





STUDENTS' ECONOMIC FORUM

A monthly publication from South Indian Bank

*To kindle interest in economic affairs...
To empower the student community...*

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What is Capital Conservation Buffer ?

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Theme 324

“CAPITAL CONSERVATION BUFFER”

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Theme No: 324: **“Capital Conservation Buffer”**

A well informed customer will make the policy makers as well as organizations which produce goods and render services more responsive to the customer needs. This will also result in healthy competition among organizations and improve the quality of its products.

The “SIB Students’ Economic forum” is designed to kindle interest in the minds of younger generation. We highlight one theme in every monthly meeting of the “Forum”. The topic of discussion for this month is “Capital Conservation Buffer”.

Basel III reforms are the response of Basel Committee on Banking Supervision (BCBS) to improve the banking sector’s ability to absorb shocks arising from financial and economic stress, whatever the source, thus reducing the risk of spill over from the financial sector to the real economy. Basel III reforms strengthen the bank-level micro prudential regulation, with the intention to raise the resilience of individual banking institutions in periods of stress. The new global regulatory and supervisory standards mainly seek to raise the quality and level of capital to ensure banks are better able to absorb losses on both a going concern and a gone concern basis, increase the risk coverage of the capital framework, introduce leverage ratio to serve as a backstop to the risk-based capital measure, raise the standards for the supervisory review process (Pillar 2) and public disclosures (Pillar 3) etc. The macro prudential aspects of Basel III are largely enshrined in the capital buffers. Both the buffers i.e. the capital conservation buffer and the countercyclical buffer are intended to protect the banking sector during the stress period.

The generous distribution of dividend to shareholders by the bank based on the future prediction of recovery is not justifiable for the bank whose capital buffer has already got eroded. These shareholders, rather than depositors, must bear the risk of recovery not forthcoming.

It is also not acceptable for banks which have depleted their capital buffers to try and use the distribution of capital for dividend payout to signal their financial strength. Putting shareholders interests above depositors is not only undesirable

from the perspective of an individual bank, it may also encourage other banks to follow suit. As a consequence, banks in aggregate can end up increasing distributions at the exact point of time when they should be conserving earnings.

What is Capital Conservation Buffer (CCB)?

The capital conservation buffer (CCB) ensures that banks build up capital buffers during normal times (i.e. outside periods of stress) which can be drawn down when losses are incurred during a stressed period. The requirement is based on simple capital conservation rules designed to avoid breaches of minimum capital requirements. The Bank is required to maintain a minimum Capital to Risk Weighted Assets Ratio (CRAR) of 9% {11.5% including Capital Conservation Buffer (CCB)}, with minimum Common Equity Tier I (CET1) of 5.5% (8% including CCB). These guidelines on Basel III have been implemented on 1st April 2013 in a phased manner. The capital conservation buffer in the form of Common Equity will be phased-in over a period of four years in a uniform manner of 0.625% per year.

Why is Capital Conservation Buffer (CCB) required?

CCB is a concept introduced in the International Basel III norms. The concept gained importance after the financial crisis of 2008, when large banks witnessed their capital eroding at a fast pace due to the stress in the system. The Capital Conservation Buffer is aimed to cover the losses on risky investments. The Basel Committee on Banking Supervision introduced capital buffer under two structures – First one is Capital Conservation Buffer (CCB) and the Second one is Countercyclical Capital Buffer (CCB). In India the regulatory authority has decided to implement both.

What is the difference between Capital Conservation Buffer and Countercyclical Capital Buffer?

Sl No.	Capital Conservation Buffer	Countercyclical Capital Buffer
i.	Used to absorb losses during periods of financial and economic stress	It is an extension to the conservation buffer.
ii.	Banks will be required to hold a capital conservation buffer of 2.5% to withstand the future periods of stress.	It consists entirely of Common Equity Tier 1 capital and, if the minimum buffer requirements are breached, capital distribution constraints will be imposed on the bank.

iii	The capital conservation buffer must be met exclusively with common equity.	The countercyclical capital buffer is intended to protect the banking sector against losses that could be caused by cyclical systemic risks. Countercyclical capital buffer requirement requires banks to add capital at times when credit is growing rapidly so that the buffer can be reduced when the financial cycle turns.
iv.	Banks that do not maintain the capital conservation buffer will face restrictions on payouts of dividends, share buybacks and bonuses.	

Briefly describe the Implementation of Capital Conservation Buffer (CCB) in the Indian Banking System.

Initially the CCB was to be implemented in the Indian Banking System through a phased manner and by March 31, 2019 the banks have to achieve CCB of 2.5 per cent of their risk-weighted assets. The phase wise implementation of CCB and other regulatory capital in Scheduled Commercial Banks is given below:

(% of RWAs)

Minimum capital ratios	April 1, 2013	March 31, 2014	March 31, 2015	March 31, 2016	March 31, 2017	March 31, 2018	March 31, 2019
Minimum Common Equity Tier 1 (CET1)	4.5	5	5.5	5.5	5.5	5.5	5.5
Capital Conservation Buffer (CCB)	-	-	-	0.625	1.25	1.875	2.5*
Minimum CET1 + CCB	4.5	5	5.5	6.125	6.75	7.375	8
Minimum Tier 1 Capital	6	6.5	7	7	7	7	7
Minimum Total Capital**	9	9	9	9	9	9	9
Minimum Total Capital +CCB	9	9	9	9.625	10.25	10.875	11.5

* The transition period to implement the last tranche of 0.625 per cent under CCB has been extended by one year to March 31, 2020. Now, banks can achieve CCB of 2.5 per cent of their risk-weighted assets by March-end 2020.

** The difference between the minimum total capital requirement of 9% and the Tier 1 requirement can be met with Tier 2 and higher forms of capital.

Briefly explain the impact on a bank if CCB falls below the prescribed level.

Banks are required to maintain a capital conservation buffer of 2.5%, comprised of Common Equity Tier 1 capital, above the regulatory minimum capital requirement of 9%. Banks should not distribute capital (i.e. pay dividends or bonuses in any form) in case capital level falls below the stipulated level. However, they will be able to conduct business as normal when their capital conservation buffer gets eroded due to losses. Therefore, the constraints imposed are related to the distribution of dividend only and are not related to the operations of banks.

At good times i.e., outside the periods of stress, banks should hold buffers of capital above the regulatory minimum and can be drawn down when loss incur during stress period. CCB can be drawn down only when the bank faces a systemic stress. Draw down from CCB will only be allowed when the bank has a specific plan to replenish the capital through internal capital accruals and by reducing the discretionary distribution of earnings.

The Table below shows the minimum capital conservation ratios a bank must meet at various levels of the Common Equity Tier 1 capital ratios.

Sl No.	CET 1 Ratio	Retained Earnings	Dividend Payout
1	5.5% - 6.125%	100%	0%
2	6.125% - 6.75%	80%	20%
3	6.75% - 7.735%	60%	40%
4	7.735% - 8.0%	40%	60%
5	> 8.0%	0%	100%

For example, a bank with a Common Equity Tier 1 capital ratio in the range of 6.75% to 7.735% is required to conserve 60% of its earnings in the subsequent financial year and payout no more than 40% in terms of dividends and share buybacks is allowed.





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