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The State of Bank Capital in Europe: a Guide to Requirements by Country

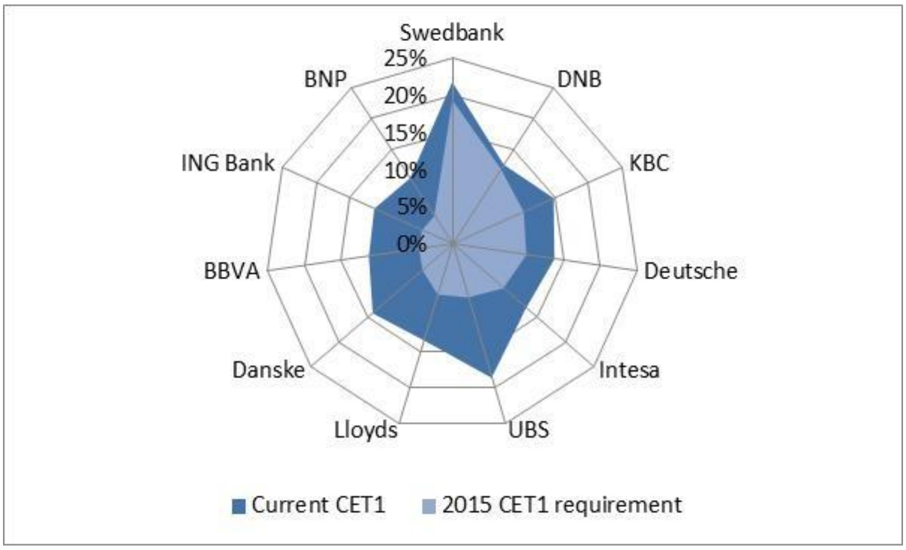
Bank capital requirements remain a central area of focus for investors and other market participants. Where relevant, European countries have made progress in implementing CRD IV/CRR but there is still work to be done. In particular, for investors in bank capital securities, better clarity regarding the various buffers comprising the combined buffer requirement (CBR) and Pillar 2 requirements would be helpful. In January 2016, breaches of CBRs will lead to mandatory restrictions on dividends and Additional Tier 1 (AT1) coupon payments – yet many of the requirements that issuers are subject to remain unknown.

As a reminder, the combined buffer requirement is comprised of the following:

1. Capital conservation buffer: 2.5% to be phased in from 2016 to 2019
2. Countercyclical buffer: Applies to exposures in a specific country. Each bank will have its own countercyclical buffer depending on the geographic spread of its credit exposures
3. Systemic buffers: Generally, the highest of the following:
    - Systemic risk buffer between 1% and 5%
    - Global systemically important institution (G-SII) buffer between 1% and 3.5%
    - Other systemically important institution (O-SII) buffer up to 2%

In this report, we take a look at the state of capital requirements for banks across the European Union, Switzerland and Norway. As shown below, the disparity in implementation is wide, even within the EU.

Chart 1: Disparity in CET1 requirements



Notes:
(1) Current CET1 as of 1Q 2015.
(2) 2015 CET1 requirements are Scope estimates based on publicly available information.
(3) For BNP, ING Bank and BBVA – minimum requirements only with no Pillar 2 estimates.
Source: Company data, Scope Ratings

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Countercyclical buffers are currently being used in the Nordic countries and Switzerland but in light of the generally muted economies in Europe we would not expect to see many other national countercyclical buffers in the near future. For systemic risk buffers, these have been set so far in the Nordic countries, Austria and the Netherlands. Meanwhile, the FSB has identified G-SIIs and updates the list on an annual basis, usually in November.

Greater uncertainty lies with Pillar 2 requirements – how much they are, where they sit in the capital stack and the implications when they are breached. In general, Pillar 2 requirements need to be met with at least 56% of CET1 capital and at least 75% of Tier 1 capital but can this vary greatly.

As supervisors become more consistent in how they assess and supervise, some banks will likely face higher Pillar 2 requirements especially in those countries which had more relaxed Pillar 2 frameworks. This can be seen already with some of the banks which have disclosed their ECB capital requirements following the Comprehensive Assessment last year. Final guidelines for the supervisory review and evaluation process (SREP) have been published by the EBA and will become effective from January 2016.

Sweden and the UK are countries which have more fully developed Pillar 2 frameworks. In these countries, banks may also be subject to a Pillar 2 capital buffer although the respective regulators have some differing views on the purpose of the buffer and how it interacts with buffers under the Pillar 1 framework.

