Special feature C: Cross-country comparison of the O-SII buffer application[158]

This special feature makes a cross-country comparison of the O-SII buffer application in the EU. To that end, it starts by briefly describing the approaches to the O-SII buffer calibration by Member States and compares the resulting buffer levels set across the EU to assess whether they sufficiently cover the systemic risk posed by O-SIIs. It then describes the use of other instruments deployed by national authorities to reach the target level of capital buffers for SIIs which they deem adequate to cover the risk. The special feature finishes by analysing whether the systemic risk of O-SIIs can be sufficiently mitigated by the O-SII buffer in light of the existing legal restrictions on buffer levels ("caps").

C.1 Methodologies used to identify O-SIIs and calibrate O-SII buffers

Most authorities follow the guidelines that the EBA issued on the identification of O-SIIs. Article 131(3) of the CRD specifies that the assessment of O-SIIs should be based on at least any of the following four criteria: (i) size of the institution; (ii) importance (including substitutability/financial system infrastructure); (iii) complexity/cross-border activity; and (iv) interconnectedness. The EBA guidelines[159], which were published in 2014, establish a scoring process for assessing the systemic importance of an institution based on a number of mandatory and optional indicators for each of these four criteria. The assessment is done at national levels and reflects mainly the concentration of the national banking system. The outcome of the assessment, which is conducted on a yearly basis, is a score allocated to the institution. This score is expressed in basis points and goes from 0 to 10,000: the higher the score, the higher the systemic importance of the institution. In addition, supervisory judgement should be used where appropriate to reflect features of the national banking systems which are particularly important given the divergence across Member States.

Estonia, Latvia, Malta and Slovenia have been assessed by the EBA as non-compliant with the EBA guidelines.[160] Half of the authorities use only the mandatory indicators of the guidelines to identify O-SIIs, while the other half uses additional indicators or supervisory judgment to complement the mandatory indicators[161]. Eight authorities used the option to adjust the standard threshold of 350 bp for O-SII identification to either 275 bp for more diversified markets or to 425 bp for more concentrated markets (500 bp in Slovenia). The majority of O-SIIs have a systemic score below 2,000 bp and only a few of them exceed the score of 3,000 bp (see Figure C.1).

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158 Prepared by Ľuboš Šesták (ESRB Secretariat) with research assistance from Pedram Moezzi (ESRB Secretariat). This special feature is based on the analysis conducted by the ESRB's expert group on use of structural macroprudential instruments in the EU. This analysis was published in the **Final report on the use of structural macroprudential instruments in the EU** (December 2017) and was further updated with 2017 data for this special feature.

159 EBA Guidelines EBA/GL/2014/10 on the criteria to determine the conditions of application of Article 131(3) of Directive 2013/36/EU in relation to the assessment of other systemically important institutions, December 2014.

160 Estonia considers an adjusted score without one binding indicator in their methodology. Latvia revised its methodology, which should now be fully compliant with the EBA guidelines. The Maltese authorities confirm that the use of the EBA methodology would have given the same results in terms of O-SIIs identified. Slovenia applies a threshold of 500 bp. See EBA Compliance Table (Appendix 1) to the Guidelines EBA/GL/2014/10 available at: **https://www.eba.europa.eu/documents/10180/930752/EBA+GL+2014+10-Compliance+Table-Guidelines+on+Criteria+for+the+assessment+of+O-SIIS.pdf/1f62d5db-043c-4a2a-a942-ca107d6b1a34**

161 See Annex 1 of the **Final report on the use of structural macroprudential instruments in the EU** for an overview of these indicators (December 2017).

In general, national authorities use two types of method to calibrate the O-SII buffer but with noticeable differences in the details. The first type of method consists of directly mapping the scores from the identification methodology to the level of the O-SII buffer, assuming that the systemic score is a good proxy for the systemic risk posed by O-SIIs. Most authorities use the so-called bucketing approach[162], but the number of buckets and the allocation of O-SIIs into these buckets differ. Examples of such methods include cluster analysis (GR, IT, PT), proportional calibration (EE, LU), peer comparison (EE), or a combination of methods (BE, DE, HU, IE, SI). Also, supervisory judgement is used (e.g. in AT, BG, CY, ES, FR, NL, PL, RO, SK), while the notifications to the ESRB do not always reveal in which way it is exercised. The ECB published a methodology in 2017, which established a floor for the O-SII buffer rate, based on the bucketing approach, to provide for harmonisation at the lower end of the buffer calibration.[163]

The second type of method derives the O-SII buffer level without a direct link to the score from the identification process. Among these, the (equal) expected impact approach[164] is the most frequently used (BE, EE, HR, HU, IE, LV, LT). Section 4 of the ESRB's final report on the use of structural macroprudential instruments in the EU, and Chapter 4 of the ESRB Handbook for Operationalising macroprudential policy in the banking sector, provide a detailed overview of these calibration methods.

