Countercyclical capital buffer rate announcement

July 5 2018

Announcement of rate

The Central Bank has today announced the countercyclical capital buffer (CCyB) rate on Irish exposures is to be increased from zero per cent to one per cent effective from July 5 2019.

The Central Bank considers a one per cent CCyB rate to be consistent with its objective of promoting resilience in the banking sector.[1] In increasing the CCyB rate at this stage, the Central Bank is looking to protect the banking sector against potential losses associated with a build-up of cyclical systemic risk and thereby support a sustainable provision of credit to the real economy throughout the financial cycle.[2]

The setting of the rate at one per cent acknowledges the exposure and susceptibility of the Irish economy to a downturn or the materialisation of cyclical systemic risk, potentially arising from an external shock. The decision also reflects the expected limited impact on the credit environment and real economy at this stage.[3]

In assessing the appropriate CCyB rate at this juncture the following has been taken into consideration:

The Central Bank views promoting banking sector resilience against cyclical systemic risk as the primary objective of the CCyB. This objective requires the buffer to be built up in advance of the realisation of systemic risk/financial stress to support credit supply by allowing the subsequent release of the buffer during a downturn. In line with this objective and taking account of the relative sensitivity of the Irish macro-financial environment, the Central Bank expects to maintain a positive CCyB rate when there is a sustained trajectory in indicators related to emerging cyclical systemic risk.

- The domestic economy has grown strongly over recent years and is moving closer to capacity limits. There has also been a considerable recovery in asset values in the commercial and residential real estate.
- The high volatility of the Irish economy means that phases of strong economic growth may be suddenly followed by substantial downturns. Moreover, the high level of indebtedness of Irish households and the overhang of NPLs on the balance sheets of banks increases the vulnerability of the Irish macro-financial system to cyclical reversals.

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[1] See Measuring and mitigating cyclical systemic risk in Ireland: The application of the countercyclical capital buffer, Financial Stability Notes, 2018, No.4 for an overview of the Central Banks high-level approach to the CCyB.

[2] MiFID investment firms that are subject to the Capital Requirements Regulation and Capital Requirements Directive IV will also be required to hold capital equivalent to one percent of their Irish risk-weighted exposures.

[3] See Using the Countercyclical Capital Buffer: Insights from a structural model, Economic Letter, Vol. 2018, No.7

- Valuation models indicate that the degree of house price misalignment has been diminishing in recent quarters, with house prices having gone from being below what might have been expected given macroeconomic developments to now being roughly in line with economic fundamentals. Accordingly, the cyclical risk of house prices moving ahead of fundamental values is now more elevated than in recent years.
- The national-specific credit gap, although still negative, is declining and on an upward trajectory. Preliminary results from an alternative national credit-to-GNI* gap, where the credit-to-GNI* ratio is modelled using a semi-structural approach, show the gap to be trending back to zero at a more significant pace.[4] All credit gap measures remain of limited value for Ireland, given the impact of the mid-2000s credit bubble on statistical measures of credit trends.
- The sustained contraction in credit seen for much of the last decade ended in recent months. While aggregate credit growth is close to zero, continued deleveraging in the SME and buy-to-let sectors obscures positive growth in home loans, consumer lending and loans to large enterprises.
- New mortgage lending continues to grow strongly. Recently-published research indicated that the ratio of new mortgage lending to household disposable income in Ireland to be broadly consistent with key structural factors in the Irish economy at end 2017. [5] However, a significant acceleration in new lending would increase the cyclical risk that mortgage credit provision exceeds its long-run potential trend path.
- Preliminary research performed by the Central Bank of Ireland supports the view that the new accounting standards (IRFS9) may increase pro-cyclicality in provisioning, which reinforces the importance of active use of the counter-cyclical capital buffer.
- The calibration of the CCyB rate takes into account the existing headroom in the capital of the banking sector.

Activation of the CCyB complements the operation of the borrower-based mortgage measures operating in Ireland, by mitigating the impact of risk taking in non-mortgage lending.

Credit Gap indicators

The benchmark CCyB rate is zero per cent. In setting the CCyB rate, the Central Bank is required to take note of the deviation in the credit-to-GDP ratio from its trend level, a measure referred to as the credit gap. A range of credit gap indicators analysed by the Central Bank show the current gap to be negative. The national-specific approach shown in Table 1 uses the data more reflective of the domestic economy than the standardised approach.[6]

[4] See Measuring and mitigating cyclical systemic risk in Ireland: The application of the countercyclical capital buffer, Financial Stability Notes, 2018, No.4 for further details on this alternative credit gap.
[5] See, Keenan & O'Brien (2018)
[6] The standardised credit gap is calculated in line with ESRB Recommendation 2014/1 and is based on a broad measure of credit. In Ireland, issues related to the presence of multi-national enterprises, as discussed in the Report of the Economic Statistics Review Group, impacts heavily on these data. The national specific approach

The credit gap concept is of limited value in the Irish context, since measures of trend credit are severely distorted by the unsustainable credit boom in the mid-2000s.

Table 1: Credit Gap and benchmark CCyB rate (based on data referring to 2017Q4)

		Standardised Approach	National-Specific Approach	Alternative (model-based) National Approach
A	Ratio	249 per cent	91 per cent	91 per cent
B	Trend	336 per cent	168 per cent	121 per cent
C	**Credit Gap** *(=A-B)*	-87per cent	-77 per cent	-30 per cent
	Benchmark CCyB rate	0 per cent	0 per cent	
	Δ credit gap since trough	NA	12pps	41pps

Reciprocity

In terms of Irish institutions applying relevant CCyB rates on exposures in other jurisdictions, a number of European authorities have announced positive CCyB rates. These are shown in Table 2 below.[7]

Table 2: Positive CCyB rate setting in Europe

Country	Current applicable rate	Implementation date	Pending CCyB rate	Pending implementation date
UK	0.50%	27 June 2017	1.00%	28 November 2018
Slovakia	0.50%	01 August 2017	1.25%	1 August 2018
Lithuania	0.00%	30 June 2015	0.50%	31 December 2018
Czech Republic	1.00%	01 July 2018	1.50%	01 July 2019
Iceland	1.25%	01 November 2017	1.75%	15 May 2019
Norway	2.00%	31 December 2017		
Sweden	2.00%	19 March 2017		
France	0.00%	30 December 2015	0.25%	1 July 2019

In the case of third countries which are material from an Irish perspective, the CCyB rate in the US is currently zero per cent.

Further information

For further information see the Macroprudential Policy section of the Central Bank website here.

looks to adjust for this by using data more reflective of the domestic economic environment, using a narrower more domestically focused measure of credit and GNI*.

[7] Further information can be found the ESRB website.