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

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The Commission presents its second report on effects of the Capital Requirements Directive (CRD) on the economic cycle. The CRD comprises Directive 2006/48/EC on the taking up and pursuit of the business of credit institutions and Directive 2006/49/EC on the capital adequacy of investment firms and credit institutions. To recall, 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 a clause which requires the Commission periodically to examine whether the CRD has significant effects on the economic cycle and to submit a biennial report together with any appropriate corrective measures. This is the purpose of the report, which, like the first report, is based on the analysis of the ECB.

Cyclicality of capital requirements: there is a consistent view among the national supervisory authorities surveyed by the ECB in 2011 that the CRD minimum required capital (MRC) is **more risk-sensitive** and tends to be more cyclical than previous Basel I requirements. The increase of cyclicality in capital requirements is mainly attributed to the higher risk sensitivity of the overall framework, in particular as regards the calculation of capital requirements under the internal ratings based (IRB) approaches.

The ECB quantitative analysis examined the extent to which input risk parameters to IRB models, namely probabilities of default (PDs) and loss given default (LGDs) estimations, and exposures, are correlated with macroeconomic factors, and how much this feeds through into cyclical MRC.

The ECB found some evidence for a cyclical MRC driven by cyclical PDs for larger Group 1 banks using the IRB approach to credit risk, offset somewhat by cyclical exposures (i.e. reduced in a downturn). Although cyclical MRCs are tentatively identified at the portfolio (corporate and retail) level, **this effect seems to be mitigated at the bank level** when the whole sample of banks is considered.

This mitigation is likely to be primarily due to portfolio adjustment concerning the size and composition of banks’ overall portfolios. However, the observed reallocations of assets were likely triggered by the financial crisis rather than changes in the underlying risk parameters *per se*. For instance, banks may have targeted a higher amount of assets eligible as collateral in central bank liquidity operations to improve their liquidity position and to be able to benefit from cheap central bank funding. In the absence of the crisis, then, the MRC may have been more cyclical.

Banks using the Standardised Approach may also have a cyclical MRC due to the method's reliance on external CRAs whose ratings are cyclical.

Impact on lending: the ability and willingness of banks to lend depends in part on the degree to which the minimum capital constraints are binding. Although the MRC calculated under the current CRD may have had some impact on actual capital levels held by banks, in addition to several other factors, expectations of stricter future regulatory requirements may have resulted in capital targets set considerably above the MRC, with significant impacts on balance sheets and lending policies. However, this is a driver that is different from the cyclicality of the current legislation.

Impact of credit availability on the economic cycle: quantifying the impacts of MRC changes on lending and GDP remains difficult.

Given all the caveats encountered in the ECB's quantitative analysis of MRC cyclicality, for instance the very limited data available and the impact of the financial crisis both via additional regulatory changes, government interventions and behavioural adjustments, it seems to be too early to make a quantitative estimate of how big the pro-cyclical impact of CRD capital requirements on lending and GDP might be.

Measures to address pro-cyclicality: in July 2011, the Commission proposed a legislative package for the reform of banking regulation, including a directive (CRD IV) and a regulation (CRR). This follows the Basel III agreement and will meet the key objective of maintaining the credit supply to the real economy in the EU.

The proposal includes a number of measures that may mitigate pro-cyclicality in banking lending:

- a single rule book;
- a countercyclical capital buffer;
- the introduction of a leverage ratio;
- reduced dependency on credit rating agencies for prudential requirements, and
- scope to undertake further measures to enhance loan availability for small and medium sized enterprises.

Where appropriate, the implementation of measures will be phased in over time in order to avoid pro-cyclical effects.