As the use of these different methods results in a significant variation in the levels of the buffer for SII risk[165], the question arises whether these buffer levels sufficiently mitigate the risk posed by O-SIIs (Figure C.1). Some divergence of the buffer levels can be explained by national specificities of banking sectors, for example an O-SII with a lower score will have a different significance in a highly concentrated banking system than in a fragmented banking system. In general, buffer rates for the majority of O-SIIs with similar O-SII scores are within a one percentage point band and O-SIIs with a higher systemic score are required to hold a higher buffer; nevertheless, there are significant outliers. The introduction of the ECB floor methodology narrowed the possible range of O-SII buffers requiring minimum buffer levels for defined buckets. The significant differences in the O-SII buffer rates pertain also to the EU cross-border groups identified in Annex 4, both in relation to their O-SII score as well as to their total assets relative to the EU's GDP (see Figure C.2).

Despite relatively similar O-SII scores across countries, there is little consistency in corresponding buffer levels. Some authorities use the full range of O-SII buffer rates (from 0% to 2%), while others only use part of this range or a flat rate for all O-SIIs. Some countries use the G-SII buffer as an upper benchmark for the O-SII buffers (ES, IT).[166] Others (e. g. IE, IT, PL, PT) structure the buffer rates in a way that no institution is assigned to the bucket with the highest systemic score, which provides a disincentive for banks to increase their systemic importance. Some authorities have intentionally designed their O-SII framework in this way.

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[162] The bucketing approach groups O-SIIs into different groups or "buckets" which are characterised by a similar level of systemic importance. The number of buckets, their size and corresponding buffer rates need to be set in a discretionary way by the national authorities.

[163] ECB, "Topical issue – ECB floor methodology for setting the capital buffer for an identified Other Systemically Important Institution", *Macroprudential Bulletin*, No 3, June 2017.

[164] Some countries use the score from the identification process as a proxy for the bank's systemic LGD in the equal expected impact method.

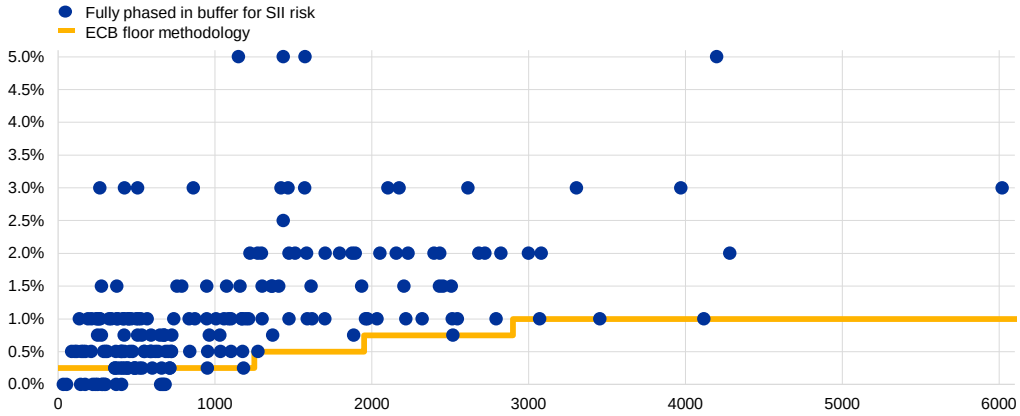
[165] The buffer for SII risk includes the O-SII buffer, the G-SII buffer and the SyRB and Pillar 2 measures only if the national designated authority publicly stated that such measures are used to target the O-SII risk. The O-SII/G-SII buffer is cumulated with the SyRB according to the CRD IV provisions.

[166] ES: Santander G-SII buffer of 1%, IT: UniCredit G-SII buffer of 1%.

Figure C.1

Relationship between the O-SII score and the fully phased in buffer rate for SII risk

(percentages, basis points)



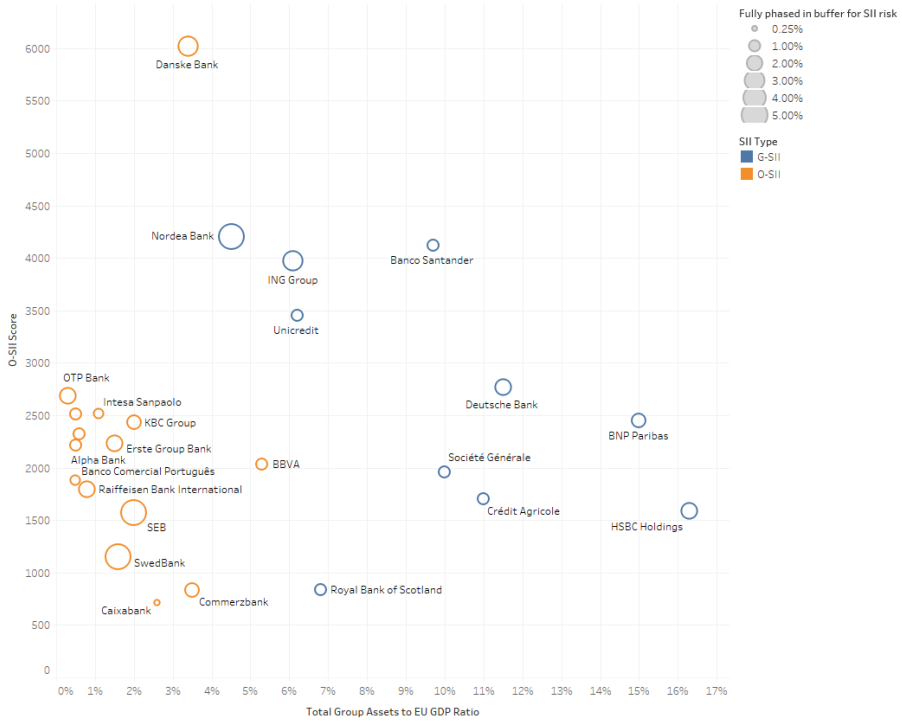
Source: ESRB.

