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## EXCERPT

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**Overlaps between minimum requirements and capital buffers: the usability of the combined buffer requirement for Italian banks**

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## Overlaps between minimum requirements and capital buffers: the usability of the combined buffer requirement for Italian banks

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The current EU capital regulation<sup>1</sup> requires that banks comply with two main frameworks at the same time: one for prudential purposes, the other for resolution purposes.

The first one includes both a risk-weighted requirement (RW) and a leverage ratio requirement (LR). Similarly, the resolution framework, which ensures that banks have enough loss-absorbing and recapitalization capacity through a Minimum Requirement of Eligible Liabilities (MREL), is based on two ratios that are to be met in parallel: the MREL as a percentage of risk weighted assets (MREL-RW) and the MREL as a percentage of the total exposure measure used for the purpose of the leverage ratio (MREL-LR).

According to the EU regulation, the CBR is only required on top of the two risk-weighted requirements (RW and MREL-RW).

This asymmetry implies that the same Common Equity Tier 1 (CET1) capital can be used simultaneously to satisfy the CBR in one framework and a minimum requirement in another framework. In these cases, we talk about overlaps, which make it impossible to use (in whole or in part) the CBR to absorb losses without violating a minimum requirement.<sup>2</sup>

The term ‘buffer usability’ refers to banks’ ability to use the CBR without breaching any minimum requirements. In the event of overlaps, a bank would not use (all or part of) the CBR even when allowed to do so because such a use would lead to a breach of a minimum requirement.

This issue, in turn, can undermine the decision of macroprudential authorities to release part of the CBR<sup>3</sup>, i.e. to draw it down in order to allow banks to support the economy in bad times. Usability should not be confused with the unwillingness/reluctance of banks to use the buffers because of disincentives of various kinds (for instance, stigma effects due to financial market reactions or maximum distributable amount restrictions<sup>4</sup>).

A comprehensive measure of the overlaps (and hence CBR usability) can only be obtained by jointly comparing the use of the CET1 capital in each of the regulatory frameworks in place. That is why a comprehensive methodological approach is taken to measure the usability of the CBR.<sup>5</sup>

This approach differs from the one recently adopted by the ESRB<sup>6</sup>, as it provides a broad overview of the actual usability of the CBR, considering that this is required not only on top of the RW requirement but also in addition to the MREL-RW requirement. Should the MREL-RW requirement prove to be higher than the RW one, the CBR may be more usable than it would be using the approach based solely on the RW requirement.

In panel (a) of Figure 1, a hypothetical bank is characterized by a binding MREL-LR. In this example, the MREL-LR is the requirement that absorbs most CET1 capital, fully overlaps with the CBR in the RW framework and partially overlaps with the CBR in the MREL-RW framework.

The CBR usability is therefore reduced to 50 per cent (1.5 per cent of RWAs instead of 3.0 per cent, as shown by the last bar in panel (a) of Figure 1).

In this case, if we only consider the CBR stacked on top the RW framework, the buffer usability would be equal to 0 per cent (i.e. the CBR usability from the interaction between the RW and MREL-LR).

A discrepancy between the approach focusing on the RW framework alone and our comprehensive approach can also occur when a bank is characterized by a binding MREL-RW requirement, if the MREL-LR requirement met with CET1 capital is higher than the RW requirement.

In panel (b) of Figure 1, the CET1 absorbed by the MREL-RW and MREL-LR is higher than the CET1 absorbed by the RW requirement. The CBR usability would be equal to 0 per cent if we only compared the interaction between the RW and MREL-LR requirements. With the full comparison proposed in this article, the CBR usability is instead 100 per cent, since the CBR in the MREL-RW framework does not overlap with any other requirement.

<sup>1</sup> The ‘banking package’ comprises the Capital Requirements Directive and Regulation (CRD V/CRR II), the Bank Recovery and Resolution Directive (BRRD II) and the Single Resolution Mechanism Regulation (SRMR II).

<sup>2</sup> The consequences of the violations are proportionate to their seriousness: those relative to the minimum requirements can lead to the declaration of failure (or risk of failure) of the bank and eventually to liquidation or resolution procedures; those relative to the CBR can lead to, among other things, limits on the distribution of dividends.

