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Releasing the CCyB to support the economy in a time of stress

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Abstract

This note outlines the rationale underlying the release of the Countercyclical Capital Buffer (CCyB) in Ireland in the light of the recent COVID-19 developments. The COVID-19 outbreak presents an exceptional shock, triggering the materialisation of potential challenges for financial stability. An active use of macroprudential policy, and in particular the release of the CCyB, allows the banking system to absorb the impact of this shock. In doing so, it limits the scope for the banking system to amplify the shock to the detriment of the real economy, by facilitating banks maintaining a sustainable supply of credit to the economy in the challenging times ahead. We discuss how this particular policy response fits in the Central Bank's CCyB framework, how it interacts with other prudential policy measures, and the size of capital relief and potential additional credit supply capacity it affords.

1. Introduction

The COVID-19 outbreak represents a severe worldwide health and economic crisis. The pandemic has triggered several simultaneous shocks to both the real and the financial side of the world economy. The real economy has been directly hit both on the demand and the supply side, constrained by the necessary public health responses implemented by governments around the globe. Financial markets have responded to a similar or often more extreme extent than during the Global Financial Crisis of the late 2000's. The financial market turbulence reflects the deteriorating expectations of the economic outlook, and the extent of vulnerability to re-pricing that many asset classes had displayed in the exuberant market conditions of recent years.²

The threat to the economy has sparked widespread policy action across governments, central banks, supervisory authorities and international bodies. Domestically, the Central Bank's focus is on ensuring monetary and financial stability and that the financial system operates in the best interests of consumers and the wider economy.³ One element of the policy response, both internationally and here in Ireland, has been in macroprudential policy. Macroprudential policy aims to mitigate the risk of a disruption to the provision of financial services, which can have negative consequences for the real economy. It does this through building resilience and limiting the potential for financial vulnerabilities

¹ Corresponding author: martin.obrien@centralbank.ie. The views presented in this paper are those of the authors alone and do not necessarily represent the official views of the Central Bank of Ireland or the European System of Central Banks. Particular thanks to Gordon Barham, Stephen Doyle and Fabio Parla for their input, as well as other colleagues in the Macro-Financial Division for helpful comments and assistance. Any remaining errors are our own.

² As discussed, for example, in Central Bank of Ireland [Financial Stability Review 2019:II](#)

³ See [statement by Governor Makhoulouf](#) and [Central Bank of Ireland announcement](#).

to emerge when times are good, so that both lenders and borrowers are better able to absorb shocks when times are bad.

With COVID-19 triggering the materialisation of potential challenges for financial stability in Ireland, the Central Bank, in its role as the Irish macroprudential authority, responded by cutting the Irish CCyB rate from 1 per cent to 0 per cent. The CCyB is part of the Central Bank's macroprudential toolkit and is an instrument to promote a stable financial system for times of financial and economic distress. Unlike the previous domestic and global financial crisis in the late-2000's, the banking and financial system is not the epicenter of the current economic challenges, but rather is responding to them. The active use of the CCyB in Ireland, aims to ensure that that response does not amplify the difficulties facing households and businesses as a result of the economic shock related to COVID-19. This note outlines the rationale for the CCyB release and how it can contribute to the continued provision of credit to households and business by the banking system at this challenging time. It plays a part in the overarching public policy response to help reduce the near-term liquidity impact of the COVID-19 shock on households and businesses. These actions should also minimise the longer-term scarring effects of the COVID-19 shock on the financial system and the real economy.

The remainder of this note is structured as follows: section 2 outlines the Bank's framework for the CCyB; section 3 discusses the financial market and economic impact of COVID-19 and how these could affect the banking sector's capacity to support households and businesses through a sustainable supply of credit; section 4 discusses the rationale for and impact of the release of the CCyB; section 5 provides an overview of broader policy issues which interact with the CCyB; Section 6 concludes.

