

# Recommendation

by the

German Financial Stability Committee

dated 27 May 2019

concerning the increase of the countercyclical capital buffer

AFS/2019/1

## **A) Recommendation concerning the countercyclical capital buffer rate**

The German Financial Stability Committee (hereinafter referred to as “the Committee”) has adopted the following recommendation on the basis of section 3(2) of the Act on the Monitoring of Financial Stability of 28 November 2012 (Federal Law Gazette I, p. 2369), last amended by Article 24(35) of the Act of 23 June 2017 (Federal Law Gazette I, p. 1693), (hereinafter referred to as “Financial Stability Act”):

The Federal Financial Supervisory Authority (hereinafter referred to as “BaFin”) is recommended,

pursuant to section 10d(3) sentence 2 of the Banking Act (*Kreditwesengesetz*), to set the rate for the domestic countercyclical capital buffer at 0.25 percent of the total risk exposure amount determined pursuant to Article 92(3) of Regulation (EU) No 575/2013 as of the third quarter of 2019.

## **B) Explanatory remarks**

The Committee has concluded from its analysis and assessment of the risk situation for the German banking system that there are cyclical systemic risks which can impair financial stability in Germany. Owing to these cyclical systemic risks, the Committee deems it necessary to strengthen the loss-absorbing capacity of the German banking system. This is intended to avert adverse feedback loops between the financial system and the real economy, should a period of stress arise. This would notably be the case if banks were no longer capable of providing bank lending to the extent required by the real economy. To mitigate the effects of a materialisation of such risks and the associated repercussions for the economy, the Committee recommends, in performance of its statutory mandate pursuant to section 2(2) number 5 of the Financial Stability Act, that the domestic countercyclical capital buffer (hereinafter referred to as the “CCyB”) be increased.

### **I. Macroeconomic and financial setting in Germany**

The German economy is experiencing the longest period of expansion since the country's reunification.<sup>1</sup> Interest rates have been exceptionally low for a number of years, and asset prices are high. Furthermore, volatility in financial markets is relatively low. Germany's economy remains on a growth path, despite the fact that it is currently experiencing a weaker spell, and capacity utilisation is at an above-average level. Favourable labour market developments are bolstering household income and consumption. High capacity utilisation and labour market shortages in the euro area support the expectation of consumer prices rising over the medium term and of the interest rate level increasing at a slow pace. However, geopolitical uncertainties have also risen, and trade conflicts have intensified. The United Kingdom's intention to withdraw from the European Union is another potential setback for the economy as a whole.

### **II. Risks to financial stability**

The functional viability of the financial system is of essential importance for the real economy. Financial stability is defined as a state in which the financial system is able to fulfil its functions at all times. The main functions comprise the allocation of financial resources and risks as well as the settlement of payments. This means that a stable financial system is consistently in a position to absorb both financial and real economic shocks, including in stress situations and periods of structural adjustment. An adequate resilience of the financial system – that is, the ability to cushion even losses from unexpected developments – can prevent contagion and feedback effects between the financial market participants and between the financial system and the real economy. The financial system should neither cause nor amplify a downturn in overall economic activity.

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<sup>1</sup> See Deutsche Bundesbank (2018).

Averting risks to financial stability is the task of macroprudential oversight. Unlike microprudential supervision and regulation, which aim to ensure the stability of individual credit institutions, macroprudential oversight focuses on the stability of the financial system as a whole. Risks to financial stability arise from systemic risks. Systemic risks occur, for instance, when the distress of one or more market participants jeopardises the functioning of the entire system.

The Committee has determined in its macroprudential strategy that the purpose of its measures is to strengthen the resilience of the financial system and, inter alia, to counteract the cyclical build-up of systemic risks.<sup>2</sup> Macroprudential measures in the sense of a preventive policy are therefore aimed, amongst other things, at strengthening the resilience of lenders to unexpected adverse events (“shocks”). Such measures typically address lenders’ shock absorption capacity – that is to say, their capital base. The Committee is expressly not aiming to fine-tune the national economy or lending activity.

## **1. Threat situation**

The Committee has assessed that, in the current economic setting, the build-up of cyclical systemic risks has created a threat to financial stability. If these cyclical systemic risks materialised, there would be the danger that banks might only be able to bear the resulting losses by curbing the flow of funding to the real economy. This can lead to the creation of adverse feedback loops between the financial system and the real economy, because banks in particular would be hit in their function as a credit provider.

