EBA European Banking Authority

European System of Financial Supervision

8th December, 2011

Capital buffers for addressing market concerns over sovereign exposures

Methodological Note

Summary

The capital package (hereafter, "capital exercise") as laid out in the EBA Recommendation on temporary capital buffers requires NSA's to ensure that relevant banks build up capital buffers to reach a level of 9% Core Tier 1 ratio by the end of June 2012, after the removal of the prudential filters on sovereign assets in the Available-for-Sale portfolio and prudent valuation of sovereign debt in the Held-to-Maturity and Loans and receivables portfolio, reflecting market prices as of 30 September 2011.

The objective of the capital exercise is to create an exceptional and temporary capital buffer to address current market concerns over sovereign risk and other residual credit risk related to the current difficult market environent. This buffer would explicitly not be designed to cover losses in sovereigns but to provide a reassurance to markets about banks' ability to withstand a range of shocks and still maintain adequate capital.

This note summarises the methodology adopted for identifying capital buffers according to the new targets at the bank level.

Key dates

Banks will be required to build up their capital buffers and reach a 9% Core Tier 1 ratio (hereafter, the "benchmark") by the end of June 2012, after the removal of the prudential filters on sovereign assets in the Available-for-Sale (AFS) portfolio and prudent valuation of sovereign debt in the Held-to-Maturity (HTM) portfolio and Loans and receivables portfolio, reflecting market prices. The reference date for computing the buffers with respect to the benchmark is the 30 September 2011, which also reflects the date for relevant market prices to be used, which were assessed by the EBA.

Scope of application

The capital exercise involves 71 banks. They are the banks that participated in the 2011 EU-wide stress test, although a subset of small non cross-border banks has been exempted.

(see list below)

The capital package for Greece has been defined in such a way not to conflict with pre-agreed arrangements under the EU/IMF programme. The assistance programme already defines a set of targets for the banks in question, including quantitative objectives for the Core Tier 1 ratio, which are being monitored on a regular basis. For Greece the backstop measures exceed the EBA exercise and no new benchmarks have been set for Greek banks. Data for Greek banks are therefore not disclosed.

Definition of Core Tier 1

The definition of Core Tier 1 is the same used in the 2011 EU-wide stress test (including existing capital instruments subscribed by governments). This definition of capital comprises the highest quality capital instruments (common equity) and hybrid instruments provided by governments as announced by the EBA for the 2011 EU-wide stress test.

This definition is based on existing EU legislation in the Capital Requirements Directive (CRD). It takes the existing EU definition of Tier 1 net of deductions of participations in financial institutions and it strips out hybrid instruments including existing preference shares. It recognises existing government support measures.

To ensure a fully harmonised computation by all the banks involved in the exercise, the EBA has mapped the different capital elements of Core Tier 1 to the current COREP reporting framework. Only commercial instruments of the highest quality are included in this Core Tier 1 definition – ordinary shares or similar instruments in line with the principles detailed in CEBS/EBA guidelines on core capital.

This means, in particular, that the commercial instruments included in Core Tier 1 have to be simple, issued directly by the institution itself and able, both immediately and without any doubt, to meet the criteria of permanence, flexibility of payments and loss absorption in going concern situations. The inclusion of government support measures in this definition reflects the expectation of supervisors that those instruments will be fully available to absorb losses and shelter banks in case of difficulties. Government support measures need to be consistent with the European State aid rules and approved by the European Commission.

Eligible capital instruments for meeting the buffers

As a general rule, the capital buffers are to be covered with Core Tier 1 as defined in the EBA's 2011 EU-wide stress test. In particular, only commercial instruments of the highest quality are included in this Core Tier 1 definition – ordinary shares or similar instruments in line with the principles detailed in CEBS/EBA guidelines on core capital. However, since buffers are intended to absorb potential (contingent) losses, newly issued private contingent convertibles are eligible to be considered as a part of the buffer if consistent with the EBA's common term sheet set out at Annex III.

Existing convertible capital instruments will not be eligible unless they will be converted into Core Tier 1 according to the above definition by end of October 2012.

RWA

As in the 2011 EU-wide stress test, banks have been requested to adhere to CRD 3 for the calculation of the Core Tier 1 ratio, i.e., the changes to the trading book and securitisation treatment (so called Basel 2.5) are to be fully incorporated in the requirement (Stress VaR, IRC, Re-securitisations, Securitisation positions, Correlation trading portfolio).