Notes: Data are based on notifications received in 2017. The buffer for SII risk includes the O-SII buffer, the G-SII buffer, the SyRB and Pillar 2 measures only if the national designated authority publicly stated that such measures are used to target the O-SII risk. The O-SII/G-SII buffer is cumulated with the SyRB according to the CRD IV provisions. Those banks with a zero buffer are non-euro area banks.

Figure C.2

Relationship between the significance of O-SII groups and their fully phased in buffer rate for SII risk

(percentages, basis points)



Sources: ECB, ESRB and SNL data and ESRB calculations.

Notes: Data are based on notifications received in 2017 and total assets and GDP figures for 2016. The size of the bubbles represents the level of the fully phased in buffer for the SII risk. The buffer for SII risk includes the O-SII buffer, the G-SII buffer and the SyRB and Pillar 2 measures only if the national designated authority publicly stated that such measures are used to target the O-SII risk. The O-SII/G-SII buffer is cumulated with the SyRB according to the CRD IV provisions.

Several Member States (e.g. ES, GR, IT, PT) justify their lower buffer levels by the intention to avoid adverse effects on credit supply and the economic recovery and to limit possible disruptions to the financial system or the real economy, or are of the view that the introduction of the recovery and resolution framework of the EU addresses the same risks as the O-SII buffer. Several other countries (especially northern, central, eastern and south-eastern European countries) apply relatively higher buffers and a few others use other macroprudential tools in addition to or instead of the O-SII buffer to achieve the desired buffer levels targeting SII risks.

C.2 Restrictions posed by the O-SII buffer caps

The CRD IV[167] restricts the level of the O-SII buffer that can be applied to O-SIIs, which may therefore not be sufficient to mitigate the targeted systemic risk. The O-SII buffer rate cannot exceed 2%. Moreover, for subsidiaries of O-SIIs or G-SIIs that are EU parent institutions the buffer rate cannot exceed the higher of 1% or the buffer rate applicable at the group level. Analyses conducted by some national authorities point to the need for O-SII buffers in excess of these caps (for example in Germany[168] or the Czech Republic[169]).

As a result, O-SII buffers can be set at lower levels than G-SII buffers despite the fact that O-SIIs may have a more concentrated position in national markets. At present, the highest G-SII buffer rate set is 2.5%. The G-SII framework also has an empty bucket of 3.5% and a new, higher empty bucket would be added if any G-SII moved into the current highest bucket. [170] As O-SIIs have, in general, a greater share in their domestic market than G-SIIs in the global banking market (Figure C.3 and Figure C.4), their impact on the domestic economy could, in relative terms, be higher and may justify a higher O-SII buffer.

[167] Article 131 (5) and Article 131 (8) of the CRD.

[168] Deutsche Bundesbank, BaFin (2016), *Capital buffers for other systemically important institutions (O-SIIs)*, abridged version.

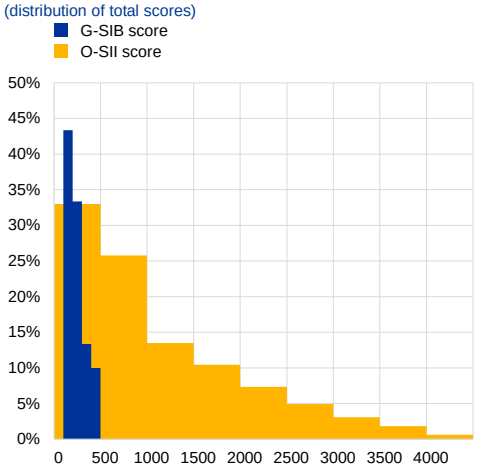
[169] Skorepa, M. and Seidler, J. (2013), "An additional capital requirement based on the domestic systemic importance of a bank", *International Journal of Economic Sciences*, Vol. II, No 3, pp. 131-142.

