

Annex 3: Methodologies for setting capital buffers

Introduction

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

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

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

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

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

1. Capital conservation buffer

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

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

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

2. Capital buffer for systematically important institutions (O-SII)

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

The FME sets the rate based on a recommendation from the Financial Stability Council (FSC). FSC also determines which institutions are systematically important, cf. point c of Article 4(2) of Act

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

² Cf. however, temporary provision XIII of Act N. 161/2002.

No 66/2014, using the following criteria, which is based on Guidelines issued by the European Banking Authority:³

- a) Size
- b) Importance for the economy of the Union or of the relevant Member State
- c) Significance of cross-border activities
- d) Interconnectedness of the institution or group with the financial system

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

3. Systemic risk buffer

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

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

The systemic risk buffer shall apply to all financial undertakings, or one or more subsets of those institutions, for which the FME decides and shall be set from 1% and then in gradual or accelerated steps of adjustment of 0.5 percentage points. The requirement to maintain the buffer can vary depending on the type of the financial undertaking. The systemic risk buffer may apply to domestic exposures but may also apply to exposures in other countries. The FME may recognise systemic risk buffers imposed by other countries for exposures in those countries.⁴

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

When the systemic risk buffer only applies to domestic exposure, the effective risk buffer rate is calculated by multiplying the proportion of the domestic credit risk exposure by the domestic systemic risk buffer rate.

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

4. Countercyclical capital buffer

According to Article 86 (d) of Act No. 161/2002, the FME can impose a requirement for institutions to maintain a countercyclical capital buffer based on recommendations from the FSC. The requirement must be met by CET1 capital and is calculated as a percentage of total risk exposure amount and shall be maintained on an individual and consolidated basis. The FSC shall on a quarterly basis present a recommendation to the FME on the value of the buffer based on

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

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

analysis performed by the SRC. If the buffer rate is increased, it should generally take effect no later than 12 months after the decision is made.

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

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

The countercyclical capital buffer enhances institutions' resilience and reduces the likelihood of financial crises. Releasing the buffer during times of stress gives institutions capacity to lend money during a financial cycle downturn, thereby mitigating its impact on the real economy. When deciding to impose the buffer, the financial cycle position is considered, as is the buffer's expected impact on credit growth which is determined, among other things, by the scope of the increase in capital requirements which must take place as a result of the decision.

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

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

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

The weight for the buffer add-on rate applicable in a given jurisdiction is the credit risk charge that relates to private sector credit exposures allocated to that jurisdiction, divided by the institutions' total credit risk charge that relates to private sector credit exposures across all jurisdictions.

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

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

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

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

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