Risk weighted assets (RWA) are computed by multiplying the total capital requirements (including the Basel 1 transitional floor) with 12.5.

Core Tier 1 ratio = Core Tier 1/RWA

Floors

Banks using advanced measurement approaches for credit and operational risk (IRB and AMA) have been asked to apply the Basel 1 floors (80%). There are a variety of ways in which the floors have been applied nationally and banks have followed different approaches depending on the existing national guidance.

NSAs have been asked to choose one of two of the most widely used approaches, which are outlined below, and direct all banks in their jurisdiction to adopt that approach. Banks will disclose the floor treatment used in the templates and the EBA will publish a summary list. Banks on the standardized approach will show N/a in the template.

Approach 1

According to approach 1, the transitional floor capital requirement is the maximum between 0 and the difference between the 80% of the Basel 1 (B1) capital requirement and total minimum own funds:

Transitional floor capital requirement = Max [(80%*(Capital Requirement B1) – (Total Minimum Own Funds)),0]

where Total Minimum Own Funds = (Minimum Total Capital Requirement - IRB Shortfall - IRB Provision excess); IRB shortfall is the negative amount “IRB Provision shortfall and IRB equity expected loss amounts” deducted for the computation of total own funds (COREP line 1.3.8) and IRB provision excess is the positive amount (COREP line 1.2.1.7) included in the calculation of total own funds.

This would assess the total minimum own funds that would be required under Basel 1 against total minimum own funds according to the relevant regulation. Since for the recapitalisation exercise banks have been required to apply the CRD3 market risk requirement the following formula should be applied:

Transitional floor capital requirement = Max [(80%*(Capital Requirement B1 - MktRiskCapReq B1 + MktRiskCapReq CRD3) - (Total Minimum Own Funds CRD3)),0]

where MktRiskCapReq B1 and MktRiskCapReq CRD3 are the capital requirements towards market risk under Basel 1 and the CRD3 respectively.

Approach 2

According to approach 2, the transitional floor capital requirement is the maximum between 0 and the difference between the 80% of the Basel 1 capital requirement and the total own funds:

Transitional floor capital requirement = Max [(80%*Capreq B1) – Total Own Funds, 0]

where Total Own Funds = Total Own Funds (gross/net of IRB shortfall/excess provision) – IRB shortfall - IRB Provision Excess); IRB shortfall is the negative amount "IRB Provision shortfall and IRB equity expected loss amounts" deducted for the computation of total own funds (COREP line 1.3.8) and IRB provision excess is the positive amount (COREP line 1.2.1.7) included in the calculation of total own funds.

This would assess the total own funds that would be required under Basel 1 against total own funds as of September 2011. Since for the recapitalisation exercise banks have been required to apply the CRD3 market risk requirement the following formula should be applied:

Transitional floor capital requirement = Max [(80%*(CapReqB1 - MktRiskCapReq B1 + MktRiskCapReq CRD3) - (Total Own Funds)),0]

where MktRiskCapReq B1 and MktRiskCapReq CRD3 are the capital requirements towards market risk under Basel 1 and the CRD3 respectively.

Under both approaches, the RWAs corresponding to the transitional floor capital requirement are computed as follows:

RWA Floor = 12.5*Transitional floor capital requirement

Sovereign debt exposures

Sovereign debt exposures for the purpose of the capital exercise are those towards the central, regional and local governments of the European Economic Area (EEA) countries. They include direct and indirect sovereign exposures (i.e., on- and off-balance sheet) in the trading and in the banking book. Central bank deposits are not included. Furthermore, the definition does not include exposures to counterparts (other than sovereigns) with full or partial guarantees from central, local or regional governments.

Prudential filters

The AFS portfolio comprises equities, loans and receivables as well as other financial instruments (other available-for-sale assets). According to CEBS guidelines issued in

2004, fair-value revaluation reserves on AFS assets are subject to the following prudential filters:

- For equities, unrealised losses should be deducted after tax from original own funds and unrealised gains should only partially be included in additional own funds before tax.
- For loans and receivables, the unrealised gains and losses, apart from those related to impairment, are neutralised in own funds after tax.
- For other available for sale assets (e.g., debt securities, financial instruments subject to interest rate risk, etc.) two methods can be applied.
  - items classified in this portfolio are treated as equities,
  - items classified in this portfolio are treated as loans and receivables.

So far, there is no harmonised application of CEBS guidance on prudential filters for regulatory capital across EU jurisdictions. It is worth noting that prudential filters will be removed under Basel 3 rules.