Europe – disclosures by certain banks in Belgium, Germany and Italy

Under CRR, banks must meet own funds requirements of 4.5% CET1 capital, 6% Tier 1 capital and 8% total capital. From the limited disclosures made by banks, the wide disparity seen in requirements leads us to question what banks' actual capital requirements really are. We would expect this to become more harmonised as the ECB further establishes itself as the supervisor for European banks and the EBA's guidelines for SREP are implemented.

In February 2015, Deutsche Bank disclosed that the ECB is requiring a minimum 10% CET1 ratio on a transitional basis. As the current Pillar 1 requirement is 4.5%, this leaves a gap of 5.5%. As the capital conservation buffer is not yet in effect and no systemic or countercyclical buffers have been set the difference could be interpreted as the Pillar 2 requirement but we are not sure.

At the request of the market regulator CONSOB, Italian banks disclosed their capital requirements as set by the ECB during the first quarter of 2015. The banks disclosed both their transitional CET1 ratio requirements as well as their total capital ratio requirements. For Intesa, this was 9% CET1 capital and 11.5% total capital. For UniCredit, this was 9.5% CET1 capital and 13% total capital. As the capital conservation buffer of 2.5% has been fully implemented in Italy since January 2014 this implies a Pillar 2 requirement of 2% for Intesa and 2.5% for UniCredit.

In March 2015, KBC Group also disclosed that the ECB is requesting that it hold a minimum 10.5% CET1 ratio – but on a fully-loaded basis rather than on a transitional basis. As the current Pillar 1 requirement is 4.5%, this leaves a gap of 6%. As the capital conservation buffer is not yet in effect and no systemic or countercyclical buffers have been set the difference could be interpreted as the Pillar 2 requirement but again we are not certain. We note that previously the Belgian regulator had requested KBC to maintain a minimum 9.25% CET1 ratio on a fully-loaded basis (excluding AFS reserves).

Austria

Systemic risk buffers for banks with Central and Eastern Europe exposure

In June 2015, the Financial Market Stability Board (FMSB) determined that the largest banks (Erste Group, Raiffeisen Zentralbank and UniCredit Bank Austria) would be subject to a 3% buffer to cover systemic risks. The requirement will be phased-in until mid-2017.

Netherlands

Systemic risk buffers have been set

In April 2014, De Nederlandsche Bank (DNB) announced that it will impose an additional capital buffer of 3% for ING Bank, Rabobank and ABN Amro Bank and of 1% for SNS Bank. The buffer will be phased-in between 2016 and 2019.

The banks have been deemed to be systemically important. In making its decision, DNB noted that the Dutch banking sector is equivalent to more than four times the size of annual Dutch GDP and the level of concentration is high. The three major banks are responsible for the majority of lending to Dutch households (85%) and companies (60%). SNS Bank was also deemed systemically important as it holds relatively large amounts of Dutch consumer savings although it is a much smaller bank and has smaller market share.

The banks are subject to Pillar 2 requirements but are not currently permitted to disclose them.

Sweden

Multiple Pillar 2 requirements

Swedish authorities took the initiative to implement higher capital requirements without a phasing-in period, with the exception for the grandfathering of capital instruments not fully compliant with CRR. In September 2014, Finansinspektionen, the Swedish Financial Supervisory Authority (SFSA), indicated capital requirements for Swedish banks beyond the minimum 7% of CET1 capital (4.5% minimum plus 2.5% capital conservation buffer).

As of January 2015, the four major Swedish banks (Handelsbanken, Nordea, SEB and Swedbank) have been assigned a systemic risk buffer of 3% in CET1 capital within the Pillar 1 framework and an additional 2% of CET1 capital within the Pillar 2 framework. The countercyclical buffer for Swedish exposures is 1% from September 2015 and will increase to 1.5% from June 2016.

Since 2013, the SFSA has had a risk weight floor for Swedish mortgages as a supervisory measure under Pillar 2. In September 2014, the risk weight floor was raised to 25% from 15%. In some cases, the floor may go beyond 25%. There is also a 25% risk weight floor for mortgage exposures in Norway. In light of the overall low level of asset intensity, any harmonisation of risk weights may lead to further floors for Swedish banks.