[170] The new buckets would be added in increments of 1 pp, i.e. 4.5%, 5.5%, etc. See Article 47 of Global systemically important banks: updated assessment methodology and the higher loss absorbency requirement. **https://www.bis.org/publ/bcbs255.pdf**

Figure C.3

Comparison of O-SII and G-SII total scores

(distribution of total scores)

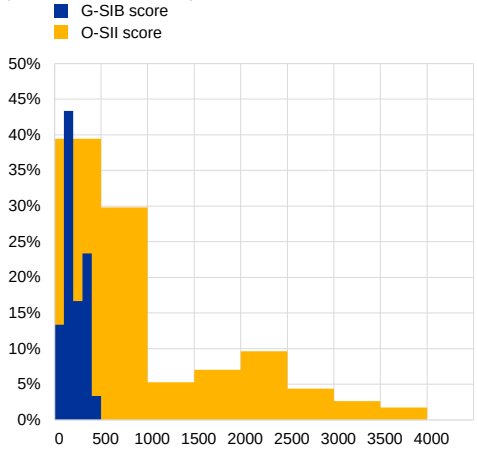


Sources: Loudis, B. and Allahrakha, M. (2016)[171] and ESRB calculations.
Note: O-SII scores refer to 2016 and G-SII scores to 2015 data.

Figure C.4

Comparison of O-SII and G-SII size scores

(distribution of size scores)



Sources: Loudis, B. and Allahrakha, M. (2016)[172] and ESRB calculations.
Note: O-SII scores refer to 2016 and G-SII scores to 2015 data.

While the cap's aim is to prevent ring-fencing of capital at the subsidiary level and to facilitate financial integration in the EU, it can potentially lead to a level playing field distortion or compromise financial stability in host countries. Banks in a jurisdiction should be subject to a consistent, coherent and non-discriminatory treatment regardless of their ownership. As a rule, two banks of similar systemic importance should therefore be subject to a similar O-SII buffer. However, this might not be possible if the O-SII buffer for one of them is capped at a lower level than deemed necessary by the host authority. As a result, either the risk would be insufficiently addressed (which affects financial stability) or the level playing field principle would be compromised. The cap, if applied to at least one subsidiary, thus indirectly affects all banks in the host jurisdiction including domestically owned banks and may ultimately have a negative impact on financial stability in host countries.

Facing the financial stability risk, host authorities might use other instruments to ensure the desired bank capitalisation, which might not be optimal. However, the additional cap should limit the inefficient allocation of capital within banking groups and prevent undesired competition between EU home and host supervisors with regard to the allocation of capital. Furthermore, it is perceived that different buffer levels across the EU could constitute an obstacle to cross-border bank acquisitions and could inhibit the development of pan-European banking groups.

There are 23 Member States where there is an O-SII subsidiary whose parent is an O-SII or a G-SII located in another Member State. In the majority of these countries, at least some subsidiaries are constrained by the buffer set at group level (Figure C.5). For some of them, the O-SII buffer set for the parent group does not pose any restrictions. However, in a number of cases the parent institutions are based in jurisdictions where the buffers are set at such levels that this may lead to a distortion of the host O-SII buffer framework.

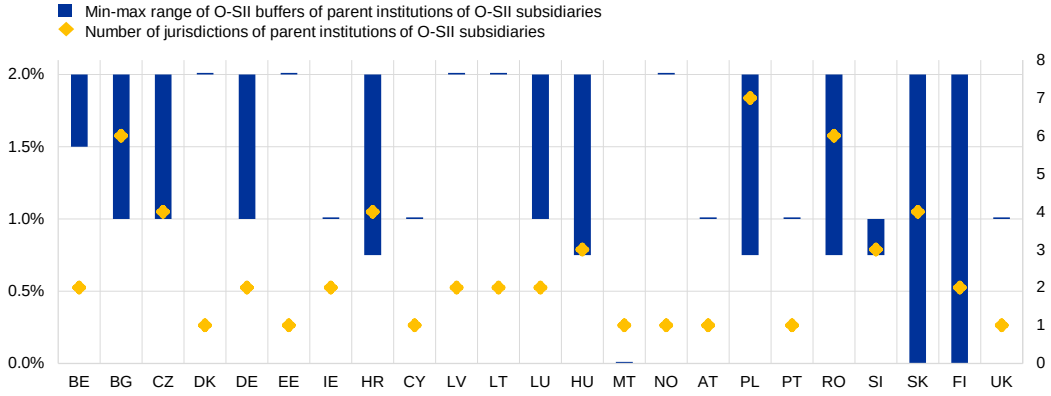
171 Loudis, B. and Allahrakha, M. (2016), "Systemic Importance Data Shed Light on Banking Risks", *Brief Series*, No 16-03, OFR, April.

172 ibid.

Figure C.5

O-SII/G-SII buffer rates of EU parent institutions of O-SII subsidiaries

(percentages, numbers)



Source: ESRB.