Conservative valuation of sovereign exposures in the HTM and Loans and receivable portfolio

Banks have been asked to carry out a conservative valuation of the EEA sovereign exposures booked in the HTM portfolio and loans and receivable portfolio, making use of existing market prices as of September 2011 and current bond yields by maturity as a reference for loans and non traded assets. Banks' assessment has been used for computing the buffers and checked by the EBA. The maturity buckets are 3 months, 1 year, 2, 3, 5, 10 and 15 years.

For the loans and advances in the HTM and L&R portfolios, a cap has been be set at zero for valuation changes and therefore no offset is possible between potential gains and potential losses.

Tax treatment

For HTM and loans and receivables holdings (i.e., the conservative valuation of sovereign exposures) the buffer has been computed gross of taxes.

For AFS holdings, the buffer has been computed following current CEBS guidance on tax for AFS prudential filters (i.e., net of tax).

Computation of the target capital buffers

The capital buffers is computed as follows:

1. Buffer AFS. Prudential filters on EEA sovereign exposures held in the AFS portfolio are removed, i.e., banks are required to build a buffer of Core Tier 1 capital vis-à-

vis prudential filters (BufferAFS). If the filter is positive, this implies a negative AFS valuation reserve (potential losses)[1].

2. Buffer HTM. EEA debt sovereign exposures in the held-to-maturity (HTM) and loans and receivable portfolio are valued in a conservative fashion, making use end of September data as a reference for loans and non traded assets. Banks have thus been required to build a buffer of Core Tier 1 capital (BufferHTM) equal to the difference between the book value of those assets and their revalued amount.

3. Banks have been allowed to offset positive (i.e., potential losses) and negative value (i.e., potential gains) adjustments for the debt securities in the HTM and L&R portfolios. For loans and advances in the HTM and L&R portfolios banks cannot benefit from potential gains.

4. The sum of BufferAFS and BufferHTM has been capped to zero (i.e., banks cannot end-up with a negative buffer):

   $BufferSOV = (BufferAFS + BufferHTM) \geq 0$

5. The capital shortfall is the sum of the difference between 9% of risk-weighted assets and the actual Core Tier 1 capital plus BufferSOV:

   $Shortfall_{Sept2011} = (0.09xRWA_{Sept2011} - CT1_{Sept2011}) + (BufferSOV_{Sept2011})$

Actions to address identified shortfalls

The amount of the capital shortfall has been set based on September 2011 sovereign exposure figures and a capital requirement determined by a 9% Core Tier 1 threshold. The buffer to be held against sovereign debt exposures is fixed (i.e. it will not be revised as a result of later market valuation changes and/or changes of the exposures, even though banks have until end June 2012 to meet the overall capital target).

$$Shortfall_{Sept2011} = (0.09xRWA_{Sept2011} - CT1_{Sept2011}) + (BufferSOV_{Sept2011})$$

By June 2012 the shortfall should be zero:

$$Shortfall_{Jun2012} = 0 = (0.09xRWA_{Jun2012} - CT1_{Jun2012}) + (BufferSOV_{Sept2011})$$

In cases of compliance with this Recommendation banks will be required to submit capital plans to their national supervisors before 20th January 2012 setting out the proposed mix of actions, including new capital raising, asset disposals and other measures, to meet both the required 9% target and the sovereign market valuation buffer, thereby bringing the shortfall to zero by June 2012. Prior to agreeing these capital plans, NSAs will consult with relevant colleges of supervisors and consideration will be given at the European (EBA and ESRB) level as to how best to ensure that such

[1] *In countries where prudential filters are not applied, the impact of the valuation of assets in the AFS portfolio is directly reflected in the capital position.*

plans do not lead to excessive deleveraging, disrupting lending into the real economy and cognisant of the broader context, including the availability of bank funding.

Banks should first use private sources of funding to create the capital buffer, including retained earnings, reduced bonus payments, new issuances of common equity and suitably strong contingent capital, and other liability management measures. Reductions in RWAs as a means of attaining the target should be limited to selected sales of assets that do not lead to a reduced flow of lending to the real economy but simply to a transfer of contracts or business units to a third party. Reductions in RWAs due to the validation and roll-out of appropriate internal models to additional portfolios should not, in general, be allowed unless these changes are already planned and under consideration by the competent authority.

