximum allowed under the CRD.<sup>74</sup>**

The ECB cannot set a higher capital buffer requirement.

If the CCoB regime were amended, as described above, and a national authority exercised its discretion to increase the rate up to 2.5%, then the ECB could not

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<sup>73</sup> The ECB could also extend the exposures to which the rate set by the national competent or designated authority applies. For example, if the national authority sets an SyRB rate for domestic exposures, Article 133(5)(a) of the CRD would allow the ECB to extend that rate to all exposures in the Union, under sub-paragraph (c) of that provision.

<sup>74</sup> See, for example, the maximum level for the O-SII buffer under Article 131(8) of the CRD.

further increase the rate.<sup>75</sup> However, it could use non-binding tools (such as recommendations) to invite national authorities to reconsider their decisions.

### 3. Increasing the space to act

9. It is clear from above that the ECB's scope to act is inversely related to the prior exercise by national authorities of their discretion to set capital buffer requirements. It could be argued that to free up the space for the ECB to act, if this were desirable from a policy perspective, the ECB could issue a recommendation to national authorities under Article 4(3) of the SSM Regulation, asking them not to set capital buffer requirements. However, such a recommendation may be inconsistent with the intention of the legislator, who specifically introduced a split of tasks between participating Member States and the ECB. Furthermore, national law is likely to impose an obligation on national authorities to act, and that obligation cannot be ignored by those authorities. Therefore, in the presence of existing systemic risks, it might be unlikely that national authorities would not exercise their powers, allowing the ECB to act. That said, the ECB could still play a role in coordinating the reaction of national authorities where risks of similar features are present in different Member States simultaneously.

## B. Using the top-up power in a uniform, i.e. centralised, way

### 1. Setting a common "base" or "core" rate

10. To ensure that all banks in participating Member States build up sufficient levels of releasable buffers in a consistent or uniform way, the ECB could consider setting a common "base" or "core" buffer rate.
11. In this context, it is important to recall that the capital buffer requirements under the CRD are designed to address specific macroprudential or systemic risks. Furthermore, the discretion to impose capital buffer requirements is intended to be exercised after careful analysis of the specific situation of the financial system, economic situation and economic cycle, as applicable, in the relevant Member State. Furthermore, as mentioned above, the SSM Regulation specifically requires the ECB to take into account the specific situation of the financial system, economic situation and economic cycle in individual Member States or parts thereof.
12. Therefore, the ECB would have to show that setting a common base or core buffer rate for the whole SSM is aimed at addressing these risks and takes into

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<sup>75</sup> Nonetheless, it would be possible for the ECB to seek to increase the level of the CCoB beyond 2.5% under Article 458(2)(d)(vi) of the CRR. It should be noted that Article 458 is only applicable to the CCoB; it cannot be used to increase the cap for the O-SII buffer for subsidiaries under Article 131(8) of the CRD.

account the idiosyncratic nature of the discretions; otherwise, there would be a significant risk that an ECB decision setting a common base or core buffer rate for the whole SSM could be challenged successfully. In particular, it would have to be shown that imposing the same level of capital requirements simultaneously in all participating Member States is consistent with the legislator's intention, given that doing so would appear to sidestep the national character of the macroprudential measures laid down in the CRD. Questions could also be raised about the proportionality of such policy. Nonetheless, it is conceivable that protecting against an external systemic shock, such as a global pandemic that may affect the financial systems of the participating Member States similarly, might justify setting a common base or core rate. But again, this would have to be assessed against the relevant requirements.<sup>76</sup>

## 2. Decision-making and close cooperation with the competent authorities of participating Member States whose currency is not the euro

13. According to Article 26(8) of the SSM Regulation, the Supervisory Board has a key role to play in carrying out preparatory work for the supervisory tasks conferred on the ECB. This includes drafting decisions, such as decisions under Article 5(2) of the SSM Regulation, to be adopted by the Governing Council. Nonetheless, in this particular field of decisions under Article 5(2) of the SSM Regulation, the Governing Council has the right to endorse, object to or amend any proposals from the Supervisory Board. It can also initiate the setting of higher buffer requirements by asking the Supervisory Board to submit a proposal for a decision or to provide specific analysis (see Article 13h(3) of the ECB Decision 2004/257/EC<sup>77</sup>). It is conceivable, therefore, that the Governing Council may deviate from the Supervisory Board's proposal.
14. In this context, it is important to note that central bank governors/presidents from Member States whose national competent authorities have established close cooperation with the ECB are not members of the Governing Council. Accordingly, centralising the governance of certain macroprudential powers (i.e. competence for a specific capital buffer) in the Governing Council may mean a lack of participation/involvement by the national competent authority in close cooperation.