The threat situation results from three risk areas: (i) risks relating to the path of the economy which are not comprehensively covered by microprudential credit risk measurement (“economic risk”); (ii) real estate lending risk (“real estate risk”); and (iii) interest rate risk – that is, the risk of interest rates persisting for even longer at the zero lower bound (“low interest rate environment”) or rising sharply (“interest rate risk”). The threat situation is derived in particular from the simultaneous materialisation of the various risks.

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<sup>2</sup> See German Financial Stability Committee (2014), pp. 42 ff.

### **(i) Economic risk**

The healthy state of the economy has reduced credit risk, as reflected by low risk provisioning by banks and a drop in risk-weighted assets (RWAs) for market risk. This is consistent with the, on average, improvement of balance sheet metrics in the corporate sector. However, analyses by the Bundesbank and the International Monetary Fund up to 2015 and 2016, respectively, signal that increased lending activity was related to allocation risk.<sup>3</sup> In the period under review banks increased the supply of credit to comparatively financially weaker enterprises.<sup>4</sup> In other words, loans were granted more to enterprises whose balance sheet metrics tended to be weaker than those of other enterprises, even though the balance sheet metrics of all enterprises had improved on average.

These weaknesses can be seen in both the capital ratios and the interest coverage ratios of these enterprises. If the economy were to worsen, credit quality levels of these enterprises in particular could deteriorate to such an extent that loan losses would increase. Banks would be forced to step up their risk provisioning, perhaps substantially, at short notice. Scenario analyses prepared on the basis of supervisory reporting data reveal that capital ratios would come under intense pressure if impairment ratios and thus risk provisioning were to rise again or even go beyond the normal magnitude on account of a cyclical downturn.<sup>5</sup> Analyses based on stress tests indicate that banks are likely to respond to a scenario of unexpectedly heavy losses from the aforementioned risk areas, at least in part, by deleveraging as a way of stabilising their tier 1 capital ratios.<sup>6</sup> Because of the impact this would have on balance sheets, this scenario can be expected to cause banks to curb the supply of credit to an excessive degree, which would have a negative knock-on effect on the real economy.

The scenario described here concerns all banks. At banks using the Credit Risk Standardised Approach to calculate their capital requirements (SA banks), migrations of loans into classes subject to higher risk weights could drive up capital requirements. At banks using the Internal Ratings-Based Approach to calculate their capital requirements (IRB banks), the described effects would tend to be more pronounced due to the higher risk sensitivity of internal models. Measured as an average for the past nine years, IRB risk weights are currently at a low level. They could increase sharply if the economy takes a downturn. That would be problematic from a macroprudential perspective as primarily potential systemically important institutions (PSIs) are using internal models (IRB PSIs). IRB PSIs include banks which apply the IRB approach and are categorised as posing a potential systemic risk pursuant to section 20(1) sentence 3 of the Recovery and Resolution Act (*Sanierungs- und Abwicklungsgesetz*). These notably include other systemically important institutions (O-SIIs) pursuant to section 10g of the Banking Act as well as those institutions for which simplified requirements cannot be applied to their recovery plans pursuant to the

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<sup>3</sup> See Deutsche Bundesbank (2018) and International Monetary Fund (2018a).

<sup>4</sup> See Deutsche Bundesbank (2018), pp. 73 ff.

<sup>5</sup> See Deutsche Bundesbank (2018), p. 79.

<sup>6</sup> See Deutsche Bundesbank (2018), p. 80.

criteria set out under section 19(2) of the Recovery and Resolution Act. Both the categorisation as O-SIIs and the granting of simplified requirements for recovery plans are based on a methodology shared by BaFin and the Bundesbank. This methodology is based on guidelines issued by the European Banking Authority (EBA) and a Commission Delegated Regulation. The group of IRB PSIs is of particular importance for the German banking system, since these institutions are responsible for a large share of domestic lending to the private non-financial sector (around 40%) and account for the bulk of the German banking system's aggregate total assets (roughly 54%).

Capital reserves as a proportion of total assets, including the capital buffer and the surplus capital held over and above that, are low at IRB PSIs compared with small and medium-sized banks. The stress test also shows that banks whose tier 1 capital ratios are closer to the regulatory minimum reduce their assets to an above-average extent.<sup>7</sup> Therefore, IRB PSIs are more at risk of being unable to cushion losses from unexpected macroeconomic developments using their existing capital reserves. This means that there is a strong risk of deleveraging (i.e. a collective shortening of the balance sheet) in this key group of banks for the financial system and therefore the risk of a procyclical amplification of a potential economic downturn.

