

EPFSF Briefing

“New capital rules: Anticipating the effects of the regulatory reforms in the real economy”

Summary

There is general consensus about the need to enhance the capital requirements in order to strengthen the resilience of the banking sector. It is important that changes to capital requirements are appropriately targeted, to address risks that have been shown not to be adequately capitalised under the current rules. Capital requirements should not be increased indiscriminately. Capital should also not be treated as a substitute for good risk management. Increases to capital requirements should be accompanied by increased scrutiny of bank risk management.

However, the costs of the regulatory measures need to be taken into account as well. Changes to bank solvency requirements will have an impact on banks' lending capacity, which is a key factor for economic recovery. There appears to be a trade-off between the solvency of the banking sector – main factor of resilience and contributing to a higher average GDP in the long run - and the lending capacity of the banking sector – availability and price of credit as a key factor for economic recovery. The link is stronger in the European Union, where the economy is financed for 70% by banking intermediation and for 30% through capital markets, than in the US, where the opposite is true. In addition, there may be doubts about the capacity of the banking sector to raise sufficient private investments to meet all proposed requirements.

A phase-in implementation might help to overcome these problems related to costs and investments.

In such a major overhaul of the prudential standards, the preservation of the level playing field becomes an issue, not only between jurisdictions but also between the banking industry and other economic sectors.

1. Introduction

In the context of the financial and economic crisis, prudential regulations have come under closer scrutiny. As envisaged in the April 2009 G20 Declaration on strengthening the financial system, the Basel Committee should review the levels of capital and should develop “internationally agreed rules” over the course of 2010 to improve both the quantity and quality of capital.

The G20 Declaration envisaged that the new prudential measures should be implemented once the economy has recovered from the crisis and that “until recovery is assured the international standard for the minimum level of capital should remain unchanged”. There is no doubt that stability is a primary objective, but it is also true that the weakened post-crisis economy needs banks lending. And there are grounds for thinking that increasing solvency requirements will constrain lending capacity.

The price that a general increase of the capital requirements would mean for European banks and the EU economy, notably for households and businesses, is not sufficiently clear so far. Therefore, there is need for an overall assessment from different angles, including all the stakeholders and ultimately the real economy.

2. Scope of the regulatory reform

This is a major overhaul of the prudential standards in response to a major turmoil in the financial system. The objective of these measures is to fine-tune and recalibrate the Basel II framework to enhance the resilience of the banking sector. Proposed changes relate i.a. to the definition of capital, risk coverage, a leverage ratio, countercyclical buffers and liquidity ratios. Other changes to the Basel II framework, including a significant overhaul of capital requirements for market risk in the trading book which is expected to increase capital requirements materially, are scheduled to come into effect at the end of 2010.

3. Cumulative impact

The fine-tuning and recalibration of the Basel II framework has raised a general concern about the potential consequences of the cumulative impact of the envisaged measures over the banking system and ultimately over the wider economy.

During 2009, banks increased their capitalisation levels, but the currently accrued cushions would not probably be used to meet higher capital requirements, for the following reasons:

- A significant part of the increased capital injections was public and should be replaced by capital injections from the markets.
- As illustrated in experience, banks tend to operate with certain cushion of capital over the minimum requirement. