Prudential requirements for credit institutions and investment firms. Capital Requirements Regulation (CRR)

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The Commission presented a report on the effects of Regulation (EU) No 575/2013 and Directive 2013/36/EU on the economic cycle.

Background to the report: to combat financial instability, financial sector regulation and macroprudential policy aim to limit systemic risk. Drawing lessons from the crisis, ensuring sufficiently high capital levels, especially for banks, generally appears to reduce the likelihood of systemic financial crises and their cost, if they occur.

However, capital ratio requirements designed to guarantee sufficient capital could themselves become a source of instability. Indeed, the risk-based approach included in Regulation (EU) No 575/2013 and Directive 2013/36/EU implies that capital ratio requirements become more flexible in times of economic recovery and more stringent in times of slowdown. Such procyclicality of capital ratio requirements is an important potential externality of the financial system that can threaten financial stability.

This report examines whether capital ratio requirements are procyclical and, if so, whether they affect the level of capital that banks actually hold or wish to hold. If such pro-cyclical effects are detected, the Commission is required to submit a proposal on possible appropriate corrective measures.

The Commission has prepared previous and similar reports on the procyclicality of capital ratio requirements in 2010 and 2012. This third report is the first product under Regulation (EU) No 575/2013.

Main conclusions: the report concludes that while a procyclical impetus from capital ratio requirements is acknowledged in the literature as a potential source of risk, the empirical evidence is not conclusive as regards its actual strength for banks in the Union. There is no evidence of a strong procyclical bias of the current framework which would affect the non-financial sector in the economy.

Given the weak evidence of pro-cyclical effects due to the provisions of Directive 2013/36/EU and Regulation (EU) No 575/2013, the Commission considers that there is no reason at this juncture to propose significant alterations to the prevailing regulatory framework for bank capital. The higher capital ratios achieved in recent years imply that the procyclical impact of a given loss will be weaker. The Union financial regulatory framework already includes various tools to deal with any procyclical effects. These include:

- higher capital ratio requirements;
- capital conservation buffer and countercyclical capital buffer: these extra buffers, built up over good economic times, can be released in an economic downturn to enable banks to absorb their losses in an orderly way that does not lead to costly increases in the price of credit, which can aggravate recession. These buffers have been built up, but to date there is no experience with releasing such buffers. Reflections are ongoing in Basel and in the Union on the merits of introducing sector-specific buffers to address the cyclical nature of some specific risks;
- risk weights for specific exposures and other supervisory measures: Regulation (EU) 575/2013 allows authorities to adjust risk weights for targeting asset bubbles in the residential or commercial property sector or to take measures such as adjusting the level of the own funds or the level of the Capital Conservation Buffer, with a bearing on the capital base of banks. The EU regulatory framework further comprises measures to mitigate the impact of cyclical risks on banks;
- introduction of a leverage ratio: the leverage ratio is an additional non risk-based capital requirement conceived to supplement the risk-based capital ratio requirements. It would help to limit excessive bank lending during the upswing of an economic cycle when banks have momentum to expand balance sheets without an appropriate increase in capital. Empirically, banking sector leverage has been procyclical at an aggregate level in almost all Member States, tending to fall in credit booms and rising in downturns;
- reduced reliance on rating agencies for prudential requirements: Regulation (EU) 575/2013 encourages the use of internal ratings and strengthens provisions on how external ratings can be used. For banks using an internal ratings based approach, it requires independent risk assessment capability and creates incentives to better manage credit risk. A through-the-cycle approach could help smooth the impact on capital ratio requirements;
- stress tests: in the aftermath of the financial crisis, micro-prudential stress tests were used promptly to assess the capital needs of individual banks. Such stress tests are helpful in informing how buffers can be set, also above minimum requirements.

Prospects: the Commission stresses the need to:

- regularly monitor the impact on the economic cycle of EU regulatory capital ratio requirements and further analyse the impact, effectiveness and efficiency that counter-cyclical instruments can have;
- collect, as and when necessary, any concrete evidence that might indicate the existence of a possible pro-cyclical bias linked to the tightening of capital ratio requirements.

Concrete proposals to change the current set-up should be based on such evidence becoming available.