



CENTRAL BANK OF CYPRUS

EUROSYSTEM

MACROPRUDENTIAL POLICY

Policy on: a) setting a list of criteria for the assessment of the materiality of third countries for the Cyprus banking system, in relation to the recognition and setting of countercyclical capital buffer rates on exposures to each material third country; and b) setting the countercyclical capital buffer rate on exposures to third countries.

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Part 1. Introduction

1. The Central Bank of Cyprus (CBC) is, as from 1 January 2016, according to the provisions of the *Macroprudential Oversight of Institutions Law, 2015* (Law 6(I) of 2015), responsible, *inter alia*, for the:
 - setting and recognition of the countercyclical capital buffer rate (CCyB)¹ of the total risk exposure amount of institutions with exposures in the Republic of Cyprus on a quarterly basis; and
 - setting and recognition of the countercyclical capital buffer rate of the total risk exposure amount of institutions that have exposures in other member states of the EU and in third countries, for the purposes of the calculation of their institution-specific countercyclical capital buffer.
2. The CBC, as the macroprudential authority, has to assess the macroprudential risks stemming from excessive credit growth in Cyprus, the EU and third countries. Such risks could arise from cross-border exposures of the domestic banking system to third countries, which might serve as a contagion channel of these risks. In particular, excessive credit growth in a given third country could, if not addressed by means of macroprudential policies taken by that country, lead to substantial losses for the domestic banking sector and, ultimately, pose a threat to financial stability.
3. According to the provisions of the Law 6 (I) of 2015, the CBC, as the designated authority, can receive guidance from the European Systemic Risk Board (ESRB) by way of recommendations.
4. The ESRB recommendation of 11 December 2015 on recognising and setting countercyclical buffer rates for exposures to third countries (ESRB/2015/1), defines, *inter alia*, the following recommendation:

Recommendation B is addressed to the designated macroprudential authorities in relation to recognising and setting countercyclical capital buffer rates for exposures to third countries.
5. Through recommendation B(i), it is recommended that the macroprudential authorities set a list of criteria for the materiality assessment of third countries, which should be reported to the ESRB.
6. To that end, the CBC has defined criteria that govern additions to and deletions from the list of material third countries. These criteria are designed to be: a) conservative, i.e. it is easier for a third country to be added to the list than to be deleted from it; and b) transparent, i.e. the criteria for adding to and deleting from the list are based on simple rules.
7. In Part 2 of this policy document, the CBC has complied with recommendation B(i) of recommendation ESRB/2015/1 on setting a list of criteria for the materiality assessment of third countries.

¹ The countercyclical capital buffer is designed to help counter pro-cyclicality in the financial system, which amplifies variances of uptrends and downturns of the financial cycle and of the real economy. Capital should be accumulated when cyclical systemic risk is judged to be increasing, creating buffers that increase the resilience of the banking sector during periods of stress when losses materialise. This will help maintain the supply of credit and dampen the downswing of the financial cycle. The countercyclical capital buffer can also help dampen excessive credit growth during the upswing of the financial cycle.

8. In Part 3 of this document, the procedure that the CBC will follow on setting countercyclical capital buffer rates on exposures of domestic institutions to third countries is presented.
9. Where a countercyclical capital buffer rate has been set and published by the relevant authority in a third country, the designated authority of each member state may set a different countercyclical capital buffer rate for the exposures of institutions to that third country for the purposes of the calculation of their institution-specific countercyclical capital buffer rate. The designated authority may set a different countercyclical capital buffer rate for these exposures, if it reasonably considers that the countercyclical capital buffer rate set by the third country authority is not sufficient to appropriately protect its institutions from the risks of excessive credit growth in that third country.
10. In Part 4 of this document, the amended communication framework of the CBC is presented, which now encompasses decisions on recognising and setting countercyclical capital buffer rates on exposures of domestic banks to third countries.

Part 2. Policy on setting a list of criteria for the assessment by the CBC of the materiality of third countries for the Cyprus banking system, in relation to the recognition and setting of countercyclical capital buffer rates on exposures to each material third country.

The CBC's policy on setting a list of criteria for the assessment of the materiality of third countries for the Cyprus banking system, in relation to the recognition and setting of countercyclical capital buffer rates on exposures to each material third country, is based on the Decision of the ESRB of 11 December 2015 (ESRB/2015/3), in relation to the assessment of materiality of third countries for the EU's banking system in relation to the recognition and setting of countercyclical capital buffer rates.

Article 1 Scope

This policy defines the CBC's procedures for assessing the materiality of third countries for the domestic banking system in relation to the recognition and setting of countercyclical capital buffer rates on exposures to each material third country.