List of banks

Code	Name	Country
AT001	Erste Group Bank AG	AT
AT002	Raiffeisen Zentralbank Österreich AG	AT
AT003	Österreichische Volksbank AG	AT
BE004	DEXIA	BE
BE005	KBC BANK	BE
CY006	MARFIN POPULAR BANK PUBLIC CO LTD	CY
CY007	BANK OF CYPRUS PUBLIC CO LTD	CY
DE017	DEUTSCHE BANK AG	DE
DE018	COMMERZBANK AG	DE
DE019	Landesbank Baden-Württemberg	DE
DE020	DZ BANK AG Dt. Zentral-Genossenschaftsbank	DE
DE021	Bayerische Landesbank	DE
DE022	Norddeutsche Landesbank -GZ	DE
DE023	Hypo Real Estate Holding AG, München	DE
DE024	WestLB AG, Düsseldorf	DE
DE025	HSH Nordbank AG, Hamburg	DE
DE026	Landesbank Hessen-Thüringen GZ, Frankfurt	DE
DE027	Landesbank Berlin AG	DE
DE028	DekaBank Deutsche Girozentrale, Frankfurt	DE
DE029	WGZ BANK AG Westdt. Geno. Zentralbk, Ddf	DE
DK008	DANSKE BANK	DK
DK009	Jyske Bank	DK
DK010	Sydbank	DK
DK011	Nykredit	DK
ES059	BANCO SANTANDER S.A.	ES
ES060	BANCO BILBAO VIZCAYA ARGENTARIA S.A. (BBVA)	ES
ES061	BFA BANKIA	ES
ES062	CAJA DE AHORROS Y PENSIONES DE BARCELONA	ES
ES064	BANCO POPULAR ESPAÑOL, S.A.	ES
FI012	OP-Pohjola Group	FI
FR013	BNP PARIBAS	FR
FR014	CREDIT AGRICOLE	FR
FR015	BPCE	FR
FR016	SOCIETE GENERALE	FR
GB088	ROYAL BANK OF SCOTLAND GROUP plc	GB
GB089	HSBC HOLDINGS plc	GB
GB090	BARCLAYS plc	GB
GB091	LLOYDS BANKING GROUP plc	GB
GR030	EFG EUROBANK ERGASIAS S.A.	GR
GR031	NATIONAL BANK OF GREECE	GR
GR032	ALPHA BANK	GR
GR033	PIRAEUS BANK GROUP	GR
GR034	AGRICULTURAL BANK OF GREECE S.A. (ATEbank)	GR
GR035	TT HELLENIC POSTBANK S.A.	GR
HU036	OTP BANK NYRT.	HU
IE037	ALLIED IRISH BANKS PLC	IE
IE038	BANK OF IRELAND	IE
IE039	IRISH LIFE AND PERMANENT	IE
IT040	INTESA SANPAOLO S.p.A	IT
IT041	UNICREDIT S.p.A	IT
IT042	BANCA MONTE DEI PASCHI DI SIENA S.p.A	IT
IT043	BANCO POPOLARE - S.C.	IT
IT044	UNIONE DI BANCHE ITALIANE SCPA (UBI BANCA)	IT
LU045	BANQUE ET CAISSE D'EPARGNE DE L'ETAT	LU
MT046	BANK OF VALLETTA (BOV)	MT
NL047	ING BANK NV	NL
NL048	RABOBANK NEDERLAND	NL
NL049	ABN AMRO BANK NV	NL
NL050	SNS BANK NV	NL
NO051	DnB NOR Bank ASA	NO
PL052	POWSZECHNA KASA OSZCZĘDNOŚCI BANK POLSKI S.A. (PKO BANK POLSKI)	PL
PT053	CAIXA GERAL DE DEPÓSITOS, SA	PT
PT054	BANCO COMERCIAL PORTUGUÊS, SA (BCP OR MILLENNIUM BCP)	PT
PT055	ESPÍRITO SANTO FINANCIAL GROUP, SA (ESFG)	PT
PT056	Banco BPI, SA	PT
SE084	Nordea Bank AB (publ)	SE
SE085	Skandinaviska Enskilda Banken AB (publ) (SEB)	SE
SE086	Svenska Handelsbanken AB (publ)	SE
SE087	Swedbank AB (publ)	SE
SI057	NOVA LJUBLJANSKA BANKA D.D. (NLB d.d.)	SI
SI058	NOVA KREDITNA BANKA MARIBOR D.D. (NKBM d.d.)	SI