Pillar 2 basic requirement

In addition, as part of the supervisory capital assessment the SFSA indicates the amount of additional capital which should be held to cover risks or risk elements not covered by Pillar 1 – known as the Pillar 2 basic requirement. The Pillar 2 basic requirement is in addition to both the minimum capital requirement and capital buffers. More specifically, as implemented in Sweden, the Pillar 2 basic requirement sits above minimum capital requirements in Pillar 1 and below the combined buffer.

The SFSA has further established explicit methods for assessing Pillar 2 capital requirements for three types of risk: credit-related concentration risk, interest rate risk in the banking book and pension risk. These requirements comprise part of the Pillar 2 basic requirement. The Pillar 2 basic requirement for the 10 largest banks is currently set at 2% of RWAs. From the third quarter of 2015, the SFSA will use capital requirements based on the new methods. According to the SFSA, aggregate capital requirements for the three risk types are estimated at 1.6% of RWAs on average for the four major banks. In addition, banks are expected to keep additional capital for risks types not covered by the SFSA’s methods.

The Pillar 2 basic requirement should be met as a general rule according to the same allocation of capital as Pillar 1 capital requirements, including static buffer requirements (capital conservation buffer, systemic risk buffer and buffers for other and global systemically important institutions). For the four major banks, this means that the Pillar 2 basic capital requirement should be met with at least 75% of CET1 capital.

Capital planning buffer

In addition to the above Pillar 2 basic requirement, the supervisory process also contains an assessment of a firm's need to hold a capital planning buffer. The capital planning buffer which must be met by CET1 capital is intended to cover at a minimum the deterioration in capital adequacy that may arise in severe but plausible stress. The capital held to cover minimum capital requirements and other buffer requirements may not be used to cover the capital planning buffer, with the exception that capital held to cover the capital conservation buffer may be used to cover the capital planning buffer to a limited extent. It is the SFSA's view that the purpose of the capital conservation buffer overlaps with that of the capital planning buffer while the systemic risk buffers do not. In effect, the SFSA notes that the capital planning buffer covers the same risks that are covered by Pillar 1 and Pillar 2 basic requirements.

On a quarterly basis, the SFSA publishes updated capital requirements for the 10 largest Swedish banks, both total capital and CET1 capital requirements. As of 31 March 2015, total capital requirements for the four largest banks ranged from 19% to nearly 24.9% while CET1 capital requirements ranged from 14.7% to 19.1%. We highlight that these figures are based on a standardised 2% Pillar 2 basic requirement.

Chart 2: Capital requirements for four largest Swedish banks

	Total capital requirements	CET1 capital requirements
Capital conservation buffer	2.5%	2.5%
Countercyclical buffer[1]	0.2 - 0.6%	0.2 - 0.6%
System risk buffer	3.0%	3.0%
Pillar 2 for systemic risk	2.0%	2.0%
25% RW floor for Norwegian mortgages[1]	0.3 - 0.4%	0.3%
25% RW floor for Swedish mortgages[1]	1.0 - 6.4%	0.8 - 5.0%
Pillar 2 basic requirement, excl RW floor & systemic risk[2]	2.0%	1.5%
Minimum AT1 and T2 capital	3.5%	n.a.
Minimum CET1 capital	4.5%	4.5%

[1] Data as of 31 March 2015. Firm-specific requirements. Figures provided are the range for the four largest banks.
[2] Currently the standardised Pillar 2 basic requirement is 2%. From 3Q 2015, these will be firm specific.
Source: SFSA, Scope Ratings

Currently, the SFSA does not intend to make a formal decision regarding Pillar 2 requirements (Pillar 2 basic requirement and capital planning buffer) for individual banks. As long as a formal decision has not been made, the capital requirements under Pillar 2 do not affect the level at which automatic restrictions on dividend and coupon payments take effect (due to a breach of the combined buffer requirement). However, if there were a breach, the SFSA within the framework of intensified supervision will demand that the firm explain how it intends to restore the capital. It remains unclear how breaches of Pillar 2 requirements would affect the payment of coupons on AT1 securities. The Basel 1 floor also continues to apply although the buffer requirements in CRR/CRD IV, including systemic risk buffers for systemically important Swedish banks is calculated without taking into account the Basel 1 floor.