Article 2 Definitions

For the purposes of this policy, the following definitions apply:

«countercyclical capital buffer rate»: means the rate that the institutions must apply in order to calculate their institution-specific countercyclical capital buffer, which is set in accordance with articles 10 and 11 of Law 6(I) of 2015 or by a relevant third country authority, as the case may be.

«institution»: has the meaning of a licensed credit institution, as defined in the *Business of Credit Institutions Law*.

«exposure»: has the meaning as defined in Part 1 of the Preliminary Provisions, section 2, sub-section (1) of the *Business of Credit Institutions Law*.

«material exposures»: has the meaning of credit exposures which could potentially result in substantial losses for the institutions, negatively affecting the financial stability of Cyprus.

«monitoring of a material third country»: has the meaning of governance, maintenance and regular update of a set of indicators and quantitative tools to signal potentially excessive credit growth in material third countries.

«third country»: means any country outside the European Economic Area.

«material third country»: means a third country to which the domestically licensed institutions have material exposures.

Article 3
Collection of data

1. For the purposes of assessing which third countries are material for the domestic banking system, the CBC assesses aggregated supervisory data.
2. In assessing whether a third country is material for the domestic banking system, the following metrics shall be considered:
 - (a) risk-weighted-exposure amounts
 - (b) original exposures
 - (c) defaulted exposures.
3. In particular, the CBC collects on a quarterly basis from the COREP templates the following data points of the supervisory data for each third country:

Template C 09.01: intersection of rows 070, 080, 090, 100, 110, 120, 130, 140, 150, 160 and columns 010, 020 and 080².

Article 4
Materiality assessment

1. A third country shall be identified as material for the domestic banking system and added to the list of material third countries when:
 - (a) the arithmetic mean of exposures on a case by case basis (i.e. for each metric of exposure amount presented in points a), b) and c) of paragraph 2) of article 3) in a specific country, in the eight quarters preceding the reference date, was at least 1% or greater than the arithmetic mean of total exposures where appropriate, for at least one of the metrics listed in article 3, and
 - (b) the exposures in each of the two quarters preceding the reference date were at least 1% or greater than the arithmetic mean of total exposures where appropriate, for at least one of the metrics listed in article 3.
2. A country shall be deleted from the list of material third countries when:
 - (a) the arithmetic mean of exposures on a case by case basis (i.e. for each class of exposure presented in points a), b) and c) of paragraph 2) of article 3) in a specific country, in the 12 quarters preceding the reference date, was less than 1% of the arithmetic mean of total exposures where appropriate, for all metrics listed in article 3, and
 - (b) the exposures in each of the two quarters preceding the reference date, were less than 1% of the arithmetic mean of total exposures where appropriate, for all the metrics listed in article 3.

² The rows represent the following exposures, based on COREP templates: 070 Corporates, 080 Retail, 090 Secured by mortgages on immovable property, 100 Exposures in default, 110 Items associated with particularly high risk, 120 Covered bonds, 130 Short-term claims on institutions and corporates, 140 Collective investments undertakings (CIU), 150 Equity exposures, 160 Other exposures. The columns represent the following exposures, based on COREP templates: 010 Original exposure pre conversion factors, 020 Exposures in default and 080 Risk weighted exposure amount.

3. A third country identified as material for the domestic banking system, based on the criteria set out in paragraph 1), shall be monitored by the CBC unless:
 - (a) this third country is on the list of countries identified by the ESRB as material third countries for the EU based on the Decision of the ESRB of 11 December 2015 (ESRB/2015/3), in relation to the assessment of materiality of third countries for the EU's banking system with regards to the recognition and setting of countercyclical buffer rates, and
 - (b) the CBC decides that the monitoring, as defined in Article 2, of this third country, will be performed by the ESRB, based on the provisions of Recommendation ESRB/2015/1.
4. The CBC may exercise its discretion during the identification of a material third country for the domestic banking system. This will most likely take place in cases where a third country meets the materiality criteria only marginally
5. The list of material third countries is revised by the CBC on an annual basis. The revision is based on the aggregate supervisory data that are collected for the twelve quarters preceding 31 December of the current calendar year.
6. The list and any amendments thereon will be reported to the ESRB.

Article 5
Transitional Provisions

1. The initial list of material third countries will be compiled during 2016Q3 and will be compiled on the basis of reference data for 2016Q2.
2. The first revision of the list of material third countries, as identified by the CBC, will take place in 2017Q2, using supervisory data and as a reference date 31 December 2016.
3. The revision of the list reflects the need to have sufficient data to apply the entry or deletion criteria. As a result:
 - (a) During the revision of the list during the second quarter of 2017, only potential additions to the list will be considered
 - (b) During the revision of the list from the second quarter of 2018 onwards, potential additions and deletions to the list will be considered.