### ***(ii) Real estate risk***

The German real estate market has been undergoing a remarkable upswing since 2010. In 2018, as in 2017, the overvaluations in towns and cities were between 15% and 30%.<sup>8</sup> Other indicators for assessing real estate prices, such as the ratio of purchase prices to annual rents, for example, support the view that valuation levels in towns and cities have remained high.<sup>9</sup> Due to the sharp rise in real estate prices over the past decade (during the 2010 to 2018 period, real estate prices in Germany were up by 59% overall and in Germany's seven largest cities by around 98%)<sup>10</sup> and estimated price exaggerations in residential real estate markets, the probability of a – considerable – price correction is rising. An unexpectedly sharp decline in real estate prices, especially in conjunction with an economic slump, can lead to turmoil in the real estate markets. In such a scenario, if household incomes deteriorate significantly and real estate prices drop at the same time, this can lead to rising defaults on residential real estate loans and an increase in losses given default when liquidating real estate collateral.

Turmoil in the real estate markets would hit the overall German banking system. : In the fourth quarter of 2018, over 50% of lending to domestic households and enterprises by the savings banks and credit cooperatives was accounted for by housing loans to households. For commercial banks, this figure is just over 37%. The results of a residential real estate

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<sup>7</sup> See Deutsche Bundesbank (2018), p. 80.

<sup>8</sup> See Deutsche Bundesbank (2019), p. 55.

<sup>9</sup> See Deutsche Bundesbank (2018), p. 46 and Deutsche Bundesbank (2019), pp. 53-55.

<sup>10</sup> Bundesbank calculations based on data provided by bulwiengesa AG.

stress test show that, over a three-year stress scenario in which, amongst other things, residential real estate prices drop by a total of 30%, banks' estimated expected losses would rise considerably.<sup>11</sup> These rising losses would affect both new and older loan vintages. The risk of losses in the loan portfolio is therefore not eliminated by the significant appreciation of the residential real estate serving as loan collateral, caused by rising prices in the past.

Unlike in the case of portfolio risk, for which there is sufficient evidence, data gaps make it difficult to comprehensively analyse risks from new housing loans. Currently available indicators do not show any risks to financial stability that are so substantially heightened as to signal a need for macroprudential action to be taken at present.

In addition, should funding conditions deteriorate suddenly (see section B.II.1.iii regarding interest rate risk on page 6), the commercial real estate market could also increasingly come under pressure, as it is characterised by shorter-term and more floating rate financing. To make matters more difficult, it is possible that banks, in the current environment of dynamically rising real estate prices, might overestimate the value of real estate accepted as collateral and thus underestimate the risk of their credit exposure.

### ***(iii) Interest rate risk***

Interest rate risk likewise affects all banks. Interest income accounts for an important share of total income for small and medium-sized banks, in particular. Persistently low interest rates weigh on net interest income and thus, over the longer term, on banks' solvency as well. Banks' weak earnings give them an incentive, because of low interest margins, to increase their risk-taking and expand their lending in order to generate income. An abrupt rise in interest rates would, in addition, make funding more expensive over the short to medium term and erode the value of fixed-rate assets, in particular. In the event of an increase in interest rates, credit risk could also rise if the interest burden on borrowers goes up. The resilience of the banking system to interest rate risk is therefore of particular importance.

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<sup>11</sup> See Deutsche Bundesbank (2018), pp. 61-62

## **2. Insufficient shock absorption capacity**

The Committee is concerned about whether the banking system is able to cushion potential unexpected shocks that might arise if the aforementioned cyclical systemic risks materialise, without curbing the function it performs for the real economy. It refers here to analyses according to which, if cyclical systemic risks materialise, the banking system at least in part could be forced to shrink its balance sheet. Stress test-based analyses show that banks under stress would deleverage their total assets considerably in order to maintain sufficient capital to comply with supervisory or market capital requirements. Given the current level of German banks' capital, there is believed to be a sufficient probability of considerable deleveraging if the aforementioned risks do materialise. This is particularly true for IRB PSIs, which have only little excess capital compared with other banks. One of the potential consequences would be a significantly constrained supply of credit to the real economy. Under those circumstances, the banking system could no longer sufficiently play its role for the real economy. This is why resilience and the associated loss absorption capacity of the banking system need to be strengthened as a preventative measure.