UK

Capital requirements include a firm-specific leverage ratio requirement

The UK's Prudential Regulatory Authority (PRA) has largely decided not to use transitional provisions for determining capital requirements. Nevertheless for additional Tier 1 and Tier 2 capital, the PRA is following transitional provisions with adjustments being phased in at 20% per annum from 2014 to 2018. In addition to Pillar 1 requirements under CRR, major UK banks and building societies have had to maintain since 2014 a minimum CET1 ratio of 7% and a minimum Tier 1 leverage ratio of 3% on a fully-loaded basis.

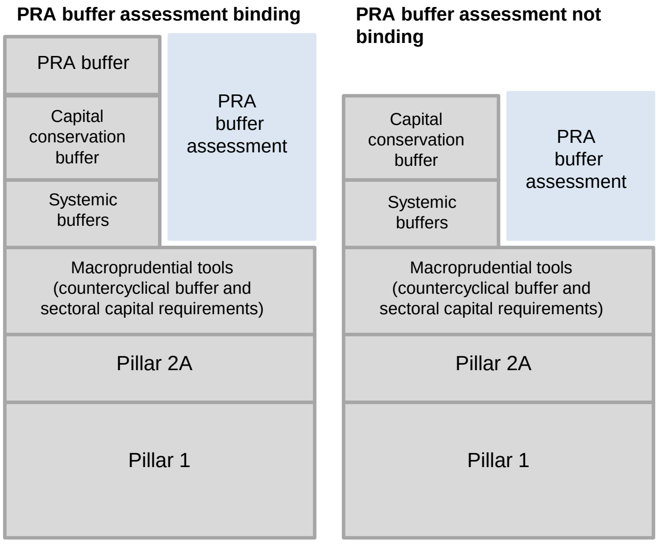
Pillar 2 requirements

Under the Pillar 2 framework, the PRA determines individual capital guidance (comprised of Pillar 2A and Pillar 2B) based on internal capital adequacy assessments and supervisory reviews. Pillar 2A covers risks which are not captured, or not fully captured under CRD IV (e.g. interest rate risk in the non-trading book or credit concentration risk, respectively). In addition to Pillar 1 requirements, the PRA regards Pillar 2A capital as the minimum level of regulatory capital a firm should maintain at all times. From January 2015, Pillar 2A must be met with at least 56% CET1 capital, consistent with Pillar 1 requirements. Additional capital held under Pillar 2B is a capital buffer which helps to ensure that firms can meet minimum requirements (Pillar 1 and Pillar 2A) during a stress period.

Pillar 2A guidance is a point in time assessment and is subject to annual review. For the four UK banks rated by Scope, the disclosed Pillar 2A guidance is as follows: Barclays (2.8%; previously 2.5%), HSBC (2%; previously 1.5%), Lloyds (3.8%) and RBS (3.5%). If a firm does not meet the guidance however, this does not mean that it no longer meets the overall financial adequacy rule.

In January 2015, the PRA published a consultation paper on the Pillar 2 framework with finalisation expected by July 2015 and implementation from January 2016. The PRA is proposing to introduce a PRA buffer to replace Pillar 2B (i.e. capital planning buffer). The PRA buffer would be met with CET1 capital, consistent with CRD IV buffers. Like the current capital planning buffer, the PRA buffer would not be a minimum to be held at all times but could be drawn down as necessary. Unlike with CRD IV buffers, use of the PRA buffer would not lead to automatic capital distribution restrictions. In order to avoid duplication with CRD IV buffers, the PRA buffer should be offset against a firm's systemic risk and capital conservation buffers so that the PRA buffer would be any excess capital required over and above systemic risk buffers and the capital conservation buffer.

Chart 3: UK Pillar 2 framework



Source: UK PRA

All firms will be subject to a PRA buffer assessment and the PRA will set a PRA buffer only if it deems that CRD IV buffers are inadequate for a particular firm in a stress scenario or where the PRA has identified risk management and governance failings. In order to address weaknesses in risk management and governance, the PRA is proposing a scalar to be applied to firms' CET1 Pillar 1 and Pillar 2A requirements, ranging from 10% to 40%. Subject to a firm's market disclosure and transparency obligations, the PRA buffer is meant to remain confidential between the firm and the PRA.

Systemic buffers

In January 2015, the UK adopted legislative changes necessary to transpose the systemic risk buffer (SRB). The SRB is to be applied to ring-fenced banks and building societies (over a certain threshold) from January 2019. By 31 May 2016, the FPC is required to create a framework for identifying the extent to which the failure or distress of systemic institutions would pose long-term non-cyclical systemic or macro-prudential risks. The PRA will then use this framework to determine which institutions would be subject to a SRB, ranging from 1% to 3%.