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<sup>76</sup> From a practical point of view, it is worth highlighting the high number of procedures the ECB would have to launch to operationalise such a policy. In addition, the ECB would need to follow national law transposing those discretions, which adds another layer of complexity. Finally, the procedural and coordination rules in the CRD would, in certain circumstances, require an opinion from the European Banking Authority (EBA) and the ESRB, as well as an authorisation from the Commission. See, for example, Article 131(15) of the CRD, which requires the setting of the buffer to be authorised by the Commission if the sum of the G-SII or O-SII Buffer rate and the SyRB rate were to exceed 5%. This means that if the ECB wanted, for example, to set an SyRB rate of 3% for all banks in participating Member States, it would need to seek authorisation from the Commission in those cases where a G-SII or O-SII is already subject to a buffer of more than 2%.

<sup>77</sup> 2004/257/EC: Decision of the European Central Bank of 19 February 2004 adopting the Rules of Procedure of the European Central Bank (ECB/2004/2) (OJ L 80, 18.3.2004, p. 33).

15. One way to address this could be, for example, to grant a permanent observer seat at the Governing Council to the governor/president of the national central bank whose national competent authority has established close cooperation. The permanent seat could be granted solely for discussions on macroprudential measures, or the relevant persons from the Member State whose national competent authority has established close cooperation could be (regularly) invited to the respective meetings of the Governing Council.
16. The applicability of the Disagreement Procedure<sup>78</sup> with respect to macroprudential decisions needs to be explored further.

## II. Possible changes to existing legal framework

17. If the (re-)setting and release of any of the macroprudential buffers under the CRD by the Governing Council is considered too constrained under the current legal framework, the ECB could use the Commission's upcoming review of the macroprudential rules under Article 513 of the CRR<sup>79</sup> or the triennial review under Article 32(d) of the SSM Regulation to seek a change to Article 5(2) or Article 26(8) of the SSM Regulation or to confer on the ECB additional powers.
18. A change could take the form of an amendment to the SSM Regulation or a new Council regulation based on Article 127(6) of the TFEU, which could confer new powers on the ECB. More specifically, a new Council regulation could confer upon the ECB a power to release a specific capital buffer requirement in the event of an SSM-wide systemic shock, whether or not that capital buffer requirement has been set by the ECB or a national authority.
19. The conferral of additional, specific macroprudential tasks upon the ECB could be achieved, for example, by introducing an additional paragraph under Article 5 of the SSM Regulation, setting out that in deviation from paragraphs 1 and 2 of Article 5 of the SSM Regulation, the ECB can release a specific capital buffer requirement, including a requirement set by a national authorities, to mitigate SSM-wide systemic shocks.

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<sup>78</sup> Pursuant to Article 7(7) of the SSM Regulation, "If a participating Member State whose currency is not the euro notifies the ECB in accordance with Article 26(8) of its reasoned disagreement with an objection of the Governing Council to a draft decision of the Supervisory Board, the Governing Council shall, within a period of 30 days, give its opinion on the reasoned disagreement expressed by the Member State and, stating its reasons to do so, confirm or withdraw its objection".

<sup>79</sup> See footnote 42.



## Annex 2: Relevant excerpts on buffer usability from recent FSB, BCBS and MPAG/MPPG reports

### A. FSB interim report to the G20 on “Lessons learnt from the COVID-19 pandemic from a financial stability perspective”<sup>80</sup>

Authorities released countercyclical capital buffers (CCyB) quickly, but these were not always available or of sufficient scale to provide substantial additional macroprudential space. Some jurisdictions had set a positive CCyB in recent years and most released the buffer in response to the pandemic. In other cases, where a positive CCyB was not in place, authorities lowered other regulatory requirements or buffer levels. While it is difficult to assess the quantitative effect of these capital releases, there is some evidence that they had a positive effect on lending during the pandemic. These findings suggest that it may be beneficial to consider whether there is sufficient releasable capital in place to address future systemic shocks.

Banks generally did not need to use their capital buffers to meet loan demand thus far. Such buffers, which sit above regulatory minimum requirements, are intended to be used in times of stress to absorb losses and to allow banks to continue to supply credit to the economy, which supports a faster recovery and lower subsequent losses. Overall, banks maintained their strong capital positions during the pandemic, as reflected in significant capital headroom (Graph 2.3). In part, this has been due to fiscal support to households and non-financial firms that helped to reduce loan losses and the restrictions on capital distributions via dividend payments and share buybacks that resulted in banks retaining capital. Taken together, most banks did not, in fact, need to use their buffers.

However, some evidence suggests that banks may have been hesitant to dip into their buffers had it been needed, in spite of the flexibility embedded in the regulatory framework. Potential reasons include: the fear of market stigma associated with buffer use that may lead to adverse market reactions; the uncertainty in macroeconomic outlook that prompts capital buffer conservation to be able to absorb potential future losses, and the preservation of liquid assets; and the uncertainty in supervisory expectations or responses in case of buffer use (including in terms of the timeframe for rebuilding those buffers). Overall, the functioning of capital and liquidity buffers may warrant further analysis.