## **3. Impairment of financial stability**

Collectively, the three types of risk described above, which are in some instances interdependent, result in a scenario of a cyclical systemic risk. Each type of risk individually, as well as a combination of all three, can lead to undesirable adjustment reactions if banks' loss absorption capacity is insufficient. There is also the possibility of herd behaviour in the banking system in response to the materialisation of the risk scenario.

The possibility that, in such situations, the ability to increase capital by retaining profits or borrowing on the market is constrained cannot be ruled out; in that case, the only other option would be to shrink the balance sheet or reduce risk-weighted assets. If banks are not able to cushion losses from macroeconomic shocks through capital held in excess of regulatory requirements, they are forced to take balance sheet measures (capital increase, asset deleveraging) to stabilise their capital ratios. Stabilising capital ratios through collective balance sheet contraction, such as by reducing lending, would amplify an economic downturn (procyclicality) and adversely affect the real economy. This subsequently creates considerable potential for economic losses should the aforementioned risk scenarios materialise.

The lengthy upswing has created the potential for a macroeconomic setback – in the form of, for instance, simultaneous and suddenly increasing credit defaults caused by falling GDP, increased risk of losses caused by falling real estate prices, or rising risk weights. By those standards, the German banking system's ability to absorb losses is low. This is where the Committee sees a threat to financial stability. Implementing this recommendation is intended to enhance banks' resilience to the effects of the materialisation of cyclical systemic risks. It

must be noted that taking macroprudential measures to strengthen resilience is exclusively preventive.

When selecting and calibrating macroprudential instruments to avert the impairment to financial stability explained here, the remaining uncertainties regarding both the probability of the above described risks materialising and the size of potential expected losses are taken into account.

### **III. The countercyclical capital buffer as a measure to strengthen resilience to financial stability risks**

The Committee thinks that setting a rate of 0.25 percent for the CCyB pursuant to section 10d of the Banking Act as of the third quarter of 2019 is a suitable and necessary measure to avert the aforementioned threat to financial stability. Although banks' capital adequacy and the associated loss absorbing capacity are consistent with the currently favourable economic environment (microprudential dimension). However, they do not sufficiently cover unexpected, adverse systemic developments (macroprudential dimension). Setting a positive rate for the CCyB will strengthen the banking system's resilience and thus reduce the likelihood of the banking system responding procyclical in an economic downturn scenario. In the Committee's opinion, no other less severe but equally effective means of averting risks to financial stability are available. Banks have 12 months to build up this buffer. The appropriateness of the CCyB rate will also be subject to quarterly review during this phase-in period – particularly in terms of GDP and credit growth – and any adjustments deemed necessary will be made.

#### **1. Suitability of the CCyB**

The cyclical systemic risk situation and the resultant threats to financial stability engender the need for a macroprudential buffer to enhance the resilience of the banking system. The CCyB was created with a view to enhancing resilience to cyclical systemic risks. It is intended to enhance banks' capacity to absorb losses by building up additional capital reserves during the phase of a rise in cyclical systemic risk, which in the run-up to past financial crises has often been reflected in excessive growth in credit to the private non-financial sector. If risks materialise in a downturn, the buffer can be immediately reduced or tapped in order to cover losses. This is ultimately designed to stabilise lending since, by tapping the CCyB, banks would not be forced to reduce their assets in order to cover losses.<sup>12</sup> The CCyB is, by that token, economically suited, and can be used in a targeted manner, for restricting the procyclicality of the financial system.

#### ***Existence of the preconditions for the CCyB***

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<sup>12</sup> See Basel Committee on Banking Supervision (2010) and European Systemic Risk Board (2014).



From the Committee's point of view, the preconditions for activating the CCyB are in place. Even though the credit-to-GDP gap currently does not indicate a positive buffer guide (reference value derived from the credit-to-GDP gap) for setting a CCyB rate, further indicators point to the need for activation. There are also the aforementioned cyclical systemic risks.

Building on the legal basis, BaFin and the Bundesbank have defined a methodological framework for the application of the CCyB and particularly for deciding on the appropriate CCyB calibration. When setting the CCyB rate, two components are taken into account according to the methodological framework.<sup>13</sup> The starting point is the rules-based component based on the deviation of the credit-to-GDP ratio from its long-run trend (credit-to-GDP gap). From this, a reference value for the CCyB rate is derived (buffer guide). If the credit-to-GDP gap exceeds two percentage points, the build-up of a buffer is indicated. This guide is not a strict rule. As part of the discretionary component, additional quantitative and qualitative indicators of cyclical systemic risk are taken into account. After looking at all the information from the rules-based and discretionary components, the CCyB rate is then set.