2. The countercyclical capital buffer

The CCyB is a time varying capital requirement which applies to banks and investment firms. It aims to promote a sustainable provision of credit to the economy in both good times and bad by making the banking system more resilient and less pro-cyclical.

By increasing regulatory capital requirements in line with the cyclical systemic risk environment, the CCyB looks to ensure additional capital is in place to absorb losses when risks materialise. In addition, the release of the CCyB during a downturn looks to limit the potential that regulatory capital buffers act as an impediment to the supply of credit to the economy.

The Central Bank is the designated authority for setting the CCyB rate in Ireland and as such sets the rate for Irish exposures, having consulted with the ECB, on a quarterly basis.⁴

2.1 The Central Bank's framework for setting the CCyB

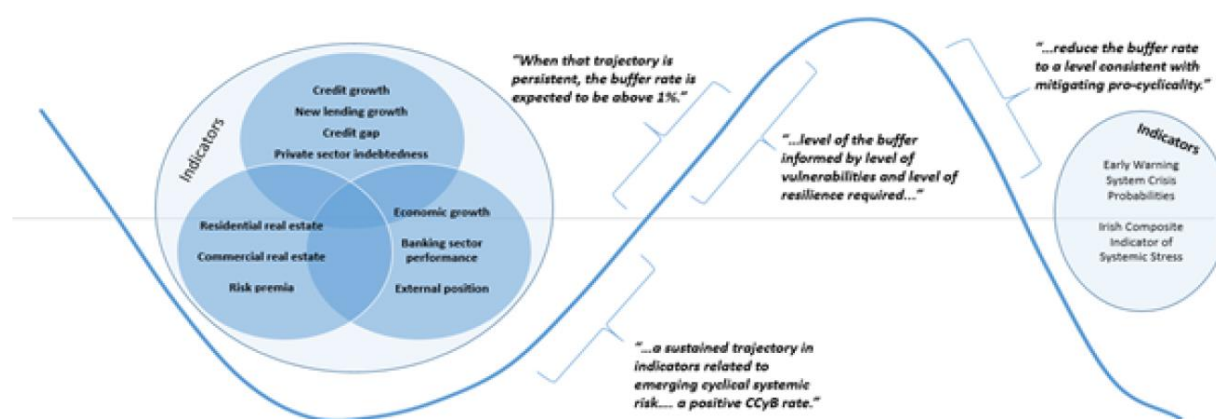
The primary objective of the Central Bank in using the CCyB is promoting resilience in the banking sector with a view to facilitating a sustainable flow of credit to the economy through the cycle.

⁴ Under the powers conferred on it by the Single Supervisory Mechanism Regulation the ECB assesses CCyB decisions of national authorities and if necessary has the power to set a higher rate. As such, the CCyB rate set by the Central Bank is done so having consulted with the ECB.

Underlying this objective are a number of elements to the framework for how the Central Bank sets the CCyB rate, a stylised representation of which is in Figure 1⁵.

A key aspect of the Central Bank's framework is the setting of a positive buffer sufficiently early in the cycle to effectively promote resilience. This element of the framework is informed not only by the Bank's objective for the CCyB but also by the nature of the Irish economy, where its responsiveness to external shocks has been shown historically to be higher than that of other euro area countries.⁶ Setting a positive buffer early in the cycle facilitates to the extent possible the build-up of a buffer prior to the materialisation of cyclical systemic risks, and thereby maximises the chances that the buffer is in place and the potential for its release to have a practical benefit.

