



CENTRAL BANK OF CYPRUS

EUROSYSTEM

# Macroprudential policy of the Central Bank of Cyprus for setting the countercyclical buffer rate

---

November 2022

## **Contents**

Part 1.	Introduction and strategy.....	3
Part 2.	Macroprudential policy of the Central Bank of Cyprus for setting the countercyclical buffer rate .....	4
Part 3.	Review of cyclical systemic risks.....	5
Part 4.	Communication framework of the Central Bank of Cyprus for setting the countercyclical capital buffer .....	6
Part 5.	Entry into force.....	6
Part 6.	Policy review .....	6

## Part 1. Introduction and strategy

The Central Bank of Cyprus (“CBC”), as the national macroprudential authority, is responsible for the macroprudential oversight of the financial system, with the ultimate objective to ensure the stability of the financial system. The above competence constitutes one of the main tasks of the CBC, based on section 6(2)(e) of the Central Bank of Cyprus Law, 2002 as amended (the “CBC Laws”). In accordance with section 47A(1) of the CBC Laws, the CBC, when conducting its macroprudential oversight of the financial sector, identifies, monitors and assesses the risks that threaten financial stability, and implements policies to prevent or limit these risks in order to achieve its ultimate objective.

Based on the provisions of the Macroprudential Oversight of Institutions Laws 2015 to No (2) of 2021<sup>1</sup> (hereafter “the Law”), the CBC is the designated authority responsible for the application of the macroprudential tools available under the Capital Requirements Directive (Directive 2013/36/EU - “CRD”).

The CBC, as the designated macroprudential authority, based on section 10(2) of the Law, assesses the intensity of cyclical systemic risk and the appropriateness of the countercyclical buffer rate in the Republic of Cyprus, on a quarterly basis, and after requesting and taking into consideration the views of the competent authorities, as defined in section 2 of the Law<sup>2</sup>, sets and adjusts the countercyclical buffer rate, if necessary.

Based on the same section of the Law, when acting as above, the CBC takes into consideration the following: the calculated buffer guide, any current guidance maintained by the European Systemic Risk Board (ESRB) and any recommendations issued by the ESRB on the setting of a buffer rate, as well as any other variables that the CBC considers relevant for addressing cyclical systemic risk.

As per the above-mentioned framework, the methodology for the setting of the countercyclical buffer rate takes into consideration the Recommendation ESRB/2014/1 on guidance for setting countercyclical buffer rates. If it is deemed necessary to adjust the said buffer rate, prior to taking such decision, the European Central Bank (ECB) is consulted, in accordance with Article 5 of the Single Supervisory Mechanism (SSM) Regulation.

The scope of application of the current Policy encompasses the institutions as defined in section 2 of the Law.

Through this Policy, the CBC defines its **strategy** regarding the setting of the countercyclical buffer rate, based on the following principles:

- a) To create a safety buffer in order to strengthen the resilience of the financial sector during periods of stress, supporting the uninterrupted supply of credit to the economy.
- b) To contribute towards the mitigation of procyclicality within the financial system.
- c) To set a positive countercyclical buffer rate on the risk-weighted assets of the institutions, when risks are assessed to be neither subdued nor elevated and the intensity of cyclical systemic risk is assessed as being neutral.
- d) To adjust the countercyclical buffer rate either upwards or downwards, according to the intensity of the risks at the system level, after taking into consideration the views of the competent authorities.

---

<sup>1</sup> Law 6(I) of 2015, Law 93(I) of 2021 and Law 161(I)/2021.

<sup>2</sup> For licensed credit institutions, the CBC, and for the Cyprus Investment Firms, the Cyprus Securities and Exchange Commission.

- e) To follow a broadly symmetric approach i.e. when cyclical systemic risk is assessed to be decreasing or has materialised, the countercyclical buffer rate will be reduced and, where deemed necessary, shall fall to zero. At the same time, when cyclical systemic risk is assessed to be increasing the said buffer rate will be increased.

The countercyclical buffer rate expressed as a percentage of the total risk exposure amount of credit institutions that have credit exposures in the Republic, is between 0% and 2,5%, calibrated in steps of 0,25% or multiples of 0,25%. Where justified, the CBC may set the countercyclical buffer rate above 2,5%<sup>3</sup>.

Based on Recommendation ESRB/2014/1, the general principles governing the setting of the countercyclical buffer rate follow the principle of guided discretion, i.e. a combination of a rule-based approach with the exercise of the discretionary powers of macroprudential authorities.

## **Part 2. Macroprudential policy of the Central Bank of Cyprus for setting the countercyclical buffer rate**

One of the key preconditions for setting the countercyclical buffer rate is the identification of the intensity of cyclical systemic risk in relation to the stage of the financial cycle. To this end, the current Policy predetermines **four stages of intensity of cyclical systemic risk**.

### **Stage 1: Risks facing the financial system are very subdued: the post-crisis repair phase (Low cyclical risk intensity)**

The risks in the financial system during the post-crisis recovery phase are usually subdued, i.e. the phase when the financial system and the borrowers are repairing their balance sheets and they do not extend them further. Among others, asset prices tend to be low and/or undervalued. New lending is generally restricted and the risk appetite of borrowers and lenders tends to be low, while the likelihood of the financial system facing a renewed stress in the medium term is limited.

