26 October 2011

Capital buffers for addressing market concerns over sovereign exposures

Methodological Note

Summary

The capital package (hereafter, "capital exercise") proposed by the EBA and agreed by the Council on 26 October 2011 requires banks to build up additional capital buffers to reach a level of 9% Core Tier 1 ratio by the end of June 2012, after the removal of the prudential filters on sovereign assets in the Available-for-Sale portfolio and prudent valuation of sovereign debt in the Held-to-Maturity and Loans and receivables portfolio, reflecting current market prices.

The objective of the capital exercise is to create an exceptional and temporary capital buffer to address current market concerns over sovereign risk. This buffer would explicitly not be designed to cover losses in sovereigns but to provide a reassurance to markets about banks' ability to withstand a range of shocks and still maintain adequate capital.

This note summarises the methodology adopted for identifying capital buffers according to the new targets at the bank level.

Key dates

Banks will be required to build up their capital buffers and reach a 9% Core Tier 1 ratio (hereafter, the "benchmark") by the end of June 2012, after the removal of the prudential filters on sovereign assets in the Available-for-Sale (AFS) portfolio and prudent valuation of sovereign debt in the Held-to-Maturity (HTM) portfolio and Loans and receivables portfolio, reflecting current market prices. The reference date for computing the buffers with respect to the benchmark is the end of September 2011.

The EBA estimated the preliminary impact of this approach (as per banks' communications to the market) according to June 2011 data. In particular, banks were requested to provide to the EBA:

- The capital position as of end June 2011;
- The sovereign exposures as of end June 2011.

However, September 2011 market prices have been used for the valuation of sovereign exposures as well as for estimating the amount of prudential filters on sovereign AFS assets. Internal EBA proxies, based on bond yields, have been used when the overall value-adjustments on HTM and Loans and receivables portfolios estimated by banks were lower than EBA's estimates.

The final total target buffer will be based on September 2011 data, and is expected to be published in the course of November. At this time banks estimates and EBA's benchmarks will be compared at the level of each sovereign and the higher taken.

In computing the preliminary figures, banks have been allowed into take in consideration significant events (capital injections, de-leveraging, restructuring) occurred between June and September 2011. These figures are not audited, have been provided by banks on a best effort basis and have not been checked by the EBA. Furthermore, at this stage, no check has been carried out on the eligibility of capital instruments and appropriate implementation of CRD3 provisions.

Actual amounts according to September-end 2011 data will therefore differ from the preliminary estimates published today on the basis of June 2011 exposures.

Scope of application

The capital exercise involves 70 banks. They are all the banks that participated in the 2011 EU-wide stress test, apart from a subset of small non cross-border banks.

(see list below)

The capital package for Greece has been defined in such a way not to conflict with pre-agreed arrangements under the EU/IMF programme. The assistance programme already defines a set of targets for the banks in question, including quantitative objectives for the Core Tier 1 ratio, which are being monitored on a regular basis. For Greece the backstop measures exceed the EBA exercise and no new benchmarks have been set for Greek banks.

Definition of Core Tier 1

The definition of Core Tier 1 is the same used in the 2011 EU-wide stress test (including existing capital instruments subscribed by governments). This definition of capital comprises the highest quality capital instruments (common equity) and hybrid instruments provided by governments as announced by the EBA for the 2011 EU-wide stress test.

This definition is based on existing EU legislation in the Capital Requirements Directive (CRD). It takes the existing EU definition of Tier 1 net of deductions of participations in financial institutions and it strips out hybrid instruments including existing preference shares. It recognises existing government support measures.

To ensure a fully harmonised computation by all the banks involved in the exercise, the EBA has mapped the different capital elements of Core Tier 1 to the current COREP reporting framework. Only commercial instruments of the highest quality are included in this Core Tier 1 definition – ordinary shares or similar instruments in line with the principles detailed in CEBS/EBA guidelines on core capital.

