ANALYSIS

How can Finland's use of the countercyclical capital buffer requirement be further developed?

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Finland's application of the countercyclical capital buffer (CCyB) requirement could support bank lending in a more flexible manner than at present in situations where an external shock to the financial system poses a serious threat to the functioning of the credit market. This could involve, for example, setting the buffer requirement above zero already at the neutral phase of the credit cycle, which could be carried out in a variety of ways but would necessitate regulatory changes.

The capital buffer requirements used as macroprudential policy tools in Finland should

be developed further. They should allow the macroprudential authority to better support bank lending in a difficult environment. One possibility would be to relax the requirement to maintain a countercyclical capital buffer (CCyB) if, for example, an external shock to the financial system were to cause losses to banks and seriously undermine the provision of credit. This is not an option at present.

In Finland, the CCyB requirement can currently be imposed if, based on the applicable risk indicators, the credit market is observed to be overheating or there is other evidence of the existence of cyclical systemic risks. If the credit market is calm (i.e. the credit cycle is in a neutral phase), the CCyB rate has to be kept at zero and may not be relaxed. The other existing instruments would be of no help either, because, as a rule, the structural buffer requirements[1] are not meant to be relaxed unless the risks or vulnerabilities addressed by them are easing.

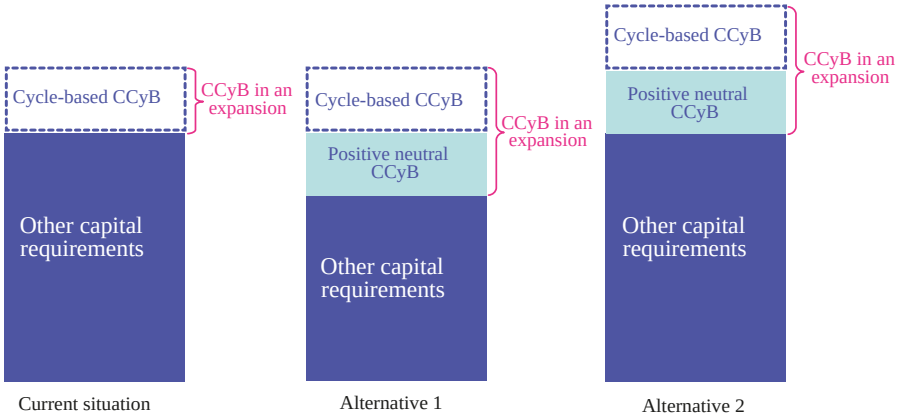
Systemic stress in the credit market can originate not only from the realisation of systemic risks inherent in the financial system but also from severe external shocks such as the COVID-19 pandemic that began in 2020 or Russia's invasion of Ukraine, which started last year. For this reason, many European countries and certain other countries, too, have decided to set their CCyB rate at a higher level than would be justified on the basis of the phase of the credit cycle.

Chart 1 compares the current application of the CCyB requirement in Finland and two alternative approaches for meeting severe external shocks to the financial system. Under both alternative approaches, the CCyB rate is already set at a specific level (i.e. above zero) in the neutral phase of the credit cycle and is raised further in the cycle's expansion phase. At the contraction phase of the cycle or during other shock events, the buffer can be fully released.

1. Systemic risk buffer (SyRB) and buffer requirements for global and other systemically important institutions (G-SII and O-SII buffers).

Chart 1.

Alternatives for imposing positive CCyB requirement in neutral phase of credit cycle



CCyB = countercyclical capital buffer.

Source: Bank of Finland.

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A positive neutral rate for the CCyB requirement, i.e. a positive rate for the CCyB in the neutral phase of the credit cycle, could be applied using alternative 1, that is by keeping the total amount of capital buffers unchanged while reducing the other macroprudential capital requirements. Using alternative 2 instead, the positive neutral CCyB component would be added to the other capital requirements, in which case the total amount of capital buffers would increase. It would also be possible to combine both alternatives 1 and 2 by relaxing the other capital requirements by an amount that is smaller than the size of the positive neutral CCyB component. The choice between the alternatives would depend on the regulatory parameters and on the estimates of the total amount of capital required on the basis of systemic risks.

In addition to determining the total capital requirement, there are other practical issues related to the use of the positive neutral CCyB requirement which would need to be resolved either by regulation or by decision of the macroprudential authority. These include the size of the positive neutral CCyB requirement and whether the authority would be obliged to keep the CCyB rate at zero for a specified period if the rate had been lowered to that level because of an economic shock.

A positive neutral CCyB requirement would offer a number of advantages[2]:

- The macroprudential authority could react to extensive financial system shocks – both internal and external – in all cyclical phases, rather than reacting only

2. For more details of the advantages, see e.g. Stojkov, K. (2020), 'Different Approaches to Implementing a Countercyclical Capital Buffer', Reserve Bank of Australia Bulletin; and Darracq Pariès, M., Kok, C. and Rottner, M. (2020), 'Enhancing macroprudential space when interest rates are "low for long"', ECB Macroprudential Bulletin, Vol. 11.

after overheating of the credit cycle.

- At the different phases of the credit cycle, the requirement could then be relaxed by more than is currently allowed . If the credit cycle overheats, the requirement would be raised in the normal manner.
- A greater variation range than at present for the CCyB rate would reduce the need for banks to fall short of their combined buffer requirements, which would improve the usability of banks' capital buffers.

Under the Basel III framework, the Basel Committee on Banking Supervision (BCBS) originally envisaged a zero level for the CCyB rate in times of neutral cyclical conditions. However, the BSBC has expressed its support for the positive neutral CCyB rates introduced in many countries. This was made clear in the BCBS's Newsletter of October 2022, but with the condition that compliance be maintained with the agreed calibration of the minimum capital requirements and other regulatory buffers under the existing Basel standards.[3]

To gain additional macroprudential policy space, it would be justifiable for Finland, too, to shift to applying a positive neutral CCyB requirement, as is the case in many other countries. This would necessitate national regulatory changes, however, as the current precondition for imposing the CCyB requirement is that cyclical systemic risks are increasing.

Tags

credit cycle, countercyclical capital buffer requirement, macroprudential policy

3. See the Newsletter of the Basel Committee on Banking Supervision on positive cycle-neutral countercyclical capital buffer rates, October 2022.