#### ***(i) Rules-based component***

The key indicator in the rules-based component is the credit-to-GDP gap as calculated using the national method. In the fourth quarter of 2018 it stood at -0.84 percentage point. For 20 quarters now, the gap has been moving towards positive territory. The credit-to-GDP gap calculated using the national method incorporates credit granted by domestic monetary financial institutions (MFIs) to the domestic private non-financial sector. Alongside the national method, the credit-to-GDP gap according to the Basel method is also used to ensure comparability at the international level. This method uses a broader definition of credit which also includes credit granted by foreign lenders and credit granted by non-banks. The credit-to-GDP gap according to the Basel method was -0.42 percentage point in the third quarter of 2018. The buffer guides based on the national and Basel methods thus both came to 0%.

In addition to the current figure, the Committee also looks at the dynamics of the development of the credit-to-GDP gap. Only by building up buffers at an early stage can it be ensured that capital buffers are actually available in a crisis or a cyclical downturn. The credit-to-GDP gaps calculated using both the national and Basel methods have been moving towards positive territory over the past few quarters (Figure 1 in the annex on the national credit-to-GDP gap). Based on forecasts, the Committee is of the view that, if this development continues, the credit-to-GDP gap is likely to be in territory that signals an increase in the buffer. Continuation of this dynamic is suggested by the fact that the components of the credit-to-GDP gap (credit, GDP, trend) are slow-moving and statistical features in the calculation of the trend encourage persistent developments. The rate of

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<sup>13</sup> See Deutsche Bundesbank (2015), hereinafter "methodological note".

change in the credit-to-GDP gap is thus indicating that the gap will lie above the 2 percentage point threshold in future.<sup>14</sup> At present, the credit-to-GDP gap is already higher than the long-term average.

## ***(ii) Discretionary component***

Article 136(3) letter (c) of the Capital Requirements Directive (CRD IV) provides for other variables that the designated authority considers relevant for identifying cyclical systemic risks to be taken into account when setting the CCyB.

Due, in particular, to the uncertainty surrounding the predictive power of the credit-to-GDP gap, the additional indicators play an important role in the decision on the appropriate level of the CCyB.<sup>15</sup> The indicators specified in the methodological note are not definitive, however. In line with the legal provisions, the methodological note provides for the option of reviewing and expanding the analytical framework.<sup>16</sup> Besides the set of indicators, further information that signals a build-up of cyclical systemic risks can thus be used, as limited experience in the application of the CCyB argues against a rigid analytical framework.

Aside from growth in aggregate lending, other factors that are relevant to the build-up of systemic risks are the structure and concentration of lending. In the fourth quarter of 2018, real growth in MFI loans to non-financial corporations came to 5.14% compared with the same quarter of the previous year, and it has been above the average since 1991 (1.97%) for ten quarters. In addition to the above average growth in loans to non-financial corporations, the risk weights for loans to enterprises at banks using internal models to calculate their capital requirements have also dropped in median terms from 57% to just under 37% over the past nine years.<sup>17</sup> Because large banks, in particular, use internal models, a significant share of aggregate lending to the private non-financial sector is affected by the decrease in the risk weights. Hence, only a correspondingly smaller amount of capital has to be held against lending exposures.

The residential real estate indicators are pointing to a persistent build-up of risks, primarily in relation to price developments. If the long-lasting high prices diverge from the fundamentally justified prices, the valuation of collateral could be unsustainable. At present, growth in residential real estate prices compared with the same quarter a year earlier has been higher than the average since 1991 (2.8%) for 18 quarters. The growth rates in the past four

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<sup>14</sup> If the quarterly rates of credit growth were to increase in line with average long-term credit growth (fourth quarter of 2018: 1.44% since 1968) and nominal GDP grow in line with the long-term forecast of the International Monetary Fund, the 2 percentage point threshold would be exceeded in the second quarter of 2020 according to an analysis of the credit-to-GDP gap. Given sustained credit growth at the growth rate seen in the third quarter of 2018 (1.01%), the credit-to-GDP gap would reach this level at the start of 2022.

<sup>15</sup> See Deutsche Bundesbank (2015).