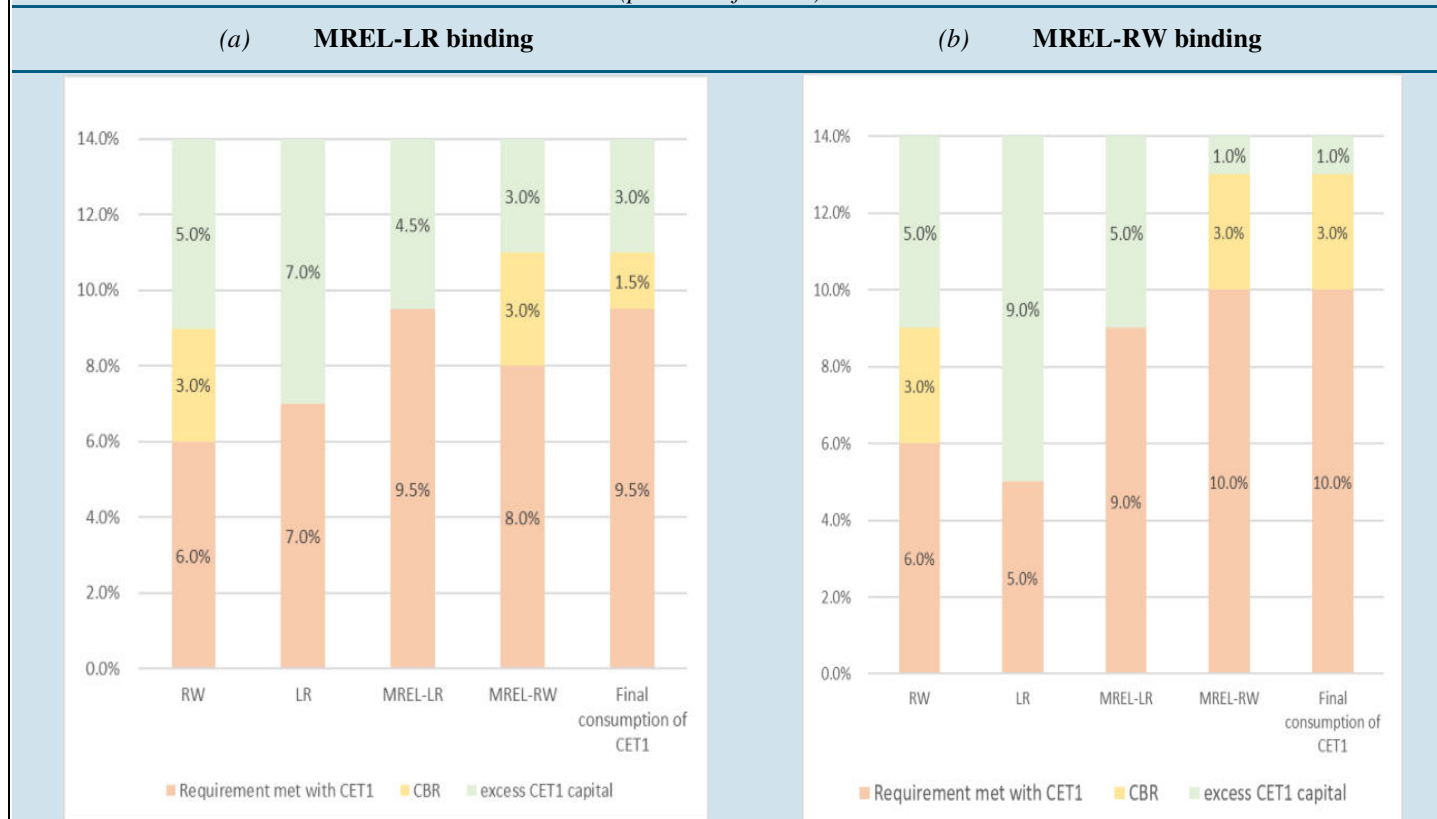
<sup>3</sup> The CBR includes both releasable and non-releasable buffers by macroprudential authorities: for example, the CCyB is releasable while the CCoB is not. Anyway, all buffers included in the CBR are usable.

<sup>4</sup> Article.141 of CRD IV introduced the concept of the Maximum Distributable Amount (MDA), which requires supervisory authorities to automatically restrict earnings distribution in the event of a CBR breach. Similarly, the MREL-MDA (M-MDA) is imposed by resolution authorities, though with more discretion and no automaticity.

<sup>5</sup> For more details on the proposed methodology, see W. Cornacchia and G. Guerra, [Overlaps between minimum requirements and capital buffers: the case of Italian banks](#), Notes on Financial Stability and Supervision – Bank of Italy, No.30, June 2022.

<sup>6</sup> For further details, see the ESRB, [Report of the Analytical Task Force on the overlap between capital buffers and minimum requirements](#), December 2021.

**Figure 1: Final effects of the overlaps**  
(per cent of RWAs)



Note: Each panel shows the bank's CET1 ratio in per cent of RWAs. In particular, the histograms indicate how CET1 is used in the different frameworks: RW, LR and MREL in its weighted and leverage based dimensions (MREL-RW and MREL-LR). The notion of a stacking order defines the sequence in which different CET1 capital layers absorb losses. In the risk-weighted capital framework (the RW bar) excess capital covers losses first (green), followed by the CBR (yellow) and minimum requirement (pink). The distinction originates from the different consequences of any breach. The CBR is only required on top of the two risk-weighted requirements (RW and MREL-RW).