This means, in particular, that the commercial instruments included in Core Tier 1 have to be simple, issued directly by the institution itself and able, both immediately and without any doubt, to meet the criteria of permanence, flexibility of payments and loss absorption in going concern situations. The inclusion of government support measures in this definition reflects the expectation of supervisors that those instruments will be fully available to absorb losses and shelter banks in case of difficulties.

Eligible capital instruments for meeting the buffers

As a general rule, the capital buffers are to be covered with Core Tier 1 as defined in the EBA's 2011 EU-wide stress test. In particular, only commercial instruments of the highest quality are included in this Core Tier 1 definition – ordinary shares or similar instruments in line with the principles detailed in CEBS/EBA guidelines on core capital. However, since buffers are intended to absorb potential (contingent) losses, newly issued private contingent convertibles might be considered eligible under very strict and fully harmonised criteria. These instruments should be fully funded and structured consistently with a common European term-sheet that the EBA is finalising. Existing convertible capital instruments will not be eligible unless they will be converted into Core Tier 1 according to the above definition by end of October 2012.

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As in the 2011 EU-wide stress test, banks have been requested to adhere to CRD 3 for the calculation of the Core Tier 1 ratio, i.e., the changes to the trading book and securitisation treatment (so called Basel 2.5) are to be fully incorporated in the requirement (Stress VaR, IRC, Re-securitisations, Securitisation positions, Correlation trading portfolio).

Sovereign debt exposures

Sovereign debt exposures for the purpose of the capital exercise are those towards the central and local governments of the European Economic Area (EEA) countries. They include direct and indirect sovereign exposures (i.e., on- and off-balance sheet) in the trading and in the banking book.

Prudential filters

The AFS portfolio comprises equities, loans and receivables as well as other financial instruments (other available-for-sale assets). According to CEBS guidelines issued in 2004, fair-value revaluation reserves on AFS assets are subject to the following prudential filters:

- For equities, unrealised losses should be deducted after tax from original own funds and unrealised gains should only partially be included in additional own funds before tax.
- For loans and receivables, the unrealised gains and losses, apart from those related to impairment, are neutralised in own funds after tax.

- For other available for sale assets (e.g., debt securities, financial instruments subject to interest rate risk, etc.) two methods can be applied.
    - items classified in this portfolio are treated as equities,
    - items classified in this portfolio are treated as loans and receivables.

So far, there is no harmonised application of CEBS guidance on prudential filters for regulatory capital across EU jurisdictions. It is worth noting that prudential filters will be removed under Basel 3 rules.

Conservative valuation of sovereign exposures in the HTM and Loans and receivable portfolio

Banks have been asked to carry out a conservative valuation of the EEA sovereign exposures booked in the HTM portfolio and loans and receivable portfolio, making use of existing market prices as of September 2011 and current bond yields by maturity as a reference for loans and non traded assets. Banks' assessment has been used for computing the buffers, with a floor set according to the EBA's own calculation based on bonds yields, sovereign by sovereign and maturity by maturity, for a basket of government bonds. The maturity buckets are the same employed in the EU-wide stress test (3 months, 1 year, 2, 3, 5, 10 and 15 years).

For the final figures published on September data, the higher of the bank's own estimate and the EBA's benchmark will be used on a country exposure by country exposure basis. For the loans, a cap will be set at zero and therefore no offset will be possible.

Tax treatment

For HTM holdings (i.e., the conservative valuation of sovereign exposures) the buffer has been computed gross of taxes.

For AFS holdings, the buffer has been computed following current CEBS guidance on tax for AFS prudential filters (i.e., net of tax).

Computation of the target capital buffers

The capital buffers identified on end September 2011 data will be computed as follows:

1. Buffer AFS. Prudential filters on EEA sovereign exposures held in the AFS portfolio are removed, i.e., banks are required to build a buffer of Core Tier 1 capital vis-à-vis prudential filters (BufferAFS). If the filter is positive, this implies a negative AFS valuation reserve (potential losses)[1].