<sup>16</sup> The Basel Committee on Banking Supervision (2010) and the European Systemic Risk Board (2014) also note that the credit-to-GDP ratio is a purely statistical measure and information derived from it can be misleading. As a result, automatically implementing the buffer guide based on the gap could, in the event of misleading signals, lead either to no buffer activation while risk builds up simultaneously (type 1 error) or to buffer activation with no simultaneous risk build-up (type 2 error).

<sup>17</sup> This change does not stem solely from cyclical developments.

quarters were all over 5%. At the same time, real growth in housing loans,<sup>18</sup> at 3.01% in the fourth quarter of 2018, is above the long-term average since the first quarter of 1991 (2.29%).<sup>19</sup>

According to the results of the quarterly euro area bank lending survey (BLS) conducted by the Eurosystem, credit standards in Germany have eased for several consecutive quarters; at the current end, they have tightened only marginally (BLS results for the first quarter of 2019, results of analyses for German CCyB in the second quarter of 2019). Because in Germany standardised data on credit standards such as the loan-to-value ratio (LTV) of housing loans or households' debt-service-to-income ratio (DSTI) are not reported, the estimation of lending standards is subject to a degree of uncertainty. Nonetheless, among the set of indicators in the CCyB, the residential real estate indicators are pointing to a build-up of risk. Given that housing loans are a key pillar of banking business in Germany, we need to keep a particularly close eye on this area.<sup>20</sup>

Overall, developments in the credit-to-GDP gap (aggregate lending), growth rates for MFI loans to non-financial corporations involving low risk weightings and low risk provisioning (distribution of lending) and price movements for residential real estate (potential overvaluation of credit collateral) point to a build-up of cyclical systemic risks, reflecting the risk areas. From the point of view of the Committee, a CCyB rate that deviates from the current buffer guide is therefore justified.

### ***Right time to set the rate***

It is appropriate to set a positive rate for the CCyB for the first time given the economic environment. In the current economic situation, which remains upbeat, it would thus be consistent with the preventive character of macroprudential policy in general and of the CCyB in particular. The aim should be to use a favourable macroeconomic setting to enable the banking system to conserve and/or accumulate sufficient equity capital in the form of buffers to render it suitably resilient to risks, should they materialise.<sup>21</sup> Nor do current data, for example on loans to enterprises or growth in residential real estate prices, indicate an end to the build-up of risk. Recently, the Financial Stability Board stated that the (still) positive economic environment should be used to build up capital buffers, especially in the advanced economies.<sup>22</sup> The International Monetary Fund, too, recommends that countries consider making more active use of the CCyB in light of the deteriorating economic activity.<sup>23</sup>

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<sup>18</sup> See Deutsche Bundesbank (2015), p. 46. Growth (p.a.) in loans to households and enterprises for house purchase. Creditors are domestic monetary financial institutions. Credit growth adjusted using the consumer price index. Calculation of average growth rates based on the geometric mean.

<sup>19</sup> The nominal growth rate of loans to households for house purchase, i.e. excluding enterprises, was 4.46% at the end of the third quarter of 2018.

<sup>20</sup> See Deutsche Bundesbank (2015), p. 22 and the literature cited there.

<sup>21</sup> See recital 80 of CRD IV.

<sup>22</sup> Source: <http://www.fsb.org/2018/10/fsb-reviews-financial-vulnerabilities-and-deliverables-for-g20-summit/>

<sup>23</sup> See International Monetary Fund (2018b), p. 31. Currently (first quarter 2019), 12 out of the 31 countries in the European Economic Area have introduced or announced the introduction of a positive CCyB rate.

## ***Appropriate calibration of the CCyB***

Given the remaining uncertainty as to the likelihood of the threat situation described here materialising and the severity of the associated economic repercussions, the Committee considers it appropriate to raise the CCyB for the first time by 0.25 percentage point as of the third quarter of 2019. The implementation deadline is in 12 months' time, meaning that credit institutions need to have built up the buffer in full by no later than the third quarter of 2020.