Figure 1: Stylised representation of the Central Bank of Ireland's high-level approach to the implementation of the CCyB relative to the stage of the financial cycle



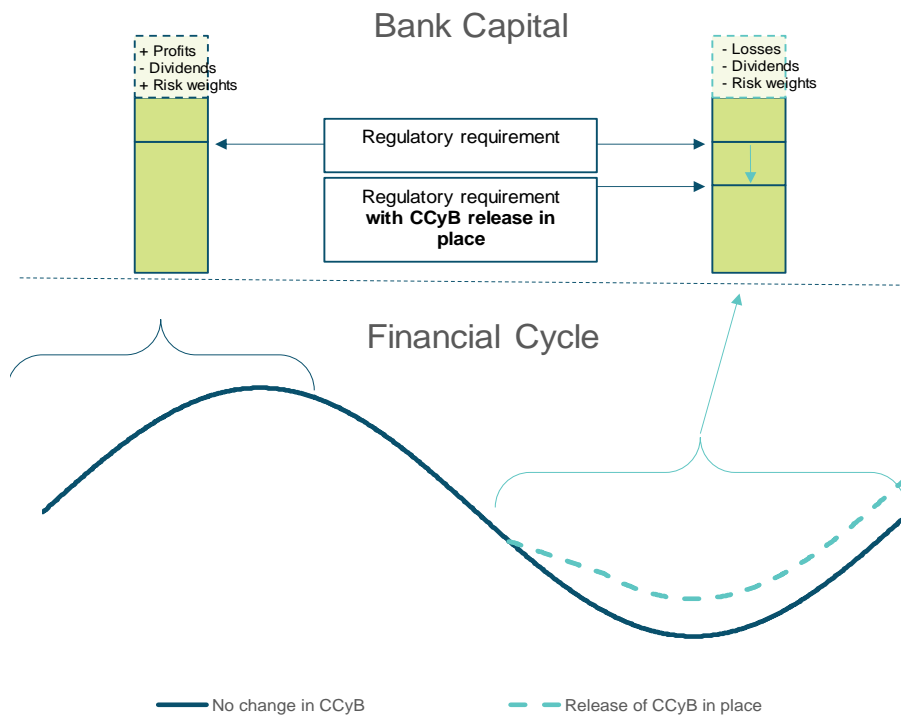
A range of indicators informs the build-up phase of the buffer, covering credit developments, real estate and other asset prices, broader economic activity, and the degree of risk appetite in the market. While these are found to be useful in identifying emerging vulnerabilities, they are often only available with a lag and can give misleading signals when risks have actually materialised. As a result, when considering a release or a reduction in the CCyB, policy-makers also consider indicators of financial market stress and expectations for economic and financing conditions. In reality, in order to ensure a timely response in both the build-up phase and the release phase, policy-makers take regard of projections and expectations of future developments, however it is often more necessary to do so in the release phase.

⁵ A more comprehensive overview of the Central Bank's framework for the CCyB can be found in "Measuring and mitigating cyclical systemic risk in Ireland: The application of the countercyclical capital buffer", [Financial Stability Note No.4 2018](#).

⁶ As discussed by Deputy Governor Donnery in [September 2019](#), the small, open and highly globalised nature of the Irish economy and the cyclical and structural vulnerabilities and risks this presents is something that informs the Central Bank's thinking on macroprudential policy generally. See also Box 2 "Financial stability considerations of being a small, highly globalised economy" in the [Central Bank Financial Stability Review 2019:I](#).

Indeed, the aspect of the CCyB framework of most relevance to the current circumstances is the fact that the buffer would be reduced or released when a downturn or materialisation of cyclical systemic risk is identified in order to limit the impact of the downturn on credit supply. A stylised representation of the intended effect of releasing the CCyB is shown in Figure 2. Binding regulatory capital requirements can potentially lead banks to take actions which exacerbate an economic downturn. As risks materialise, especially in the context of heightened uncertainty, actual and expected losses appear as a drag on bank’s capital position. At the same time, risk weights used in calculating risk-based capital requirements will typically increase during a downturn, which also depletes bank capital. As banks move closer to their required level of capital, they are incentivised to deleverage, often through tightening credit conditions and reducing their supply of credit. This response can amplify the initial economic shock, leading to further losses and impairing the system from providing intermediation services to the detriment of the real economy. The CCyB was designed to mitigate this.