### B. BCBS report on “Early lessons from the Covid-19 pandemic on the Basel reforms”<sup>81</sup>

The analysis indicates that most banks maintained capital ratios well above their minimum requirements and buffers during the pandemic partially due to authorities

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<sup>80</sup> See [Financial Stability Board \(2021\)](#).

<sup>81</sup> See [BCBS \(2021\)](#).

reducing capital requirements and buffers and imposing restrictions on capital distributions via dividend payments and share buybacks, as well as due to the extensive fiscal and monetary support provided to borrowers. This makes it difficult to draw conclusions regarding banks' willingness to use capital buffers. Though some evidence suggests that banks may have been hesitant to use their regulatory capital buffers had it been necessary.

Regression results, including a detailed study of loan data from the euro area, indicate that banks that had less headroom (ie the amount of capital resources above minimum capital regulatory requirements and buffers) tended to lend less during the pandemic than those with more headroom. However, it is 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.

Most authorities that maintained a positive countercyclical capital buffer (CCyB) prior to the pandemic reduced them in order to provide banks with additional headroom. Similarly, several authorities that did not have positive CCyBs lowered other regulatory requirements or buffer levels. While it is difficult to assess the quantitative effect of these capital releases independent of other measures, analysis provides some evidence that the capital release had a positive effect on lending during the pandemic. These findings, taken together with supervisors' survey responses, suggest that it may be beneficial to consider whether there is sufficient releasable capital in place to address future systemic shocks.

### C. Buffer Usability – Report of the MPAG/MPPG EG on “banks’ response to the crisis and policy effectiveness”

The analysis of the Expert Group (EG) covered the following topics:

(i) micro-econometric analyses of individual bank behavior in proximity of the combined buffer requirement and discussion of possible impediments to the use of capital buffers; (ii) model-based analyses of possible macroeconomic implications of impediments to the use of capital buffers; (iii) impact of pandemic capital buffer releases and dividend restrictions.<sup>82</sup>

The first area of work of the EG relates to micro analyses of banks' behaviour and possible impediments to buffer use. While unprecedented policy action in response to the pandemic supported banks' capital ratios and the supply of credit, importantly the analyses of the EG show that proximity to the CBR is associated to stronger risk weight density reductions and lower credit supply during the pandemic. There is also some evidence that proximity to the CBR translates into a smaller decrease in interest rates on small loans. These results offer insights on the functioning of the capital

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<sup>82</sup> This section is linked to the results of individual analyses presented in the study by [Couaillier et al. \(2022\)](#) and in the Special Feature A of the ECB's November 2021 Financial Stability Review on “Bank capital buffers and lending in the euro area during the pandemic” by [Couaillier et al. \(2021\)](#). See also Section 1 of the Annex 1 – Analytical annex of the ECB response to the call for advice of the European Commission on the macroprudential review.

framework<sup>83</sup> and inform on possible assumptions on banks' behaviour that could be used in macro models.<sup>84</sup>

In what concerns the possible explanation for banks' behaviour in proximity to the CBR, the evidence remains inconclusive and does not clearly point to a specific channel. Therefore, it is likely that several channels are at play. First, possible funding pressures and market stigma could result in banks' unwillingness to use the CBR. So far, however, analyses of the EG do not highlight significant market pressure on banks. Second, automatic restrictions to distributions could make banks unwilling to use the CBR.<sup>85</sup> Third, despite supervisory flexibility in response to the pandemic, banks might still be unwilling to dip into the CBR to avoid closer supervisory scrutiny.<sup>86</sup> Finally, notwithstanding the important "backstop role" of the leverage ratio, the ESRB ATF on "overlaps" highlighted the role of other binding parallel requirements (leverage ratio and MREL) in limiting the usability of the CBR. Also, the interim report<sup>87</sup> of this Expert Group highlighted that the leverage ratio could limit the use of the CBR in some banking systems.<sup>88</sup>

The second area of analysis of the EG relates to the possible macro implications of impediments to capital buffer usability. While, to date, impediments to capital buffer usability did not have visible systemic effects, to assess their possible macro impact, the EG present a scenario exercise, taking into account heterogeneous distribution of capital across banks and system dynamics. The results show that in adverse scenarios the systemic impact of constraints to capital buffer usability crucially depends on the possibility for credit substitution across banks in the system. In a situation where banks do not use the CBR (i.e. they only use management buffers), if there is large room for credit substitution in the system (i.e. when firms can freely move across banks, i.e. "upper bound" for substitution) deleveraging is limited (almost not material). Contrarily, in a scenario where credit substitution is limited (i.e. when only the existing bank-firm relationships are kept, i.e. "lower bound") deleveraging can be

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<sup>83</sup> While lessons can be learnt about the functioning of the framework during the pandemic, views from members differ on whether the pandemic can be considered a real test for the capital framework.