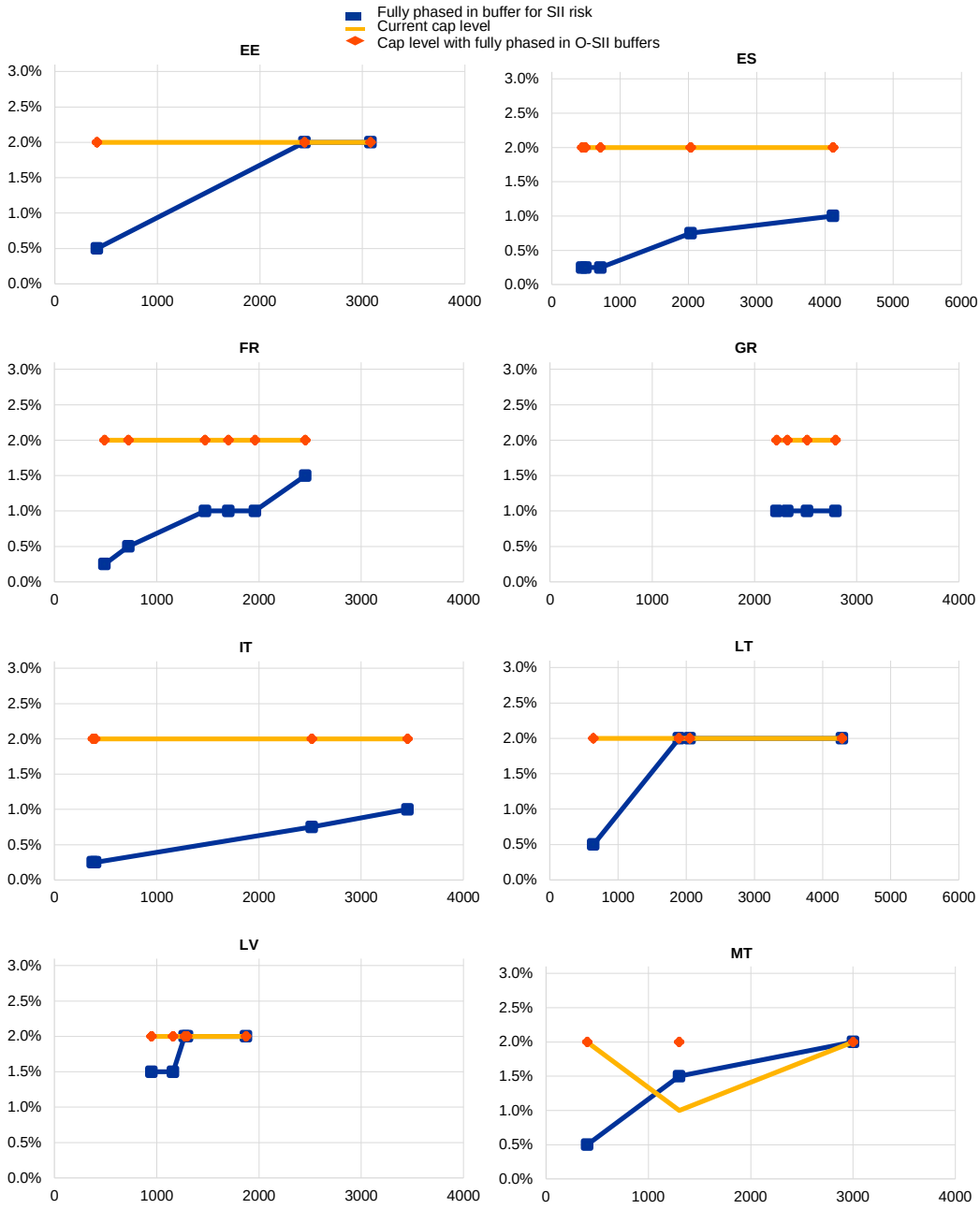
Notes: The O-SII buffer range is displayed on the left-hand axis and shows the range of the higher of O-SII/G-SII buffer rates for foreign EU parent institutions of subsidiaries located in the respective country. The number of jurisdictions in which these EU parent institutions are headquartered is displayed on the right-hand axis. Data are based on notifications received in 2016 and buffer rates applicable in 2017.

For several countries, only the general O-SII buffer cap (2%) applies at present (Figure C.6); however, this level is deemed insufficient by some countries. In France, Greece, Italy and Spain no subsidiary of a foreign bank has been identified as an O-SII, while several of their O-SIIs are themselves parent institutions of O-SIIs located in other Member States. France uses a buffer range of up to 1.5% for its O-SIIs, while the other three countries apply buffer rates only up to 1%. In the three Baltic countries, all subsidiaries are subject to the cap of 2%, as their parent banks have their O-SII buffers set at this level; the cap for subsidiaries thus does not bring any additional limitation to the O-SII framework of these countries. In Malta, the current level of O-SII/G-SII buffers of the parent could have posed restrictions on the O-SII buffer for subsidiaries; however, this restriction will cease to exist once the buffers are fully phased in. The seven aforementioned countries do not apply any other instruments to address the SII risk. Similarly, all O-SIIs in Denmark, the Netherlands and Sweden are only subject to the general O-SII buffer cap. However, authorities in these countries apply other tools such as the SyRB or Pillar 2 to set capital buffers for the SII risk at 3% (Denmark, the Netherlands) and 5% (Sweden) (Figure C.7).