Figure 2: Stylised representation of the impact of the CCyB release on the financial cycle and bank capital during the downturn phase.



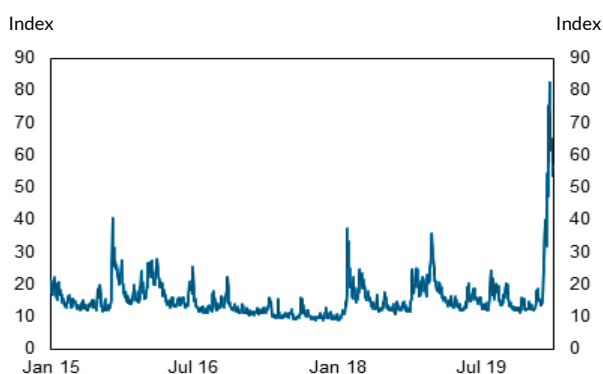
Releasing the CCyB reduces bank’s capital buffer requirement, and thus looks to limit the incentive to restrict credit supply in response to a negative shock. The additional space between the capital requirements and the level of actual bank capital that is created by the release of the CCyB enables banks to absorb more losses, absorb higher risk weights, and continue to extend credit to households and businesses. By minimising the reduction in credit supply, bank lending can in turn support consumption and investment activity in the economy. Consequently, the magnitude of the downturn phase of the cycle is reduced. This is in contrast to the situation where there is no reduction in the CCyB, and a potential for the banking system to amplify the downward phase of the cycle.

3. Financial and economic impact of COVID-19 outbreak⁷

While we remain in the early stages of the economic fallout, it is clear that the near-term shock from COVID-19 to the macro-economy will be very large. In addition, the financial market turbulence already points to extremely challenging conditions in the very near term for the macro-financial environment. That financial market response is consistent with the vulnerabilities that had built up in recent years in many asset and credit markets. In this sense, the COVID-19 outbreak is a trigger for the materialisation of a potentially damaging re-pricing of risk premia globally, with implications for domestic financial stability.⁸

Financial market turbulence associated to the COVID-19 spread was initially mainly limited to Asian markets. However, as it became clear that the spread was going to be global, market sentiments deteriorated more broadly, approaching levels not seen since the Global Financial Crisis. Measures of market uncertainty like the VIX reached historically high levels (Figure 3). Yields and spreads on riskier corporate (Figure 4) and sovereign debt increased, driven by a deterioration in market sentiment. Safe haven assets also came under strain, with widespread margin calls leading to a higher demand for cash amidst broad liquidity challenges. Central Banks reacted with significant monetary policy action across advanced economies.

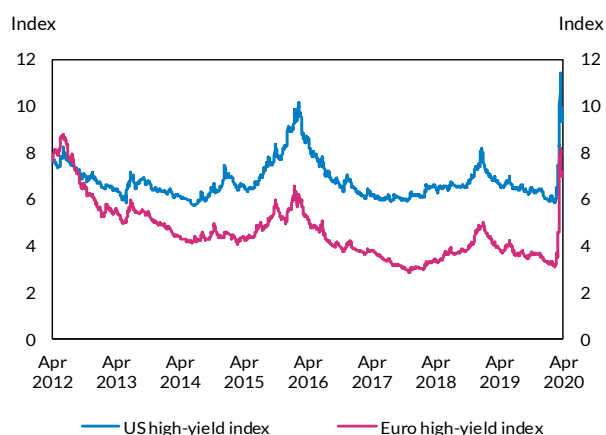
Figure 3: VIX



Source: Chicago Board Options Exchange

Note: last observation April 1st 2020, daily frequency.

Figure 4: US and Euro high-yield corporate bond indices



Source: Datastream

Note: ICE BofA US High Yield Index yield to maturity. ICE BofA Euro High Yield Index yield to maturity. Last observation April 3rd 2020.