In the Committee's opinion, the CCyB will bolster the German banking system's resilience to an unexpected, strong economic downturn. It will reduce the risks arising from procyclicality whilst ensuring that the economic cost of accumulating the buffer remains low. An analysis of capital requirements shows that German banks can achieve a CCyB rate of 0.25% primarily by drawing on existing excess capital. As a result, neither a short-term balance sheet contraction nor any resulting distortions seem likely on aggregate. The 12-month implementation deadline will allow the few banks with capital needs sufficient time to decide how best to accumulate capital. The banking system will become more resilient in the sense that the CCyB will preserve existing excess capital in the short term and give banks an incentive to build up additional capital in the medium term.<sup>24</sup>

The increase in the CCyB will be of significant benefit to all, at a reasonable cost to the banking system, since the banking sector will be better equipped to face the impact of cyclical systemic risks. This will reduce the above described negative repercussions for all, for example due to the anticipated deleveraging. Estimates show that, even if banks were to create their buffers entirely from new equity capital, this would only have a small impact on funding costs and lending rates.

The CCyB is being activated for the first time at a rate of 0.25 percentage point on the back of a baseline scenario surrounded by the abovementioned uncertainties. Its appropriateness in each case is to be reviewed taking into account future developments as part of the legally envisaged quarterly evaluation of the CCyB rate. The rules-based and discretionary components listed above form part of this evaluation. One of the key characteristics of the CCyB is that it is applied counter to the credit cycle and can be lowered in periods of stress.

## **2. Necessity of the CCyB**

It is necessary to set a positive rate for the CCyB. In the Committee's opinion, no other less severe but equally effective means of averting risks to financial stability are available. This assessment reflects the fact that macroprudential buffers such as the CCyB perform a function fundamentally different to that of microprudential minimum capital requirements. While minimum capital requirements need to be met at all times and undershooting these

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<sup>24</sup> Even if the buffer were to be met entirely using excess capital, the resilience of the banking system would be improved because capital distribution constraints would ensure that capital was preserved for crises. Banks will have an incentive to rebuild their original excess capital in order to increase their flexibility in terms of business policy.

directly results in measures ranging from supervisory action to the withdrawal of banking licences, macroprudential buffers may be undershot under certain circumstances (“breathing buffers”). Unlike microprudential minimum capital requirements, these can therefore be used by banks to absorb losses on a going-concern basis. The possibility of absorbing losses in this way provides banks with immediate financial leeway, thereby mitigating any negative effects stemming from the banking system in a cyclical downturn.

Given the currently low level of loss-absorbing capacity, the overall risk situation implies cyclical systemic risks that entail the threat of a collective shortening of the balance sheet in the event of a crisis. Microprudential requirements not only lack the breathing and loss-absorbing function that is inherent to the macroprudential buffers. On top of this, it would not be possible to address systemic risk by increasing microprudential minimum requirements. An increase in minimum requirements on the basis of Articles 124 and 164 of the Capital Requirements Regulation (CRR) (Pillar 1, risk weight adjustment in the case of mortgage loans) or in the context of Pillar 2 requirements (P2R) raises the cyclical risk in the short term because, upon the materialisation of cyclical systemic risks, capital held as part of minimum requirements cannot be utilised to a sufficient extent; rather, it is intended to be used to cover microprudential losses. Compared with capital buffers, adjusting sectoral risk weights also creates an incentive to shift lending business in a manner that is unintended from a supervisory perspective. Finally, a clear delineation of microprudential and macroprudential requirements makes it possible to define the way each works with respect to evaluation and the point at which the measure is activated or deactivated. Furthermore, the ongoing review of permission to use internal models pursuant to Article 101 CRD IV revealed that, from a microprudential perspective, the data used for the IRB approach are representative and appropriate. However, in macroprudential terms, the data available to banks do not tend to cover a complete financial cycle and, given that Germany is experiencing the longest period of expansion since reunification, they are also less well suited to forecasting a macroeconomic shock.

It would also be inexpedient to capture cyclical systemic risks by means of an institution-specific Pillar 2 add-on (Pillar 2 guidance: P2G) that could be geared towards increasing the loss-absorbing capacity of institutions with a similar risk profile. The identified risk harbours an additional financial stability component that cannot be captured by means of an exclusively institution-specific measure such as the Pillar 2 buffer. As the cyclical systemic risk to be addressed is macroprudential in nature, the notion that it is captured in the P2G framework can be ruled out. Measures pursuant to section 10(3) of the Banking Act that put in place increased minimum liquidity requirements at the individual institution level are likewise unsuitable, because the systemic risk is not attributable to a collective liquidity problem.