Figure C.6

Relationship between the O-SII score and the fully phased in buffer rate for SII risks for countries where only the general O-SII buffer cap applies

(percentages, numbers)



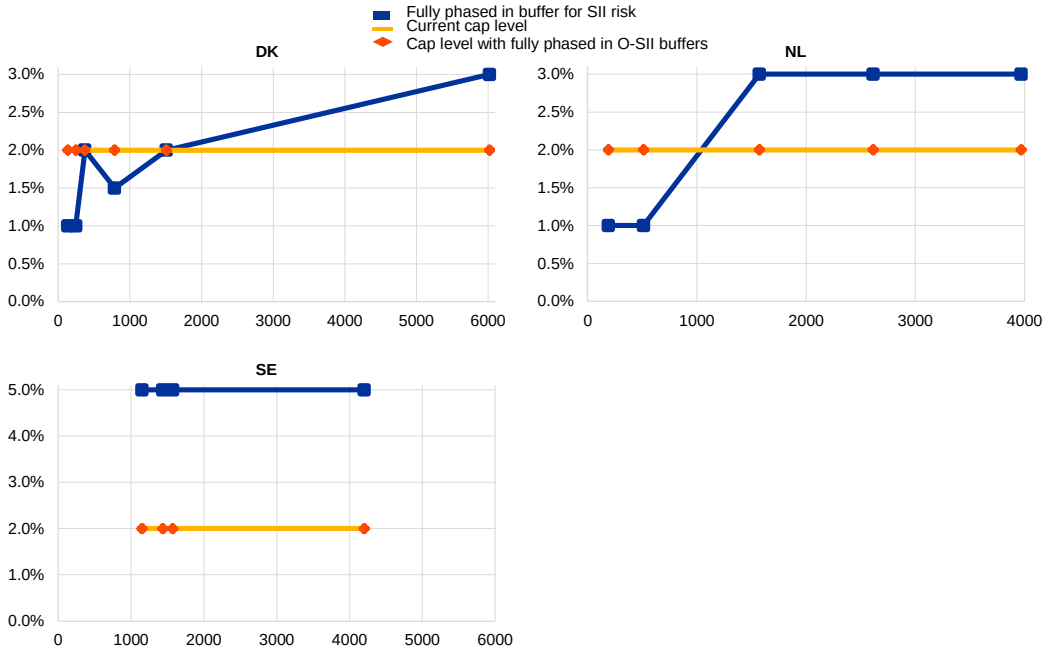
Source: ESRB.

Notes: Data are based on notifications received in 2017. Fully phased in buffer for SII risk may potentially include the G-SII buffer, the O-SII buffer, the SyRB and the Pillar 2 requirement in the country concerned (blue). Cap level refers: (i) either to the 2% O-SII buffer cap for EU parent institutions in the country concerned; (ii) or to the O-SII buffer cap for subsidiaries in the country concerned and whose parent institution is domiciled in another Member State, whichever is more binding; the cap is shown at current levels for 2017 (yellow) or at levels after full phase-in (red).

Figure C.7

Relationship between the O-SII score and the fully phased in buffer rate for SII risks for countries restricted by the general O-SII buffer cap

(percentages, numbers)



Source: ESRB.

Notes: Data are based on notifications received in 2017. Fully phased in buffer for SII risk may potentially include the G-SII buffer, the O-SII buffer, the SyRB and the Pillar 2 requirement in the country concerned (blue). Cap level refers: (i) either to the 2% O-SII buffer cap for EU parent institutions in the country concerned; (ii) or to the O-SII buffer cap for subsidiaries in the country concerned and whose parent institution is domiciled in another Member State, whichever is more binding; the cap is shown at current levels for 2017 (yellow) or at levels after full phase-in (red).

