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INSIGHTS FROM THE CENTRAL BANK OF MALTA SURVEY ON BUFFER USABILITY

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BOX 4: INSIGHTS FROM THE CENTRAL BANK OF MALTA SURVEY ON BUFFER USABILITY

This box presents the results of a survey conducted by the Bank amongst a sample of Maltese banks which included both core and non-core banks.[1] The survey sought the views and strategies of banks related to buffer usability, including the effectiveness of macroprudential buffers, as well as impediments to buffer usability. The box attempts to unearth the policy implications underlying the survey results.

Introduction

An important relationship, particularly from a macroprudential policy perspective, relates to the link between management buffers and lending growth rates. In economic downturns, banks with high management buffers may be in a better position to continue providing key services to the real economy, particularly financing both households and domestic NFCs. Management buffers act as a first line of defence against unexpected losses and/or adverse economic shocks. Based on the findings of Berrospide et al. (2021), the threat of significant losses during the pandemic appears to have heightened banks' uncertainty and risk aversion, which increases disproportionately as banks edge closer to the Maximum Distributable Amount (MDA) trigger.[2]

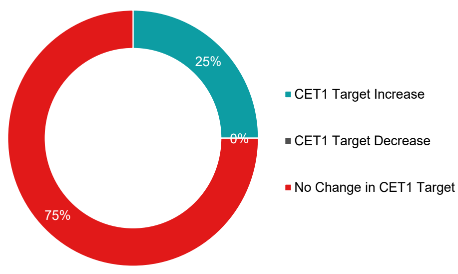
Therefore, from a macroprudential perspective, of concern would be the behaviour of banks with low management buffers, more so if such kind of banks are widespread within the financial system. Despite the Combined Buffer Requirement (CBR) being intended for use in periods of distress, literature shows that banks with low management buffers tend to be less willing to provide additional lending due to their increased proximity to the CBR.[3] Unwillingness to use the allocated capital in the CBR is a result of banks' perceived impediments to buffer usability. In fact, in the aftermath of the COVID-19 pandemic, policy makers and researchers raised concerns on banks' willingness to use capital buffers, and hence, questioning the effectiveness of the capital buffer framework.

CBM survey on buffer usability: insights and policy implications

With a view of understanding any perceived impediments to buffer usability faced by MT banks, the CBM carried out an ad-hoc survey to investigate this behaviour. In January 2022, the CBM circulated a survey amongst domestic banks on buffer usability intended to (i) analyse the effectiveness of the domestic macroprudential capital buffer framework, (ii) assess banks' willingness to use freed up capital to finance the real economy and (iii) investigate the main impediments to buffer usability.

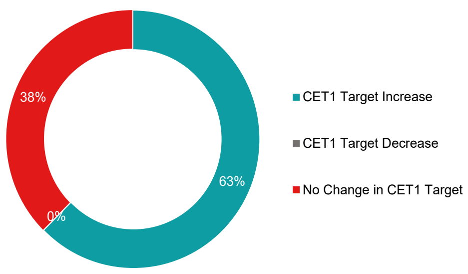
Banks were asked to disclose their preferred internal CET1 management buffer target, with 75% of respondents indicating that their preferred internal target level of CET1 management buffer lies between 0 and 3 percentage points. Furthermore, 75% of respondents indicated that, in reaction to a decrease in their OCR, they would not change their internal target level of CET1 management buffer, as shown in Chart 1(a). Banks therefore appear to set-up their internal target level of CET1 management buffer as a 'mark-up' over and above their OCR, in line with the findings of Couaillier (2021). Banks' responses suggest that when faced with a surplus over their internal CET1 target level, they are willing to use this surplus, which would increase the probability of effective buffer releases. Conversely, when management buffers dip below the desired levels, banks engage in corrective action to restore these buffers to target levels. This is relevant especially if such corrective actions take place in periods of economic uncertainty. In fact, as shown in Chart 1(b) below, 63% of respondents indicated that they would increase their CET1 target level in the wake of an uncertain economic outlook.