In Ireland, market developments, triggered by COVID-19 were consistent with a widespread reversal of financial conditions and pointed toward levels of stress significantly in excess of that evident around the time of the Brexit referendum (Figure 5).

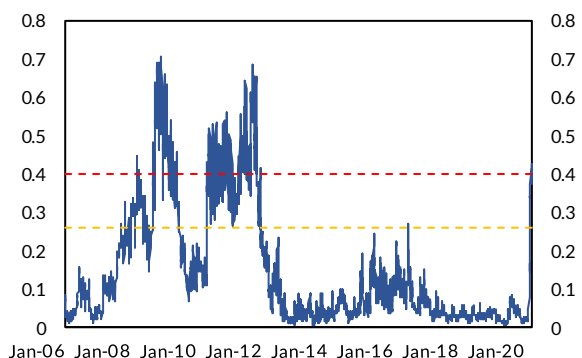
Analysis of the potential pass-through of the stress in Irish financial markets over the first two weeks in March to credit and real house prices points toward potential declines in both in the coming months

⁷ This section focuses on some of the indicators considered and evidence as was apparent for 'release-phase' decisions in the CCyB framework at the time the decision to release the Irish CCyB was made on 18 March 2020.

⁸ See Central Bank of Ireland [Financial Stability Review 2019:II](#).

(Figure 6).⁹ Combined with the build-up of vulnerabilities globally and domestically, any shock, such as that presented by COVID-19, would translate into broader challenges for financial stability. These financial market developments largely preceded the necessary wider public health containment measures in Ireland, and the subsequent direct and indirect economic consequences of these.

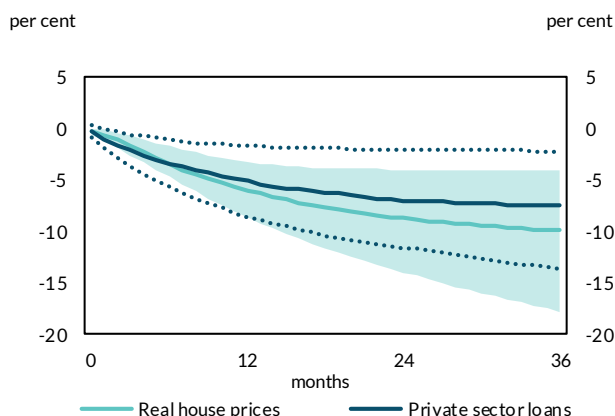
Figure 5: Irish Composite Stress Index (ICSI)



Source: Central Bank of Ireland

Note: Last observation April 1st 2020, daily frequency. Amber and red dashed lines represent 1 and 2 standard deviations above the mean of the series (1999-2020).

Figure 6: Estimated pass through of financial market turbulence in early March 2020 to macro-financial environment



Source: Central Bank of Ireland

Note: Impulse response functions show the estimated impact of ICSI movements from 28 Feb to Mar 18 on future credit and real house price developments.

Prior to its spread to Europe, the economic impact of COVID-19 on Ireland would have primarily related to a shock to foreign demand and some disruption to global value chains. However, once Europe became significantly impacted by the virus, it became clear that the domestic economic impact was going to be much more severe. The necessary public health actions required to minimise strain on health systems are likely to result in a lower levels of consumption, investment and economic activity overall, with knock-on implications for the financial conditions of businesses and households.

While there remains an unprecedented amount of uncertainty about the near-term outlook, the magnitude of the immediate economic impact has become apparent both domestically and in Ireland’s major trading partners. Activity in manufacturing and services industries across the globe have contracted abruptly. The economic arrest has strongly impacted labour markets with unemployment claims soaring in many countries. The uniquely sudden stop to activity in the affected sectors brings with it a major cash flow issue for businesses that is likely to create a significant reliance on previously undrawn credit lines and facilities that they may already have with their bank. The global economic outlook has deteriorated considerably and it is expected to continue to do so over the next months of 2020. The broader economic implications for Ireland are discussed in the recently published [Central Bank of Ireland Quarterly Bulletin, April 2020](#).

