

# Criteria for the determination of the countercyclical capital buffer

## Introduction

The countercyclical capital buffer (CCyB) is intended to underpin financial institutions' financial strength and attempt to ensure that access to credit is not seriously curtailed during distressed periods, which could exacerbate the impact of economic shocks on the financial system and the economy.<sup>1</sup>

The risk facing the financial system is uncertain at any given time. The Central Bank of Iceland Financial Stability Committee (FSN) therefore considers it appropriate, all else being equal, to maintain a CCyB rate of 2-2.5% of the domestic risk base. This provides the scope to lower the CCyB when unexpected shocks strike, thereby affording financial institutions the flexibility to absorb loan losses during a downturn. This is referred to as a positive neutral CCyB. If signs of elevated financial system risk emerge, the FSN can increase the buffer rate. If the risk materialises, however, the Committee will lower the buffer rate or set it at 0%. This gives financial institutions the leeway to address loan losses and maintain a sufficient supply of credit. The CCyB is thereby intended to support both financial institutions' resilience and the stability of the financial system. The FSN will endeavour to provide guidance on when, and under what circumstances, the buffer rate will be increased again. Account will be taken of the macroeconomic cost of increasing capital requirements and the impact it will have on economic recovery.

The FSN will review the positive neutral CCyB rate on a regular basis.

## Statutory provisions on the imposition of the CCyB

According to Article 85 of the Act on Financial Undertakings, no. 161/2002, the Central Bank is authorised, subject to Financial Stability Committee approval, to lay down rules requiring financial institutions to maintain a CCyB. The buffer is among widespread changes in international financial institutions' capital requirements, which have been adopted in Europe with Council Directive 2013/36/EU (CRD IV) and Regulation (EU) no. 575/2013 (CRR), with subsequent amendments. Both of these have been incorporated into Icelandic law in the Act on Financial Undertakings.

The FSN determines the CCyB rate on at least a quarterly basis; cf. Article 85(a), Paragraph 5 of the Act on Financial Undertakings. The buffer shall be a multiple of 0.25 percentage points and shall generally range between 0% and 2.5% of the domestic risk base, unless

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<sup>1</sup> A detailed discussion of capital requirements and financial stability can be found (in Icelandic) in a Central Bank *Special Publication* from 2021: <https://www.seðlabanki.is/utgefing-efni/rit-og-skyrslur/rit/2021/06/16/Ser-rit-15-Eiginfjarkrofur-og-fjarmalastodugleiki/>

risk factors underlying the FSN's assessment give particular cause to set a higher rate; cf. Article 85(a), Paragraph 3 of the Act.<sup>2</sup>

A reduction in the CCyB takes effect at the time the decision is made to lower it; cf. Article 84(d), Paragraph 3 of the Act on Financial Undertakings. The minimum length of time before the buffer will be increased again must be specified. This provides financial institutions with a given amount of certainty that the leeway afforded them with the reduction in the buffer will not be taken away again without advance notice. An increase in the CCyB takes effect twelve months after a decision to that effect is announced, unless extraordinary circumstances require otherwise; cf. Article 85(d), Paragraph 1.

According to Article 85(a), Paragraph 4 of the Act on Financial Undertakings, the CCyB rate shall take account of cyclical systemic risk. The assessment of cyclical systemic risk shall take account of the debt cycle, particularly the credit-to-GDP gap, risk stemming from excess credit growth in Iceland, and other relevant factors. Consideration shall also be given to the characteristics of the Icelandic economy. The Committee's decision and the underlying rationale shall be published on the Central Bank of Iceland website, in accordance with Article 85(e) of the Act on Financial Undertakings.

#### Positive neutral CCyB

The FSN's policy of maintaining a positive CCyB when there is no indication of a particularly high or low level of risk in the financial system is based primarily on general uncertainty about the risk facing the financial system at any given time. The COVID-19 pandemic is an excellent example of such uncertainty. Furthermore, the macroeconomic cost of building up capital is lower during an economic upswing than it is when risk has materialised.

In determining the positive neutral buffer rate, the FSN considers developments in financial institutions' capital ratios in the Central Bank's stress tests, among other things. Another factor considered is Iceland's exposure, as a small open economy, to external shocks and to policy decisions made by other comparable economies.

#### Reducing the CCyB

The FSN lowers the buffer rate or sets it at 0% if there is a significant likelihood of a shock that will lead to sizeable losses in the financial system due to reduced economic activity and a decline in asset prices when risk materialises.

Overall, shocks that require or warrant a change in the CCyB may be of two types. On the one hand are shocks that can materialise at a turning point in the financial cycle, after risk has accumulated over time due to, for instance, excess indebtedness, overheated asset markets, and insufficient resilience among lenders and borrowers. The FSN is obliged to respond to elevated risk of this type by increasing the CCyB and applying other macroprudential tools. The second type includes shocks that can materialise when unexpected events – such as global pandemics or large-scale natural disasters – cause

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<sup>2</sup> The risk base is the sum of credit risk, market risk, and operational risk. The share of the risk base considered domestic in the sense of Article 85(a) of the Act on Financial Undertakings is determined solely by the geographical distribution of credit risk. The CCyB requirement imposed by foreign countries is added to Icelandic financial institutions' risk base in proportion to the institutions' credit risk within the countries concerned.

the economic outlook to deteriorate markedly. The severity of the impact the shock will have, all else being equal, on the economy and on financial institutions' capital is of vital importance to the FSN's decision to lower the CCyB.

When the CCyB is lowered, capital requirements made of financial institutions are reduced. All else being equal, this gives financial institutions the scope to work through loan losses, thereby supporting their lending capacity and appetite. Lowering the buffer therefore mitigates the risk of a tightening of lending conditions that would exacerbate the effects of the shock and deepen the downturn.

If the CCyB has been raised above the positive neutral level without straining financial institutions' capital, the FSN will lower the buffer again when there are clear signs of an ongoing decline in systemic risk and a better balance in the domestic economy and financial system.

### **Increasing the CCyB**

When the FSN announces a reduction in the CCyB, it provides guidance on the conditions that could cause the buffer to be raised again. With this increased predictability, the Committee attempts to maximise the positive economic impact of the flexibility provided by lowering the buffer rate. An increase in the buffer takes effect twelve months after the increase is announced unless extraordinary circumstances require otherwise.

The FSN raises the CCyB above the positive neutral level when there are indications that cyclical systemic risk is above average and rising. This creates greater scope to lower the buffer later, if conditions deteriorate or a shock strikes the financial system. Ensuring that financial institutions are adequately capitalised reduces the probability of financial shocks and the social cost accruing from them, in part by mitigating the risk that the financial system will amplify the effects of the shocks. Increasing the CCyB can also stave off growth in systemic risk. However, a decision to raise the buffer rate must take account of the macroeconomic costs as well as the benefits.