Credit institutions: taking up and pursuit of the business. Recast

2004/0155(COD) - 23/06/2010

The minimum capital requirements for banks under the EU Capital Requirements Directive (CRD), which comprise Directive 2006/48/EC and Directive 2006/49/EC, are risk sensitive: the higher the risk, the more capital a bank needs to hold to meet that risk and cover potential losses. By consequence, as credit and market risks increase in a downturn, minimum capital requirements for banks will also increase to meet those higher risks. Banks may need to raise additional capital to meet these higher requirements at a time when their capital resources are being eroded by losses and opportunities for raising capital are scarce and costly. This may potentially constrain banks' lending capacity into the economy. The possibility that the CRD may contribute to the pro-cyclicality observed in the financial system under the predecessor Basel I framework led to the inclusion in the CRD of Article 156 which requires the Commission to monitor whether the CRD has significant effects on the economic cycle'. This report has been drawn up for that purpose.

It notes that bank capital regulation may potentially amplify the cyclicality endemic to bank lending behaviour. Due to their risk-sensitive nature, capital requirements under the Basel II framework, transposed in the EU by the CRD, are expected to rise more in recessions and grow less during expansions. Since it may be expensive for banks to raise additional capital during economic downturns, this may encourage them to cut back on lending instead. By contrast, as capital requirements become more relaxed during economic upturns, banks may have more room for manoeuvre to extend more and / or riskier credit as compared to historical average over the business cycle.

However, bank lending is pro-cyclical in nature and it cannot be assumed that cyclical capital requirements per se have an amplifying effect. Indeed, the pro-cyclical nature of bank lending has many, often interconnected sources such as limitations in the measurement of risk and information asymmetries between borrowers and lenders. Furthermore, pro-cyclicality in lending may also stem from inappropriate responses of financial system participants to changes in the economic conditions. As pro-cyclicality is driven by various factors, it is difficult to identify the exact impact of minimum capital requirements. In particular, it remains a challenge to distinguish the effects of loan supply from those of loan demand, especially as shifts in demand and supply both have an impact on bank lending rates and credit volumes.

In order correctly to identify those effects, it would be necessary to have a detailed and sufficiently large data set, which – because the CRD has only recently been implemented – is yet not available. This first assessment set out in this report is therefore partly based on qualitative information collected from banks and

borrowers.

In order for the CRD to have pro-cyclical effects, certain conditions must be fulfilled. To determine the extent to which they have held empirically, the report asks following questions:

- does the increased risk sensitivity of the CRD framework lead to a stronger cyclicality of minimum required capital (MRC) and, if so, to what extent?
- do cyclical capital requirements have an impact on the level of capital that banks hold and impact bank loan supply?
- does the cyclicality of bank loan supply have an amplifying effect on the economic cycle?

The report considers these issues and states that overall, **the extent to which the introduction of the CRD has led to more pro-cyclical bank lending is still difficult to assess**. Although the evidence presented does point to some potential links between CRD and bank lending behaviour, analysis over a longer period is needed to draw more robust conclusions. Moreover, it is important to stress that as the implementation of the Basel II framework coincided with the outbreak of the financial crisis, disentangling the effects of these two events is particularly difficult.

With regard to **the impact of credit availability on the economic cycle**, the report states that, notwithstanding the indications of ongoing substitution between market-based and bank-based financing in recent months, the predominant role of banks in providing funds for spending and investment should not be underestimated, especially given the fact that obtaining the necessary funding from alternative sources has been burdensome for some, particularly smaller, businesses. Moreover, there is recent empirical evidence that shocks to loan supply have the potential to affect economic activity in the predominantly bank-based euro area financial system.

On measures to address pro-cyclicality, the report notes thatthe recent crisis has shown that market participants expect a rise in capital levels where they do not believe that an institution is well placed to absorb losses. Enhanced counter-cyclical measures within the regulatory framework for capital requirements could help to restore confidence in banks' balance sheets, and thus reduce the likelihood that banks will have to increase capital requirements or sharply de-leverage their credit portfolios to meet market participants' expectations. The Commission agrees with international institutions such as the FSB and the Basel Committee that **additional measures are necessary to avoid excessive pro-cyclicality**. It discusses the possibility of introducing **capital buffers and/or through-the-cycle provisions.** The report also states that the in line with the Basel Committee, the Commission is considering the **introduction of a leverage ratio** with the aim of limiting the build-up of leverage in the banking sector, and introducing additional safeguards against model risk and measurement error.

The paper goes on to describe **measures already adopted by the Commission**, such as: to supplement the requirements of the CRD by an express obligation for credit institutions and investment firms to establish and maintain, for those categories of staff whose professional activities have a material impact on their risk profile, remuneration policies and practices that are consistent with effective risk management; amendments to the CRD to increase regulatory capital requirements for the trading book activities and re-securitizations held in the banking book; the establishment of European Systemic Risk Board (ESRB) to oversee the stability of the financial system as a whole. On the latter, the Commission considers that adding a robust macro-prudential overlay to the current micro-prudential approach should help to address sources of procyclicality linked to limitations in the risk measurement and inappropriate responses of market participants to risk. This should support the timely identification of cycles and the build-up of risks in the system which could enable action to be taken earlier to avoid excessive volatility and pro-cyclicality in a downturn.

In conclusion, the Commission notes that many international institutions have emphasised the importance of introducing counter-cyclical measures in the prudential framework in order to reduce excessive pro-cyclicality within the financial system. In parallel with work going on in the Basel Committee, the Commission will **examine the options which address systemic risk and pro-cyclicality in the most effective way**. These measures should be able to limit excessive risk-taking in times of economic growth but should also be designed in a way that they can be drawn down during economic downturns to increase the resilience of the banking sector and to support the credit flow into the economy. The Commission will take into account the ongoing work by the international accounting standard setter (IASB) and prudential supervisors (in particular, the Basel Committee) when considering a legislative proposal.