AUSSCHUSS
FÜR FINANZMARKTSTABILITÄT

13 October 2021: Recommendation to adjust the systemic risk buffer (AFMS/2021/3)

In order to address the structural, long-term systemic risks in the Liechtenstein banking sector, the Financial Stability Council (FSC) has recommended to the Government pursuant to Art. 33b(2)(d) of the Financial Market Supervision Act (FMAG) that a systemic risk buffer (SyRB) be established for all Liechtenstein banks in the amount of 1% of mortgage-backed loans for properties in Liechtenstein, both on a consolidated and on an individual basis. This recommendation was made on the basis of the planned revision of the Banking Act (BankG) to implement the revised EU Capital Requirements Directive (CRD V[1]), which - subject to approval by the Liechtenstein Parliament - is expected to come into force in Liechtenstein in spring 2022. The new capital buffer provisions according to this FSC recommendation are to apply as of the entry into force of the revised Banking Act.

In the revised EU Capital Requirements Directive, the O-SII buffer (Art 131 CRD V) and the SyRB (Art 133 CRD V) will be additive, whereas previously only the higher of the two capital buffers was applied. Against the background of these legal changes, a recalibration of the SyRB - but also of the O-SII buffer (see FSC Recommendation 2021/2) - is now to be carried out. Subject to the planned revision of the Banking Act, the level of the buffers will therefore be adjusted in such a way that the implementation of CRD V does not result in an increase in the effective buffer requirements merely due to the regulatory changes.

The systemic risk buffer serves to avoid or mitigate macroprudential risks or systemic risks with potential serious adverse effects on the financial system and the real economy that have not already been captured by the countercyclical capital buffer or O-SII buffer. The recalibration of the SyRB is methodologically based on the calibration in 2019, but in addition considers the regulatory changes resulting from the planned CRD V introduction.

Based on the FMA's analysis, two significant sources of systemic risk were identified for the Liechtenstein banking sector. These are systemic vulnerability and systemic cluster risk.

[1] Directive (EU) 2019/878 of the European Parliament and of the Council of 20 May 2019 amending Directive 2013/36/EU as regards exempted entities, financial holding companies, mixed financial holding companies, remuneration, supervisory measures and powers and capital conservation measures, OJ. L 150, 7 June 2019, p. 253.

1. Systemic vulnerability results from an increased vulnerability of banks to the financial system, which can arise through the interconnectedness of banks with each other, with the financial system and with the real economy. Examples of systemic vulnerability are
   a. potential risks arising from contingent liabilities to the deposit insurance scheme,
   b. reputational risks of the Liechtenstein financial center in general as well as due to the prevailing business model, and
   c. systemic risks arising from the special institutional features in Liechtenstein.
2. Systemic cluster risk arises from substantially similar risk sources in the banking sector and can lead to significant negative effects in the financial system and in the real economy due to the similarity of business models across banks. In Liechtenstein, the high mortgage portfolios in the bank balance sheets against the background of the high indebtedness of the private household sector as well as the similar dependencies vis-à-vis correspondent banks were identified as systemic cluster risks.

The level of the systemic risk buffer is calibrated using different methodological approaches, taking into account both historical crisis costs and potential costs due to the materialisation of specific systemic risks, as well as a comparison of macroprudential capital buffer requirements with similar banking systems to Liechtenstein's.

In particular, the calibration also considers overlaps with the capital buffer for other systemically important institutions (O-SII buffer) as well as risk mitigating factors. These include, for example, the lower complexity of Liechtenstein bank balance sheets due to the application of the standardised approach, the less complex business models, proportionality criteria as well as the addressing of idiosyncratic risks in the Supervisory Review and Evaluation Process (SREP) or in the Pillar 2 capital requirement. After considering the overlaps with the O-SII capital buffer as well as the risk-mitigating factors, the calibration results in a sectoral SyRB for all Liechtenstein banks of 1% of the risk-weighted amount of mortgage-backed loans secured by real estate properties in Liechtenstein. The sectoral SyRB aims to strengthen the resilience of the banking sector in relation to the identified real estate-related systemic risks. The recalibrated systemic risk buffer is expected to apply from spring 2022 - when the revised Banking Act enters into force - on both a consolidated and an individual basis, as systemic risks can manifest themselves on both a consolidated and an individual basis and capital allocation is not sufficiently flexible, especially in a crisis. At the same time, arbitrage opportunities should be excluded to ensure a level playing field for all Liechtenstein banks.

The sectoral SyRB of 1% of the risk-weighted amount of the mortgage-backed loans secured with real estate properties in Liechtenstein is considered effective, proportional and appropriate based on the stress scenarios and past crisis costs. This is based on the identified systemic risks in the Liechtenstein financial system and the potential losses due to structural risks. Should the systemic risks continue to increase - in particular due to rising risks in relation to private household debt - the FSC will consider increasing the buffer ratio in the course of the regular review of the systemic risk buffer, provided that no other (and more accurate) macroprudential instruments are available to address the systemic risks.