⁹ The analysis was conducted using a Mixed-Frequency Vector Autoregression model. See Barham, G., Parla, F., & O’Brien, M. (2019). Financial market distress and the macro-financial environment in Ireland, in [Financial Stability Review 2019:II](#).

4. Release of the CCyB in Ireland

Economic and financial shocks arising from COVID-19 can affect banks through a number of channels, namely: sharp adjustments in asset valuations, resulting in mark-to-market losses for banks; credit losses on exposures to vulnerable sectors; funding and liquidity pressures, especially in foreign-currency funding markets. Such losses would deplete the capital resources of the banking system, potentially restricting its appetite, willingness, and ability to supply credit to the real economy. This would further amplify the negative shock to the economy as a result of COVID-19, putting even more households and businesses at risk of distress.

Given the severity of impact of the COVID-19 pandemic the full release of the CCyB was judged to be appropriate by the Central Bank. In general, decisions around the release of the CCyB need to balance the benefits of releasing promptly against the possibility of responding too quickly to short-term market volatility that does not result in a materialisation of systemic risk. However, in this case the early and full release of the buffer maximises its effectiveness. As it became clear that the measures required to limit the spread of the virus would have significant economic effects, the full release supports to the extent possible the role the banking sector can play in supporting economic activity. Due to the uncertainty over the nature and extent of the COVID-19 shock and related losses, banks may be unable or unwilling to supply credit to otherwise viable firms or households in temporary distress. An early release of the CCyB aims to minimise the role of that uncertainty in a bank's credit supply decision.

4.1 Capital release provided and what it can do to support credit supply

Practically speaking, the release of the Irish CCyB frees up capital that may otherwise have to be used to meet banks' capital requirements. This capital is then available to banks to either support lending (existing or new) or absorb bank losses and possibly higher risk weights. Providing scope to the banking sector to support the drawing down of existing credit lines by viable businesses may be a particularly important element in the current situation given the cash flow crisis faced by large numbers of businesses.¹⁰

In reality, the capital released by reducing the CCyB to 0 per cent is likely to be used in combination across the range of possibilities. The extent to which this is the case will depend on a number of factors. The potential for new credit supply will be conditional on any losses experienced by banks and the extent to which other buffers (e.g. banks' own management buffers or supervisory buffers) can be used to absorb these. The CCyB release on its own enables €940 million across the domestically relevant banking sector for that purpose (Table 1).¹¹ Alternatively, the capital released could be leveraged to supply new lending. How any available capital translates into new credit supply will in turn depend on banks post-release capital requirements as well as the risk-weight density of any new lending that actually occurs (see Annex 1). Based on plausible estimates for risk-weight densities, the capacity for

¹⁰ Aggregate undrawn NFC credit at the domestic retail banks is approximately €17bn.

¹¹ The domestically relevant banking sector is defined as the five main retail banks i.e. AIB, Bank of Ireland, Ulster Bank, permanent TSB and KBC.

new lending could range from between €10 billion and €16 billion (Table 1).¹² To place these values into context, new lending to Irish residents amounted to €30 billion in 2019.¹³

Table 1 | Capital release related to the CCyB release and its potential use

Irish CCyB rate cut from 1 per cent to 0 per cent	
Capital released	€0.94 billion
Fully used for:	
- Additional loss absorption	€0.94 billion
- Additional lending capacity	€10-16 billion*

Note: Figures relate to the domestically relevant banking sector. * Depending on aggregate risk weight density of new lending. Estimates are based on risk-weight density ranging from 80% to 50%. See Annex 1 for further scenario analysis on potential for new lending capacity.