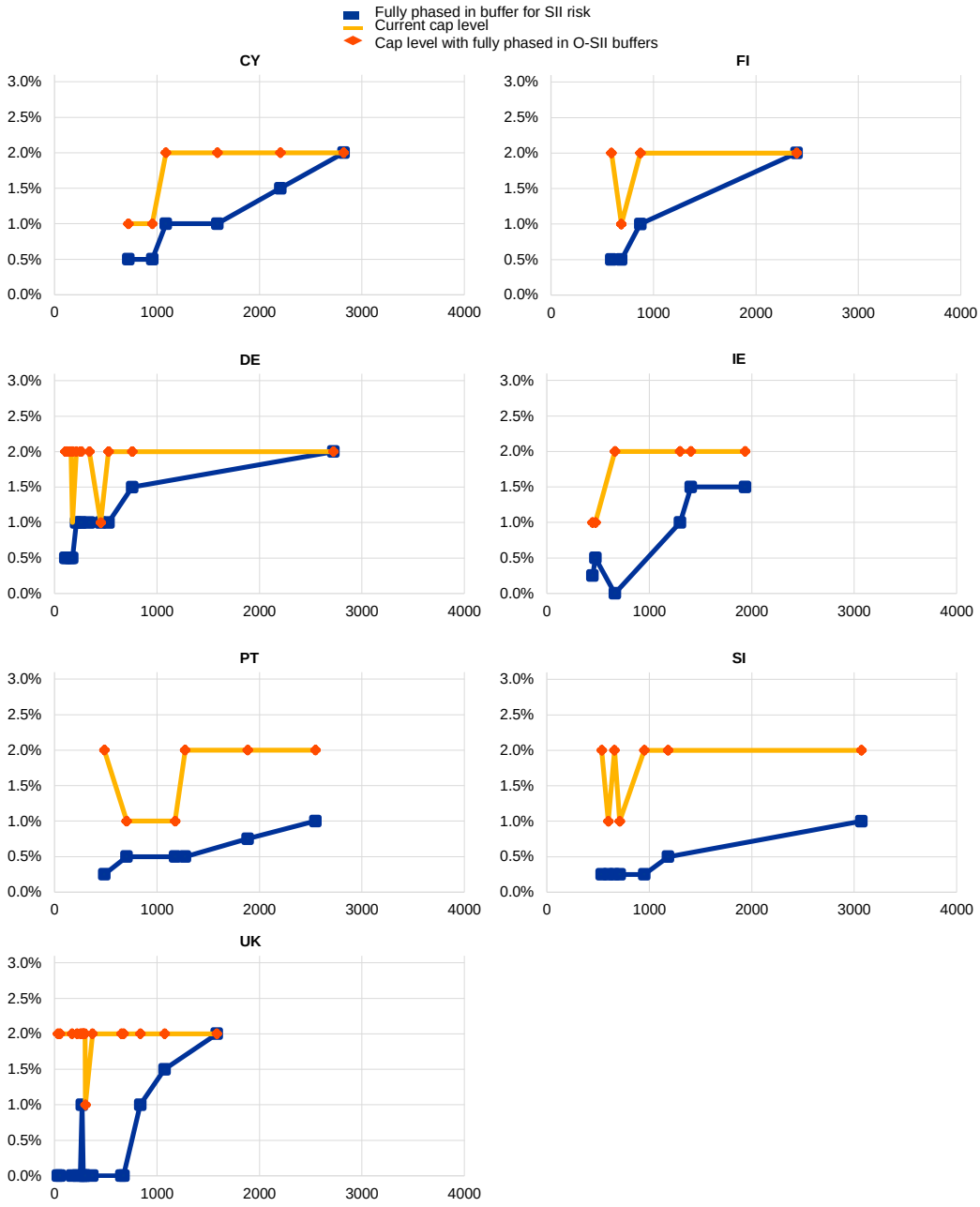
In several other countries, the O-SII buffer is constrained at 1% only for certain subsidiaries with lower O-SII scores and does not seem to distort the framework at present (Figure C.8). For Cyprus and Ireland, the cap for subsidiaries is restricting the potential range of O-SII buffers only for the lowest-ranking O-SIIs. For Finland, Germany, Portugal, Slovenia and the United Kingdom, the subsidiary cap is also in effect for lower-ranking O-SIIs, though not for the lowest-ranking one (although the cap is in effect for the fourth-largest O-SII in Germany). Nevertheless, in all these countries either the desired levels of the O-SII buffer are not restricted by the currently applicable caps or these countries may not want to use other instruments to address the systemic risks not completely covered by the O-SII-buffer.

For several Member States, the subsidiary cap restricts the potential range of the O-SII buffer applicable to the higher-ranking O-SIIs and thus the buffer might be insufficient to cover the O-SII risk (Figure C.9). While in Austria, Hungary and Malta the subsidiary cap is not in effect for the highest-ranking O-SII, for other O-SIIs, it constitutes a binding constraint. For Belgium, Bulgaria, Croatia, the Czech Republic, Luxembourg, Romania and Slovakia, the O-SII buffer rate for the highest-ranking O-SII is currently capped at 1%, though the situation will be somewhat alleviated in Belgium, the Czech Republic and Romania after the buffers for the parent institution are fully phased in. Some of these countries (BE, BG, HU, RO) set the fully loaded buffer for SII risk at the maximum possible rate under the cap. In Luxembourg, the current level of the O-SII buffer is in line with the current level of the cap; however, the fully loaded O-SII buffer rate exceeds the fully loaded O-SII buffer cap, thus potentially creating inconsistencies in the future. Finally, the Czech Republic, Croatia and Slovakia use the SyRB to reach their target buffer levels for SII risks in excess of the O-SII cap.