Chart 1(a)
DECREASE IN BANKS' OCR
(per cent)



Source: CBM Survey on Buffer Usability.

Chart 1(b)
HIGHER UNCERTAINTY IN DOMESTIC ECONOMIC OUTLOOK
(per cent)



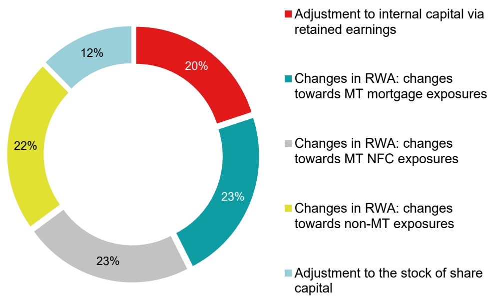
Source: CBM Survey on Buffer Usability.

When questioned on their preferred adjustment strategies in response to different scenarios, banks' responses were heterogenous, as outlined in Charts 2(a) and 2(b). Survey results indicate preference to adjusting their balance sheet to lower RWA. This is achieved by re-focusing on bank core operations such as NFC and mortgage lending. The noted sensitivity in favour of changes in risk weights to achieve the required capital targets has implications on the impact that certain types of macroprudential policies could have on bank behaviour. For example, the use of a broad-based tool, where a more focused alternative would have been more adequate, might ultimately result in banks loading up on exposures which attract relatively lower risk weights, even though these same exposures could have been the prime source of systemic risks.

Moreover, in periods of economic distress, macroprudential authorities can increase banks' management buffers by releasing certain parts of the CBR. In doing so, banks may find their actual management buffers to be in excess of their internal targets, thus having surplus capital. Such releases must be accompanied by adequate guidance and incentives to ensure that the surplus capital is used to finance the real economy rather than distributed in the form of dividends and share buybacks. This is in order to ensure the resilience of the domestic financial system is safeguarded.

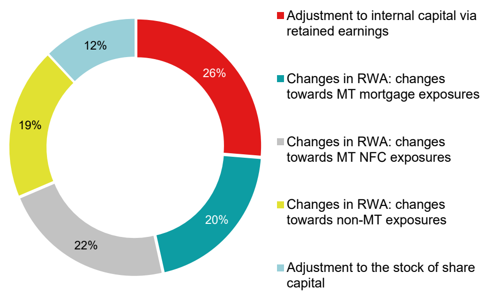
The CBM also asked about the banks' willingness to dip into their Pillar 2 Guidance (P2G) levels to assess the effectiveness of the ECB's COVID-19 temporary capital relief measures amongst others.[4] Survey replies indicate that only 25% of respondents would be willing to dip into their P2G level. The survey also investigated banks' willingness to utilise capital buffers to absorb higher unexpected losses, with only 25% of respondents indicating willingness to use the additional loss-absorbency provided in the CBR.[5]

Chart 2(a)
BANKS PREFERRED ADJUSTMENT STRATEGIES WHEN FACED WITH A DECREASE IN OCR
(per cent)



Source: CBM Survey on Buffer Usability.

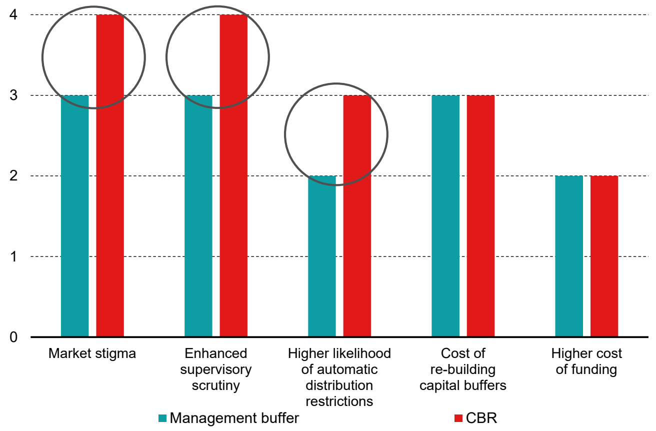
Chart 2(b)
BANKS PREFERRED ADJUSTMENT STRATEGIES WHEN FACED WITH HIGHER UNCERTAINTY IN DOMESTIC ECONOMIC OUTLOOK
(per cent)



Source: CBM Survey on Buffer Usability.