It is important to note that the future developments in credit will be as a result of both credit supply and credit demand. The CCyB release can only support credit supply. Demand for credit by households and firms may still decline, in-line with the overall demand shock facing the economy, or at least its composition may change. In the current environment, for example, there may be less demand for larger loans and facilities for investment purposes or mortgages, but greater demand for smaller working capital loans and overdraft facilities.

5. Broader policy response to Covid-19

The release of the CCyB is a key element of the macroprudential policy response in terms of limiting the potential for the banking system to amplify the shock from COVID-19 to the detriment of the real economy. Given the global nature of the impact of the COVID-19 outbreak, designated authorities throughout Europe, where they have had the scope to do so, have responded to the Covid-19 pandemic by reducing the CCyB rate in their jurisdictions.¹⁴ Given the interlinked nature of European economies

¹² Risk-weight density (RWD) measures a bank's risk-weighted assets as a proportion of total assets. The capacity for new lending for any given reduction in capital requirements will be lower the higher the aggregate risk-weight associated with that lending. In a stressed situation there may be a higher demand for riskier type loans (e.g. overdraft facilities, working capital, unsecured lending in general). The current RWD for the domestic banking system is approximately 48 per cent, but varies across banks and loan-books, with residential mortgages having a RWD of just over 30 per cent, and corporate lending (including CRE) having a RWD of over 90 per cent. (Source FINREP/COREP and EBA Transparency Exercise data).

¹³ New lending relates to new business to Irish households and non-financial corporations from resident MFIs during 2019 and excludes renegotiations on household lending. Source: Central Bank of Ireland statistical table B2.1.

¹⁴ Authorities in the UK, Belgium, Germany, Denmark, France, Iceland, Lithuania and Sweden have all publicly announced a full release of the CCyB in response to the impact of Covid-19. In Norway the CCyB rate has been reduced to 1 per cent from 2.5 per cent.

and, the highly globalised nature of the Irish economic and financial system, the widespread response among EU authorities may have positive spill-over effects.

Nonetheless, it is only one aspect of the broader policy response (e.g. fiscal, monetary, supervisory) that is required in order to mitigate the impact on the economy and financial system. The complementarity of the micro- and macro-prudential policy responses, for instance, can work to maximise the impact of policies. The release of the CCyB is consistent with the Single Supervisory Mechanism (SSM) actions in terms of providing capital and liquidity relief to institutions. As announced on March 12, the SSM will allow banks to temporarily operate below the Pillar 2 Guidance and Capital Conservation Buffer level of capital.¹⁵ These measures make capital available to banks to absorb losses and maintain lending if needs be, subject to the capital conservation plans agreed with their supervisor to restore their capital levels to above their Combined Buffer Requirement (CBR). Unlike the reduction in capital requirements that the CCyB release has entailed, the SSM relief maintains the same level of capital requirements for the banks. Given the different incentives that the approaches have for individual bank decisions on credit extension and capital conservation, a combined approach of releasing the CCyB with other buffers being available to use, maximises the benefits of each action for the sustainable flow of credit to the real economy.

Another complementary element of the supervisory response has been in relation to the payment of dividends and other distributions to shareholders by banks. The intention of the capital measures taken by the Central Bank and others is to facilitate the provision of credit to the economy and so look to minimise the negative economic consequences of the Covid-19 outbreak. On March 27 the ECB-SSM issued a recommendation prohibiting the distribution of dividends until at least October 1.¹⁶ This ensures capital is conserved in order to support the functioning of the banking sector at this time of economic stress.

In similar fashion, supervisory authorities including the ECB-SSM, have committed to a flexible approach on implementing new requirements, such as the introduction of IFRS9 accounting standards.¹⁷ This flexibility may reduce the front-loading of COVID-19 related losses on bank's balance sheets, in turn reducing an immediate depletion of bank capital, and enabling more capital to be used to maintain lending than would otherwise have been the case.