[1] In countries where prudential filters are not applied, the impact of the valuation of assets in the AFS portfolio is directly reflected in the capital position.

2. Buffer HTM. EEA debt sovereign exposures in the held-to-maturity (HTM) and loans and receivable portfolio are valued in a conservative fashion, making use of existing market price and bond yields by maturity as a reference for loans and non traded assets. Banks are thus required to build a buffer of Core Tier 1 capital (BufferHTM) equal to the difference between the book value of those assets and their revalued amount. For loans banks cannot benefit from hypothetical gains.

3. Banks have been allowed to offset positive (i.e., potential losses) and negative value (i.e., potential gains) adjustments for the HTM and L&R portfolio

4. The sum of BufferAFS and BufferHTM has been capped to zero (i.e., banks cannot end-up with a negative buffer):

   $$\text{BufferSOV} = (\text{BufferAFS} + \text{BufferHTM}) \geq 0$$

5. The capital shortfall is the sum of the difference between 9% of risk-weighted assets and the actual Core Tier 1 capital plus BufferSOV:

   $$\text{Shortfall}_{\text{Sept2011}} = (0.09\text{xRWA}_{\text{Sept2011}} - \text{CT1}_{\text{Sept2011}}) + (\text{BufferSOV}_{\text{Sept2011}})$$

Actions to address identified shortfalls

The amount of any final capital shortfall identified will be set based on September 2011 sovereign exposure figures and a capital requirement determined by a 9% Core Tier 1 threshold. The buffer to be held against sovereign debt exposures based on current market prices will be explicitly defined as of end September 2011 when it will be fixed (i.e. it will not be revised as a result of later market valuation changes, even though banks have until end June 2012 to meet the overall capital target).

$$\text{Shortfall}_{\text{Sept2011}} = (0.09\text{xRWA}_{\text{Sept2011}} - \text{CT1}_{\text{Sept2011}}) + (\text{BufferSOV}_{\text{Sept2011}})$$

The overall shortfall will also be articulated as an amount of Euros that must be addressed by banks by June 2012 when the shortfall should be zero:

$$\text{Shortfall}_{\text{Jun2012}} = 0 = (0.09\text{xRWA}_{\text{Jun2012}} - \text{CT1}_{\text{Jun2012}}) + (\text{BufferSOV}_{\text{Sept2011}})$$

Banks would be required to submit capital plans to their national supervisors before 25 December 2011 setting out the proposed mix of actions, including new capital raising, asset disposals and other measures, to meet both the required 9% target and the sovereign market valuation buffer, thereby bringing the shortfall to zero by June 2012. Prior to agreeing these capital plans, NSAs will consult with relevant colleges of supervisors and consideration will be given at the European (EBA) level as to the impact of the proposed magnitude and nature of any proposed deleveraging and cognisant of the need to maintain lending into the real economy including SMEs. The EBA will provide guidelines, templates and process maps to facilitate national authorities’ engagement with banks in a clear and consistent manner.

