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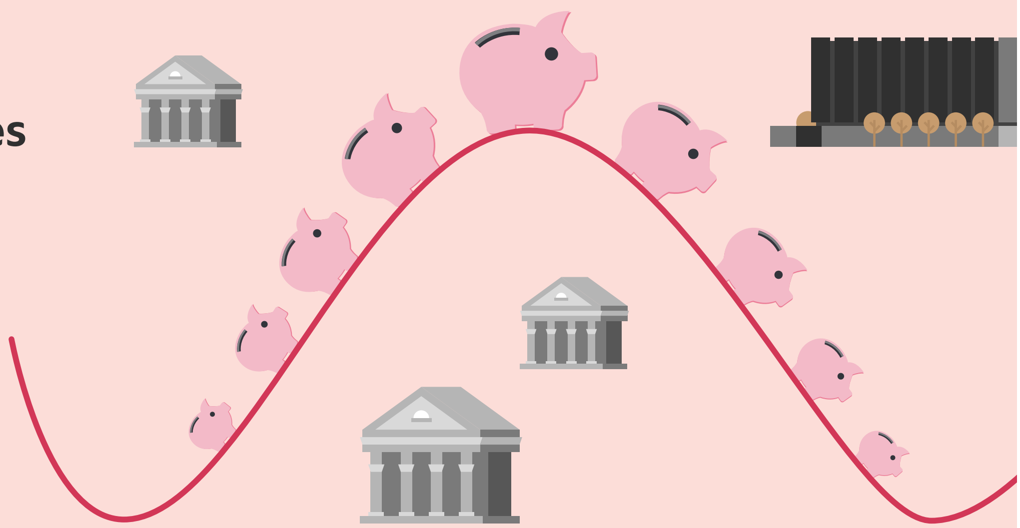
Before the warning lights start blinking

Capital buffer must be ahead of the financial cycle

If you want to hit a moving target, you must aim ahead of the target, not at its current position. This principle applies just as well when playing dodgeball at school as when shooting down enemy missiles in wartime. It also applies when policy makers determine the banks' capital buffer level required to weather hard times. They must look at the direction in which the financial development is moving, rather than at its current state.

In a Working Paper, Søren Korsgaard, Danmarks Nationalbank, examines how to apply mathematical techniques from other areas, such as sports and missile systems, to the effort to ensure a robust financial sector. The model applied shows that it is appropriate to raise the adjustable buffer requirements for banks gradually and in good time before the warning lights start blinking in the financial markets. The model is particularly relevant in relation to the

Capital must be built up in good times



Source: Danmarks Nationalbank

countercyclical capital buffer, which is a requirement of banks' and mortgage credit institutions' own funds. According to the rules, it normally takes 12 months from the decision to raise the buffer until the requirement takes effect for the banks.

In a situation where it is unknown whether the financial system is headed for an upswing or a downturn, it is thus more appropriate for policy makers to set the buffer a little too high than a little to low, according to the model. That is because a buffer rate set too high can be eased again quickly if the financial sector comes under pressure. Conversely, it takes more time to build up the buffer.

The buffer must be built up in good times
Moreover, the model includes the assumption that it is easier for the banks to raise capital to build up a buffer in financially good times than in less favourable times. This has also been the approach of Danish policy makers who have raised the countercyclical capital buffer in recent years. The buffer is intended to curb the negative effects on the real economy from a future financial crisis. When stress occurs in the financial system, the buffer is to be released. Releasing the buffer aims to prevent the banks and mortgage credit institutions from showing credit restraint during crises due to capital shortfalls.

In early October, the Danish government decided to raise the countercyclical buffer rate from 1.5 per cent to 2.0 per cent with effect from 30 December 2020. This decision complies with a recommendation from the Danish Systemic Risk Council, which monitors developments in the financial system and is chaired by Governor Lars Rohde, Danmarks Nationalbank.

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