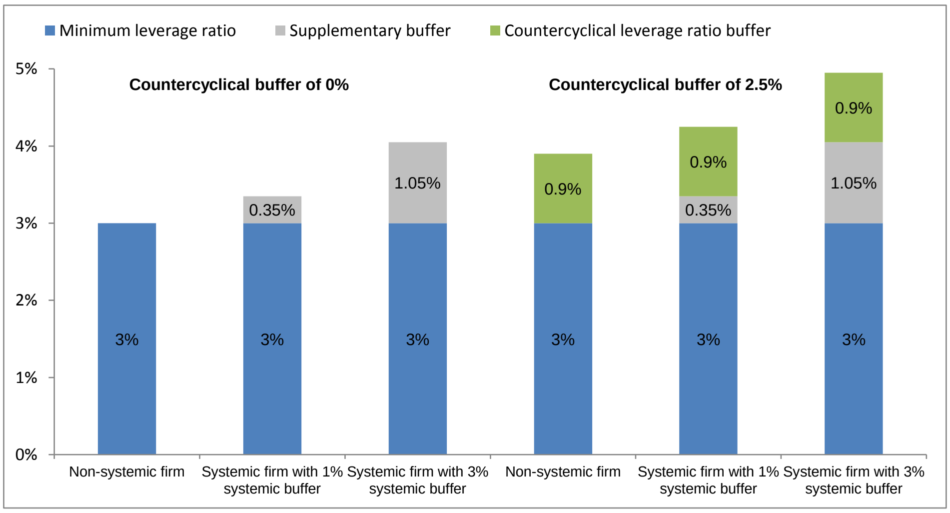
Macro-prudential tools

In January 2014, the FPC issued a statement on its powers to supplement capital requirements through the use of macro-prudential tools – the countercyclical buffer and sectoral capital requirements. Sectoral capital requirements are not currently being used while the countercyclical buffer rate for UK exposures has been set at 0%. In addition, the countercyclical rates being introduced by Norway (1% effective October 2015), Sweden (1% effective October 2015) and Hong Kong (0.625% effective January 2016) are recognised and will apply to firms as appropriate.

Leverage ratio framework

In October 2014, the FPC published final recommendations for a UK specific leverage ratio framework. The recommendations include a minimum leverage ratio of 3% to be implemented as soon as practicable for major UK banks and building societies, a supplementary leverage ratio buffer for systemically important firms of 35% of the relevant risk-weighted systemic risk buffer rate and a further countercyclical leverage ratio buffer of 35% of the relevant risk-weighted countercyclical buffer. The minimum leverage ratio is to be met with 75% CET1 capital and 25% with AT1 capital. Meanwhile, both the supplementary leverage ratio buffer and countercyclical leverage ratio buffer should be met only with CET1 capital. In February 2015, the proposals were presented to Parliament for approval.

Chart 4: UK leverage ratio framework – examples of the components and calibration



Source: Financial Policy Committee

Denmark

Systemic risk buffers have been set and the obligatory disclosure of solvency needs provides further clarity regarding capital requirements

SIFIs are subject to a SIFI capital buffer requirement of 1% to 3% by 2019 depending on their systemic importance. The requirement is phased-in between 2015 and 2019.

An institution is identified as being systemically important if at least one of the following criteria is met for two consecutive years: (i) balance sheet greater than 6.5% of GDP (ii) lending greater than 5% of total sector lending or (iii) deposits are greater than 5% of total sector deposits. In June 2014, the following institutions met the SIFI criteria: Danske Bank, Nykredit Realkredit, Nordea Bank Danmark, Jyske Bank, Sydbank and DLR Kredit.

On a quarterly basis, Danish banks must also disclose their solvency need and solvency need ratio. Through the internal capital adequacy assessment process (ICAAP), banks determine their solvency need. The solvency need is specific to each bank and is expected to cover all material risks. A bank's solvency need is based on Pillar 1 requirements but also takes into account other risks which are not included under Pillar 1 such as pension risk and business risk. Hence, the solvency need can be understood as comprising both Pillar 1 and Pillar 2 requirements.