<sup>84</sup> While standard econometrics caveats apply, these findings are robust across econometric techniques, specifications and approaches using different data which allow for a better identification of the effects of proximity to CBR on outcome variables, controlling for banks specific features, credit demand and the impact of other policies, including fiscal policies. Some methods (difference-in-differences and propensity score matching) aim at isolating the effect of the proximity to CBR from other bank-specific factors that may have affected the outcome variables during the pandemic (e.g. differences in solvency, asset quality, profitability, etc.). Other methods (based on loan-level data and bank-firm credit relationships) make sure that the unwillingness to use the CBR is not determined by differences in credit demand. In addition, all analyses control for the impact of other policies, including guarantees, moratoria and monetary policy either at the bank level or at the level of individual loans subject to guarantees or moratoria. This allows to disentangle the effect of banks' distance to the CBR on the outcome variables from the effect of the pandemic fiscal support packages and monetary policy measures. Although the results are consistent, a number of econometric caveats apply. For instance, while loan-level data strengthens the econometric identification, it limits the analyses to NFCs only, i.e. discarding the effect of bank distance to the CBR on households.

<sup>85</sup> While dividend distribution restrictions that were enacted during the pandemic made this channel less relevant in the past months, banks may still be reluctant to dip into the CBR to avoid automatic limitations in the future.

<sup>86</sup> In addition, economic uncertainty, the possible replenishment path of buffers and profitability challenges, which make buffer replenishment more difficult, can also play a role.

<sup>87</sup> See section 2.3 of the interim report.

<sup>88</sup> Earlier econometric analyses from the EG, however, do not find evidence that the distance from leverage ratio drives the different behaviour of banks.

significant, thus having material costs on economic growth. Several factors could affect the possibility for credit substitution (not analyzed in the report). On the one hand, competition in the banking system could enhance the ability of borrowers to move across lenders. On the other hand, economic uncertainty and borrowers' opacity (e.g. micro and small firms)<sup>89</sup> could limit credit substitution.

Finally, the third area of analysis covers the impact of pandemic capital releases and the effects of dividend restrictions, two possibly complementary policies. According to analyses that use micro data to control for credit demand and exploit bank's heterogeneity also in relation to capital positions, CBR and P2R releases had positive effects on the credit supply by increasing lending and lowering interest rates. Two factors are at play: First, when capital requirements are released banks revise their capital targets accordingly. This may mitigate procyclical target adjustment in crisis time. Second, if the CBR is reduced, banks gain distance to the MDA threshold and may then be less prone to the balance sheets adjustments highlighted by the micro analysis.<sup>90</sup> Furthermore, the positive effects of capital releases on the credit supply appear to be stronger for banks that are closer to the CBR and for banks with higher profitability. Regarding temporary dividend restrictions, the evidence reviewed by the EG suggests that they contributed to conserving capital,<sup>91</sup> had positive effects on lending and resulted in higher provisioning for a sample of SSM's banks. At the same time, they had negative effects on market valuations of banks on the short term.

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<sup>89</sup> Opaque borrowers could be considered less likely to find new lenders, especially in periods of heightened economic uncertainty.

<sup>90</sup> At the same time, so far, the analysis of the EG did not find evidence that flexibility granted with respect to P2G had positive effects on the credit supply.

<sup>91</sup> In September 2020, dividends not distributed following the recommendations amounted to €27.5 billion in the euro area, which positively contributed to capital ratios.

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**Sergio Nicoletti Altimari** (chair)

European Central Bank

**Markus Behn** (rapporteur)

European Central Bank

**Alessio De Vincenzo**

Banca d'Italia

**Alexandre Francart**

Nationale Bank van België/ Banque Nationale de Belgique

**Robert Kelly**

Central Bank of Ireland

**Samu Kurri**

Finnish Financial Supervisory Authority

**Ana Cristina Leal**

Banco de Portugal

**Carlos Pérez Montes**

Banco de España

**Fatima Pires**

European Central Bank

**Marc Roovers**

De Nederlandsche Bank

**Markus Schwaiger**

Oesterreichische Nationalbank

**Katja Taipalus**

Suomen Pankki – Finlands Bank

**Roberto Ugena**

European Central Bank

**Édouard Vidon**

Banque de France

**Esther Wehmeier**

European Central Bank

**Benjamin Weigert**

Deutsche Bundesbank

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Postal address 60640 Frankfurt am Main, Germany

Telephone +49 69 1344 0

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