These two findings imply that despite the fact that both the P2G and CBR are intended to be used in periods of distress, banks are unwilling to dip into these buffers. On one hand, banks treat the P2G as binding, and on the other, banks perceive that dipping into the CBR carries costs that outweigh the intended benefits. These responses are also corroborated by the findings in Andreeva et al. (2020). Moreover, based on the findings of Couaillier (2021), banks do not appear to differentiate between the different forms of capital requirements when setting their internal capital targets. This implies that banks are apprehensive to reduce their capital ratios and draw down their buffers, which raises some concerns on buffer usability.

Chart 3
MAIN IMPEDIMENTS TO BUFFER USABILITY
(degree of impediment)



Source: Central Bank of Malta.

In view of the above, the CBM asked participants on the perceived impediments to using capital allocated for both the bank's own management buffer and also towards capital allocated for the CBR. As highlighted in Chart 3, 'market stigma' and 'enhanced supervisory scrutiny' where seen as the main impediments to buffer usability and the degree of impediment for these buffers is higher in the event that banks need to utilise capital allocated towards the CBR.[6]

Furthermore, respondents indicated that supervisory expectations towards buffer replenishment should mainly be guided by banks' ability to issue new equity and pressures by stakeholders for dividend pay-outs. Respondents contend that these impediments can potentially be major obstacles to buffer usability and as such they should be studied further at a European level to ascertain a concerted effort in tackling them in the most effective manner. In response to the Call for Advice by the European Commission on the review of the EU macroprudential framework, the ESRB suggested enhancing buffer usability by increasing the amount of releasable capital. This could be achieved by:

i. allowing for earlier and more active use of the CCyB;
ii. enabling authorities to establish a positive neutral rate for the CCyB;
iii. enabling authorities to establish a positive neutral rate for the systemic risk buffer (SyRB).

Concluding remarks and policy implications

The need to monitor at all times the system-wide levels of management buffers, which are a precondition for continued financing support in periods of uncertainty, should not be underestimated. The findings emerging from the survey replies corroborate with trends observed from data, and together they highlight the important role management buffers play during periods of economic distress. The interaction between releasable buffers and management buffers as well as banks' perception on impediments to buffer usability, are also informative from a policy perspective. For releases to be effective, the resultant management buffers must exceed banks' internal targets.

Releases must also be accompanied by the right incentives to ensure that once released, this surplus capital is directed towards more lending and not be treated as a windfall. Finally, to provide clarity and reduce uncertainty, buffer releases should not be communicated as temporary; and the authorities should engage in active communication to guide the industry on expected buffer replenishment.

Notes

[1] The survey has been circulated amongst core and non-core domestic banks which cover 75% of domestic total assets. The replies of the survey are unweighted in the reported outcomes and conclusions presented.

[2] The MDA trigger is the level at which regulators automatically restrict earnings distribution. This is a level at which banks' total capital falls below the sum of its Pillar 1, Pillar 2 and CRD buffer requirements.

[3] The CBR is made up of loss absorbing capital buffers such as the Capital Conservation Buffer (CCoB) and (where applicable) the O-SII buffer, CCyB and the SyRB. By design, these buffers are also intended to be used in times of need for loss absorption, thereby avoiding dips into minimum regulatory requirements such as P2R.

[4] The ECB allowed banks to temporarily operate below the P2G level during the COVID-19 pandemic in order for banks to continue financing households and corporates experiencing temporary difficulties.

[5] In their replies, larger banks indicated a greater willingness to dip into the CBR and P2G.

[6] For the purposes of the survey, the CBM limited itself to 5 major impediments consisting of 'market stigma', 'enhanced supervisory scrutiny', 'dividend restrictions', 'cost of re-building capital buffers' and 'higher cost of funding'.

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