During this phase, the CBC expects that the countercyclical buffer rate for exposures in the Republic will remain reduced or at 0%.

### **Stage 2: Risks in the financial system re-emerge but are not elevated: a standard risk environment (Neutral cyclical risk intensity)**

In this risk environment, *inter alia*, lending tends to remain within reasonable levels and borrowers do not face any particular challenges in the repayment of their loans. Asset prices do not show any ongoing signs of overvaluation or undervaluation (they are generally in equilibrium) and the risk appetite of both borrowers and lenders tends to be close to the historical averages.

During this phase, the CBC may set the countercyclical buffer rate for exposures in the Republic at 0,5% (as a minimum).

---

<sup>3</sup> Based on section 10(3) of the Law.

**Stage 3: Risks in the financial system become elevated: stressed conditions become more likely (Increased cyclical risk intensity)**

As risks in the financial system increase, *inter alia*, borrowers are more likely to face difficulties in the repayment of their loans, new lending increases while both asset prices as well as the risk appetite of borrowers and lenders tends to be high. The likelihood for institutions to experience losses is high.

During this phase, the CBC may increase the countercyclical buffer rate for exposures in the Republic further.

**Stage 4: Risks in the financial system materialise (crystallised risks)**

In the event that a crisis is certain, i.e. when risks in the financial system start to materialise, the CBC may reduce the countercyclical buffer rate or set it (if necessary) to 0%. At this stage, where institutions' losses are now certain, the aim is to reduce the countercyclical buffer rate, so that institutions can use the released funds to absorb their losses, without having to limit their lending activities to the real economy.

The reduction of the countercyclical buffer rate and the release of funds can be immediate.

In case the CBC reduces the existing countercyclical buffer rate, whether or not it is reduced to 0%, in accordance with the provisions of the Law, it shall also decide an indicative period during which no increase in the buffer is expected. However, that indicative period shall not be binding<sup>4</sup>.

### **Part 3. Review of cyclical systemic risks**

During the assessment of cyclical systemic risks, the CBC follows a holistic approach based on both a quantitative analysis of cyclical risks (heatmap), i.e. using trends and dispersions, or relevant thresholds, as well as a qualitative analysis. The setting of the countercyclical buffer rate is done in accordance with the principle of Guided Discretion, as described above.

When monitoring cyclical systemic risks for identifying the intensity of cyclical risk per stage, the CBC takes into consideration, *inter alia*, the below indicators:

- The buffer guide it calculates based on the deviation of the ratio of credit-to-GDP from its long-term trend (Credit to GDP gap), as defined by the Recommendation ESRB/2014/1.
- A set of indicators<sup>5</sup> evaluated by the CBC on an ongoing basis, regarding, *inter alia*, the credit growth rate in the Republic, the debt of the private non-financial sector in the Republic as a % of the GDP, the resilience of the banking sector, as well as indicators relating to the real estate market, the real economy and external imbalances.

<sup>4</sup> Based on section 10(5) of the Law.

<sup>5</sup> The selection of indicators is in line with the ESRB Recommendation on the setting of countercyclical buffer rates (ESRB/2014/1). More information is available on the CBC's website: <https://www.centralbank.cy/en/financial-stability/macprudential-policy-decisions/countercyclical-capital-buffer-ccyb>

Simultaneously, the CBC evaluates and takes into consideration, *inter alia*, the following:

- Total capital requirements of institutions as well as their capital surplus over capital requirements;
- Other macroprudential tools and capital buffers enacted by the CBC;
- Risks and challenges faced by institutions;
- The ability of institutions to generate profits and thus capital;
- The potential impact on lending;
- Other macroprudential tools adopted by the CBC;
- The assessment of cyclical systemic risks of the ECB and the ESRB for Cyprus;
- The views of other competent authorities as defined in section 2 of the Law, i.e. for licensed credit institutions, the CBC, and for Cyprus investment firms, the Cyprus Securities and Exchange Commission;
- Relevant information received from the Resolution Authority;
- Current structural and other developments;
- Other national specificities of the economy and the banking sector such as, among others, growth prospects, structural weaknesses, market access etc.

#### **Part 4. Communication framework of the Central Bank of Cyprus for setting the countercyclical capital buffer**

The CBC will announce on a quarterly basis the current countercyclical buffer rate and additional information on its website, in accordance with section 10(6) of the Law. The CBC will inform the institutions when the CBC decides to adjust the countercyclical buffer rate. If considered necessary, the institutions will also be informed through oral communication.

Pursuant to section 10(6)(v) of the Law, in cases where the buffer rate is increased, the CBC shall announce on its website the date from which institutions must apply the increased buffer rate for the purpose of calculating the institution-specific countercyclical capital buffer, which shall not be less than twelve (12) months from the date of publication.

#### **Part 5. Entry into force**

The present Policy enters into force upon its approval by the Board of Directors of the CBC.

#### **Part 6. Policy review**

The CBC may revise the present Policy if necessary.