Figure C.8

Relationship between the O-SII score and the fully phased in buffer rate for SII risks for countries where the cap is restricting only for lower-rank O-SIIs

(percentages, numbers)



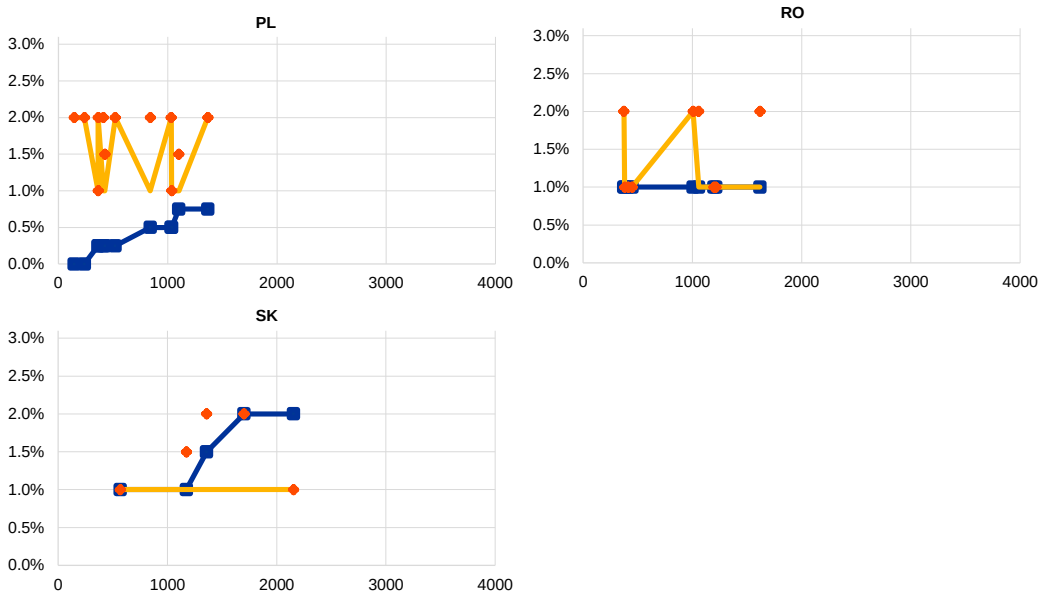
Source: ESRB.

Notes: Data are based on notifications received in 2017. Fully phased in buffer for SII risk may potentially include the G-SII buffer, the O-SII buffer, the SyRB and the Pillar 2 requirement in the country concerned (blue). Cap level refers: (i) either to the 2% O-SII buffer cap for EU parent institutions in the country concerned; (ii) or to the O-SII buffer cap for subsidiaries in the country concerned and whose parent institution is domiciled in another Member State, whichever is more binding; the cap is shown at current levels for 2017 (yellow) or at levels after full phase-in (red).

Figure C.9

Relationship between the O-SII score and the fully phased in buffer rate for SII risks for countries where the capped O-SII buffer might be insufficient to cover the systemic risk

(percentages, numbers)



Source: ESRB.
Notes: Data are based on notifications received in 2017. Fully phased in buffer for SII risk may potentially include the G-SII buffer, the O-SII buffer, the SyRB and the Pillar 2 requirement in the country concerned (blue). Cap level refers: (i) either to the 2% O-SII buffer cap for EU parent institutions in the country concerned; (ii) or to the O-SII buffer cap for subsidiaries in the country concerned and whose parent institution is domiciled in another Member State, whichever is more binding; the cap is shown at current levels for 2017 (yellow) or at levels after full phase-in (red).

C.3 Conclusions

The ability to exercise supervisory judgement and the lack of detailed guidance on O-SII buffer calibration lead to large differences in national approaches. The ESRB's final report on the use of structural macroprudential instruments in the EU identified several potential methods for the O-SII buffer calibration. In principle, each methodology has some discretionary components and parameters that are set using supervisory judgement and none of them have been identified as superior. However, it needs to be ensured that the buffers for O-SIIs are commensurate with the systemic risk they pose. The actual differences in the buffer levels and the use of alternative instruments (SyRB, Pillar 2) instead, or on top of, the O-SII buffer suggest that this is not the case. It is also important to avoid an unequal treatment of O-SIIs across the EU which could jeopardise financial stability.

The differences between buffer rates for O-SIIs across Member States are likely to continue in the near future. The varying O-SII buffer rates are partially due to the different approaches followed by Member States in setting the rates as well as the restrictions posed by the O-SII buffer caps. Some countries use other tools to overcome these restrictions; therefore changes in the design of the caps would allow the use of this dedicated tool to address the risk of SIIs. As a consequence, the ESRB, in its Opinion to the European Commission on structural macroprudential buffers, proposed fostering coordination in the calibration of O-SII buffers and increasing the O-SII buffer cap to 3% with the possibility for designated authorities to impose buffers higher than 3%, subject to approval from the European Commission. These general rules would also apply in the case of subsidiaries of EU parent institutions. Additionally for subsidiaries of EU parent institutions, the ESRB further proposed increasing their O-SII buffer cap so that their O-SII buffer would not exceed the fully phased in O-SII or G-SII buffer applicable to the group at consolidated level by more than 2 pp.