List of banks

Sample			
1	AT001	Erste Group Bank AG (EGB)	AT
2	AT002	Raiffeisen Zentralbank Österreich AG (RZB)	AT
3	AT003	Österreichische Volksbanken AG (ÖVAG)	AT
4	BE004	DEXIA	BE
5	BE005	KBC BANK	BE
6	CY006	MARFIN POPULAR BANK PUBLIC CO LTD	CY
7	CY007	BANK OF CYPRUS PUBLIC CO LTD	CY
8	DE017	DEUTSCHE BANK AG	DE
9	DE018	COMMERZBANK AG	DE
10	DE019	Landesbank Baden-Württemberg	DE
11	DE020	DZ BANK AG Dt. Zentral-Genossenschaftsbank	DE
12	DE021	Bayerische Landesbank	DE
13	DE022	Norddeutsche Landesbank -GZ	DE
14	DE023	Hypo Real Estate Holding AG, München	DE
15	DE024	WestLB AG, Düsseldorf	DE
16	DE025	HSH Nordbank AG, Hamburg	DE
17	DE026	Landesbank Hessen-Thüringen GZ, Frankfurt	DE
18	DE027	Landesbank Berlin AG	DE
19	DE028	DekaBank Deutsche Girozentrale, Frankfurt	DE
20	DE029	WGZ BANK AG Westdt. Geno. Zentralbk, Ddf	DE
21	DK008	DANSKE BANK	DK
22	DK009	Jyske Bank	DK
23	DK010	Sydbank	DK
24	DK011	Nykredit	DK
25	ES059	BANCO SANTANDER S.A.	ES
26	ES060	BANCO BILBAO VIZCAYA ARGENTARIA S.A. (BBVA)	ES
27	ES061	BANKIA	ES
28	ES062	CAJA DE AHORROS Y PENSIONES DE BARCELONA	ES
29	ES064	BANCO POPULAR ESPAÑOL, S.A.	ES
30	FI012	OP-Pohjola Group	FI
31	FR013	BNP PARIBAS	FR
32	FR014	CREDIT AGRICOLE	FR
33	FR015	BPCE	FR
34	FR016	SOCIETE GENERALE	FR
35	GB088	ROYAL BANK OF SCOTLAND GROUP plc	GB
36	GB089	HSBC HOLDINGS plc	GB
37	GB090	BARCLAYS plc	GB
38	GB091	LLOYDS BANKING GROUP plc	GB
39	GR030	EFG EUROBANK ERGASIAS S.A.	GR
40	GR031	NATIONAL BANK OF GREECE	GR
41	GR032	ALPHA BANK	GR
42	GR033	PIRAEUS BANK GROUP	GR
43	GR034	AGRICULTURAL BANK OF GREECE S.A. (ATEbank)	GR
44	GR035	TT HELLENIC POSTBANK S.A.	GR
45	HU036	OTP BANK NYRT.	HU
46	IE037	ALLIED IRISH BANKS PLC	IE
47	IE038	BANK OF IRELAND	IE
48	IE039	IRISH LIFE AND PERMANENT	IE
49	IT040	INTESA SANPAOLO S.p.A	IT
50	IT041	UNICREDIT S.p.A	IT
51	IT042	BANCA MONTE DEI PASCHI DI SIENA S.p.A	IT
52	IT043	BANCO POPOLARE - S.C.	IT
53	IT044	UNIONE DI BANCHE ITALIANE SCPA (UBI BANCA)	IT
54	LU045	BANQUE ET CAISSE D'EPARGNE DE L'ETAT	LU
55	MT046	BANK OF VALLETTA (BOV)	MT
56	NL047	ING BANK NV	NL
57	NL048	RABOBANK NEDERLAND	NL
58	NL049	ABN AMRO BANK NV	NL
59	NL050	SNS BANK NV	NL
60	NO051	DnB NOR Bank ASA	NO
61	PT053	CAIXA GERAL DE DEPÓSITOS, SA	PT
62	PT054	BANCO COMERCIAL PORTUGUÊS, SA (BCP OR MILLENNIUM BCP)	PT
63	PT055	ESPÍRITO SANTO FINANCIAL GROUP, SA (ESFG)	PT
64	PT056	Banco BPI, SA	PT
65	SE084	Nordea Bank AB (publ)	SE
66	SE085	Skandinaviska Enskilda Banken AB (publ) (SEB)	SE
67	SE086	Svenska Handelsbanken AB (publ)	SE
68	SE087	Swedbank AB (publ)	SE
69	SI057	NOVA LJUBLJANSKA BANKA D.D. (NLB d.d.)	SI
70	SI058	NOVA KREDITNA BANKA MARIBOR D.D. (NKBM d.d.)	SI