Part 3. Policy on setting the countercyclical capital buffer rate on exposures to third countries.

Article 1 Scope

This policy defines the CBC's procedures on setting the countercyclical capital buffer rate on exposures of Cyprus institutions to third countries for the purposes of the calculation of their institution-specific countercyclical capital buffer.

Article 2 Definitions

For the purposes of this Policy, the following definitions shall apply:

«institutions»: has the meaning of the institutions that are required to maintain an institution-specific countercyclical capital buffer, according to the provisions of section 5 of Law 6(I) of 2015, which are:

- (a) the licensed credit institutions in Cyprus
- (b) the Cyprus Investment Firms as they are defined in section 2 of the Investment Services and Activities and Regulated Markets Law, which:
 - i. have not been exempted from the requirement to maintain a countercyclical capital buffer due to their small or medium size, and
 - ii. provide the services of dealing on own account and/or underwriting of financial instruments and/or placing of financial instruments on a firm commitment basis.

Article 3 Application

1. According to the provisions of Law 6(I) of 2015, the CBC may set the countercyclical capital buffer rate for a third country to which the institutions have exposures, for the purposes of the calculation of their institution-specific countercyclical capital buffer, as set out in paragraph 9 of Section 1 of this present document, in the following instances:
 - (a) Where a countercyclical capital buffer rate has not been set and published by the relevant third-country authority for that third country to which one institution of the Republic of Cyprus has credit exposures.
 - (b) Where a countercyclical capital buffer rate which has been set and published by the relevant third-country authority for that third country. In such a case, the CBC may set a different buffer rate for the exposures in that third country, if the CBC considers that the buffer rate set by the third country is not sufficient to appropriately protect the institutions of the Republic of Cyprus from the risks of excessive credit growth in that country.
2. If one third country which has been assessed by the ESRB or by the CBC as material for the banking system of the EU or the Republic of Cyprus, respectively, and to which the institutions have exposures, then the countercyclical capital buffer rate that must be applied on the exposures of the institutions to that third country will be set by the ESRB or the CBC, respectively. The countercyclical capital buffer rate when set by the ESRB will be on the basis of an ESRB Recommendation and will be published on the ESRB website.

The countercyclical capital buffer rate when set by the CBC, will be communicated to the institutions via a circular letter and will be published on the CBC website.

3. If one third country which has not been assessed by the ESRB or by the CBC as material for the banking system of the EU or the Republic of Cyprus, respectively, and to which the institutions have exposures, then the CBC sets the countercyclical capital buffer rate on the exposures of the institutions to that third country as follows:
 - (a) When a countercyclical capital buffer rate has been set and published by the relevant third-country authority for that third country and which does not exceed 2,5%, then the CBC sets the countercyclical capital buffer rate equal to the one the relevant third-country authority has set for that third country. If the CBC considers that the buffer rate set by the third country is not sufficient to appropriately protect the institutions of the Republic of Cyprus from the risks of excessive credit growth in that third country, then the countercyclical capital buffer rate will be set by the CBC and will be communicated to the institutions via a circular letter and will be published on the CBC website.
 - (b) When a countercyclical capital buffer rate has been set and published by the relevant third-country authority for that third country and which exceeds 2,5%, then the countercyclical capital buffer rate will be set by the CBC and will be communicated to the institutions via a circular letter and will be published on the CBC website.
 - (c) When a countercyclical capital buffer rate has not been set and published by the relevant third-country authority for that third country, then the CBC sets the countercyclical capital buffer rate to 0%.
4. For the purposes of the calculation of the institution-specific countercyclical capital buffer institutions are required to take into account the transitional provisions of the article 16(2) of the Law 6(I) of 2015.
5. The countercyclical capital buffer rates set by third countries are published on the website of the Bank for International Settlements (bis.org).
6. The CBC may exercise its discretion during the setting of a countercyclical capital buffer rate for exposures to third countries for the purposes of the calculation of the institution-specific countercyclical capital buffer. This will most likely take place in cases where the countercyclical capital buffer rate set by a third country is considered as not sufficient to protect the institutions of the Republic of Cyprus.

Part 4. Policy for the CBC communication framework on recognising and setting countercyclical capital buffer rates for exposures of domestic banks to third countries.

The policies and communication framework of the CBC have been amended accordingly to encompass the decisions on recognising and setting countercyclical capital buffer rates for exposures of domestic banks to third countries.

Part 5. Entry into force

This policy enters into force on 14 November 2016.

Part 6. Policy review

This policy may be reviewed annually.