In regards to Pillar 2 requirements, Danish banks are permitted to use capital instruments that automatically convert or are written down if an adequately high trigger is breached (considered to be at least 7%).

Norway

Pillar 1 capital requirements including buffers have been set

CRD IV capital adequacy rules became effective in Norway in July 2013 via amendments to the Norwegian Financial Institutions Act (FIA). FIA imposes a conservation buffer of 2.5% and a systemic risk buffer of 3% for all Norwegian financial institutions.

From 30 June 2015, banks will also have to maintain a countercyclical buffer and capital buffer to mitigate systemic risk. The countercyclical buffer is current set at 1% with the Ministry of Finance determining the level each quarter. From July 2016, the countercyclical buffer increases to 1.5%. Systemically important banks must hold a further buffer of 1% in CET1 capital from July 2015, with this increasing to 2% from July 2016.

Systemically important institutions were identified in May 2014. As a general rule, an institution is deemed to be systemically important if it has total assets corresponding to at least 10% of Mainland Norway's GDP, or a share of the Norwegian lending market of at least 5%. DNB ASA, Nordea Bank Norge ASA and Kommunalbanken AS are considered to be systemically important.

Banks in Norway remain subject to the Basel 1 floor – such that RWAs cannot be less than 80% of risk-weighted volume calculated according to Basel 1 regulations. Further, the Norwegian FSA has clarified that the Basel 1 floor is a floor for calculating RWAs, rather than a minimum level of capital as defined in EU regulation.

Switzerland

Swiss finish based on Basel 3 rather than CRD IV

As it is not a member of the EU, Switzerland has implemented directly Basel 3 rather than CRD IV. The Basel 3 framework along with Swiss "Too Big to Fail" legislation was implemented in January 2013. From 2014 – 2018, there will be a five-year phase-in of goodwill, other intangible assets and other capital deductions (e.g. certain deferred tax assets) and the phase-out of an adjustment for pension plans. From 2013 – 2022, hybrid Tier 1 and Tier 2 capital instruments are also being phased-out. Systemically relevant banks (SRBs) are subject to specific SRB capital regulations. Credit Suisse and UBS have been identified as SRBs.

Progressive buffer

SRBs must hold a base of 4.5% in CET1 capital from 2015. In addition, there is a capital buffer of 8.5%, of which at least 5.5% must be in CET1 capital. Up to a maximum of 3% of the buffer can be met with high-trigger instruments (AT1 and T2 securities that write-down on convert when the CET1 ratio falls below 7%). Further, there is a progressive buffer component of up to 6% of RWAs which is dependent on the SRB's size (measured by leverage exposure) and market share in loans and deposits in Switzerland. The progressive buffer can be met with CET1 capital or low-trigger instruments (AT1 and T2 securities that write-down or convert when the CET1 ratio falls below 5%). In addition, until the end of 2017, the progressive buffer can also be met with high-trigger instruments. SRB's may be eligible for a reduction in the progressive buffer if steps are taken to facilitate recovery and resolvability to ensure the integrity of systemically important functions. Both Credit Suisse and UBS for example have established holding companies. Both the capital buffer and the progressive buffer are being phased-in until 2019.

For all banks, Swiss capital requirements also include a supplemental countercyclical buffer of up to 2.5%. Since June 2014, there is a countercyclical buffer requirement of 2% of RWAs for mortgage loans on residential property in Switzerland. However, as mortgage loans comprise only a small proportion of both Credit Suisse's and UBS' RWAs, the countercyclical buffer amounts to just 0.1% and 0.2%, respectively at 31 March 2015.

Leverage ratio framework

SRBs are also subject to a leverage ratio that is at least 24% of each of the respective minimum, buffer and progressive component requirements. As the ratio is defined by reference to capital requirements which are being phased-in, the leverage ratio is also phased-in. As of January 2015, the BIS leverage ratio framework was adopted – which measures Tier 1 capital against end of period leverage exposure. Under the previous Swiss leverage ratio framework, Tier 1 capital as well as other loss-absorbing capital was measured against a three-month average total adjusted exposure amount.

By the end of 2015, the Swiss government will consider proposals from the Brunetti group and the Swiss Federal Council about potential changes required to Swiss "Too Big to Fail" laws. The Brunetti report argued that adjustments are necessary to eliminate the implicit government guarantee in the long term while the Swiss Federal Council noted the need to implement new international standards on total loss-absorbing capacity in Switzerland.

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