While fiscal policies are paramount in mitigating the detrimental effects of COVID-related shocks to the economy, monetary stimulus is a vital complement to support financial market confidence, liquidity and financing conditions. Broad-based fiscal stimulus can help support aggregate demand and limit the adverse effects on consumption and business. Monetary policies can provide relief, not only to governments in their response to the crisis, but to all sectors of the economy (see Holton, Phelan and Stuart, 2020, for an overview of recent monetary policy actions).¹⁸

¹⁵ For the domestically relevant banking system in Ireland, this action has made approximately €5.3 billion available for use to absorb losses and maintain lending.

¹⁶ ECB-SSM press release: [ECB asks banks not to pay dividends until at least October 2020](#)

¹⁷ For information on the measures taken by the ECB see [ECB Banking Supervision provides temporary capital and operational relief in reaction to coronavirus](#). For a discussion of IFRS 9 and an application to the Irish mortgage market see E. Gaffney and F. McCann *The cyclical nature of SICR: mortgage modelling under IFRS9*, [Central Bank of Ireland, Research Technical Paper, Vol. 2018 No. 16](#).

¹⁸ S. Holton, G. Phelan and R. Stuart *COVID-19: Monetary policy and the Irish economy*, [Central Bank of Ireland, Economic Letters, Vol. 2019 No. 2](#).

6. Conclusion

The challenges presented to the economy and the financial system by the COVID-19 outbreak are substantial. All aspects of economic policy across multiple jurisdictions are responding, not just to minimise the immediate impact of the outbreak, but also to reduce the likelihood that this shock leaves long-term scars on the economy. Macroprudential policy is no different. At the forefront of the macroprudential response, both here in Ireland and in many other countries, has been the release of the CCyB. Having a releasable capital buffer minimises the potential that the banking system will act as an amplifier of the negative economic shock to the detriment of households and businesses. The active approach to the CCyB, which underlies the Central Bank of Ireland framework for the policy instrument, builds resilience in the financial system, which can be drawn upon to ensure a sustainable flow of credit in both good times and in bad. Releasing the CCyB provides greater scope for the banking system to both absorb COVID-19 related losses and support the real economy during this challenging time. It complements the primary fiscal policy response, as well as the actions taken in monetary and supervisory policy. Considerable uncertainty remains about the near-term outlook. As the situation evolves, macroprudential policies should be kept under review so they respond appropriately to mitigate the risk of a disruption to the financial system that would ultimately damage the real economy.

Annex

Capacity for potential new lending (€ billions), arising from cutting the CCyB rate on Irish exposures to 0%, under a range of loss scenarios and risk weight densities

RW density of new credit drawn down	Losses not absorbed elsewhere (€ millions)									
	0	100	200	300	400	500	600	700	800	900
10%	80.4	71.8	63.3	54.8	46.2	37.7	29.2	20.6	12.1	3.6
20%	40.2	35.9	31.6	27.4	23.1	18.8	14.6	10.3	6.0	1.8
30%	26.8	23.9	21.1	18.3	15.4	12.6	9.7	6.9	4.0	1.2
40%	20.1	18.0	15.8	13.7	11.6	9.4	7.3	5.2	3.0	0.9
50%	16.1	14.4	12.7	11.0	9.2	7.5	5.8	4.1	2.4	0.7
60%	13.4	12.0	10.5	9.1	7.7	6.3	4.9	3.4	2.0	0.6
70%	11.5	10.3	9.0	7.8	6.6	5.4	4.2	2.9	1.7	0.5
80%	10.0	9.0	7.9	6.8	5.8	4.7	3.6	2.6	1.5	0.4
90%	8.9	8.0	7.0	6.1	5.1	4.2	3.2	2.3	1.3	0.4
100%	8.0	7.2	6.3	5.5	4.6	3.8	2.9	2.1	1.2	0.4

Notes: Based on the domestically relevant banking sector.