The buffer for O-SIIs pursuant to section 10g of the Banking Act is ill suited to addressing the identified risks due to how it works. These risks have their foundation not just in the systemic importance of the relevant institutions in line with their O-SII designation but also in the

cyclical decrease in the German banking system's risk provisioning. Activation of the systemic risk buffer pursuant to section 10e of the Banking Act requires the existence of a long-term, structural macroprudential risk. The cyclical property of the identified risk therefore precludes the application of this measure. The macroprudential increase in the capital conservation buffer on the basis of section 48t of the Banking Act is specifically and generally suited to addressing the identified risk. This add-on works in much the same way as the countercyclical capital buffer, although it has a higher capital impact because the buffer is imposed on all exposures rather than just domestic exposures in the case of the CCyB. At the same time, a variation on the capital conservation buffer could only be applied if the CCyB were, for its part, not suited to addressing the identified risk. This is not the case here.

Borrower-based instruments (cap on the loan-to-value ratio and (minimum) amortisation requirement, section 48u of the Banking Act) concern all new loans for the construction or purchase of residential real estate in Germany. They are not suited to addressing the identified overall risk as existing risks in the loan portfolio cannot be addressed. The available indicators likewise show no increased build-up of risks to financial stability arising from new residential real estate loans that would justify the activation of borrower-based instruments pursuant to section 48u of the Banking Act. Furthermore, residential real estate loans represent only part of the identified overall risk.

### **C) Implementation of the recommendation**

Pursuant to section 3(2) of the Financial Stability Act, the addressee of this recommendation is required to inform the Committee by 14 June 2019 of the manner in which it intends to implement the recommendation, thereafter regularly reporting to the Committee on the status of implementation. The recommendation shall be implemented by no later than 30 June 2019.

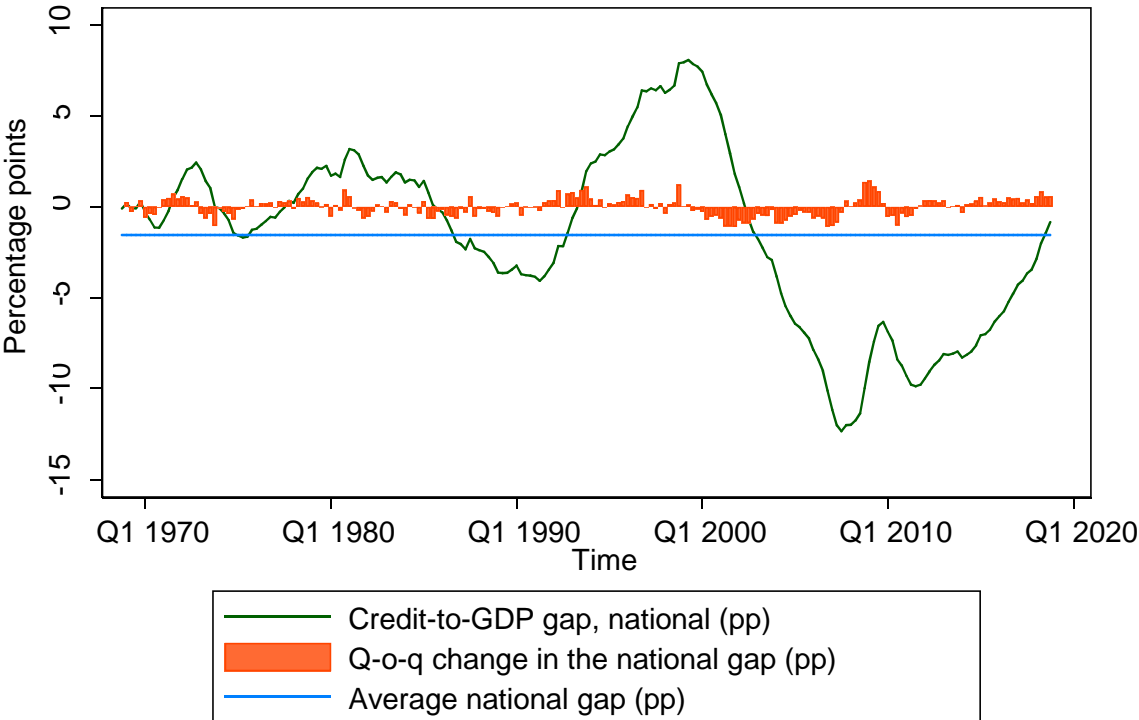
Chair of the German Financial Stability Committee

Berlin, 27 May 2019

[signature]

**Annex**

*Chart 1: Credit-to-GDP gap for Germany (national method)*



Source: Deutsche Bundesbank, data as at Q4 2018.



## List of references

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