Table 1 highlights the contribution of the comprehensive approach being proposed by applying it to actual data for Italian banks. Around one fourth of the Italian banks are constrained by one of the leverage-based requirements (LR, MREL-LR, TLAC-LR): in such cases, an overlap occurs and reduces the CBR usability. The table shows the difference in the CBR's usability between the proposed approach and the RW approach. As illustrated in the two previous examples, applying the comprehensive approach reveals a significantly higher CBR usability: the CBR usability increases from 26.7 to 73.6 per cent for the whole Italian banking system. This improvement is driven by the Italian banks subject to MREL requirements (11 out of a total of 150 banks, which account for 80 per cent of total system assets), whose CBR usability increases from 10.8 to 69.0 per cent. Indeed, when the MREL-RW requirement met with CET1 is higher than the RW one (as in panel (b) of Figure 1), the CBR is more usable than is apparent from the approach based solely on the RW requirement. This explains why, by considering the regulatory requirements of the resolution framework as well, the usability of the CBR increases.

**Table 1: CBR usability of Italian banks**  
(per cent of CBR; data as of December 2020)

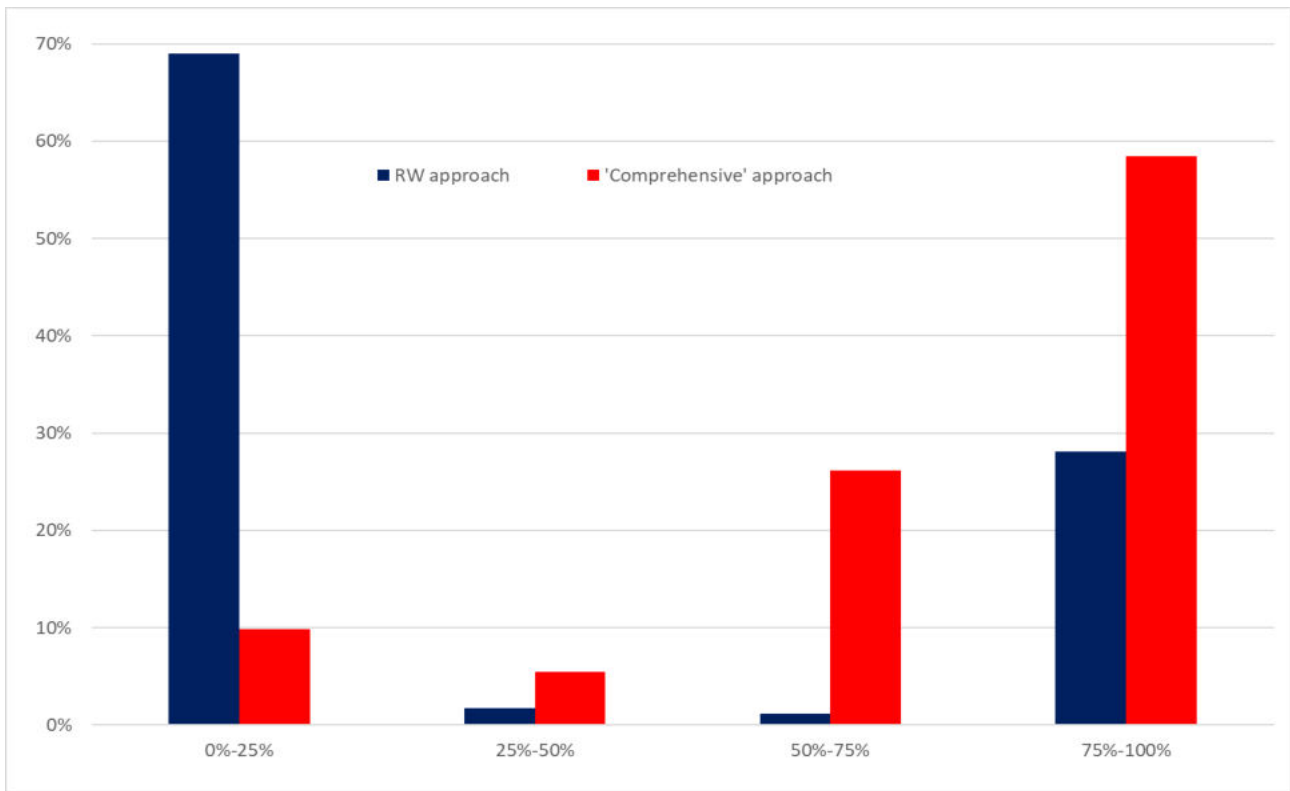
	RW approach	Comprehensive approach
Banks with MREL requirements (11 banks)	10.8	69.0
Whole system (150 banks)	26.7	73.6

Source: Supervisory and resolution reporting.

Note: The assumption of closing the shortfalls applies in each column. In our calculations, the P2R is included in the minimum RW requirements.

The difference between the two approaches to measuring the CBR's usability also emerges from the distribution of the risk-weighted assets (RWAs) of Italian banks by buckets of CBR usability (see the figure 2). In particular, based on the RW approach, almost 70 per cent of the banking system RWAs are attributable to banks with a very limited CBR usability (between 0 and 25 per cent). According to the comprehensive approach, instead, 85 per cent of RWAs are attributable to banks with a medium/high CBR usability (above 50 per cent).

**Figure 2: Distribution of Italian banking system RWAs according to CBR usability**  
*(share of banking system RWAs by bucket of CBR usability; data as of December 2020)*



Source: Supervisory and resolution reporting.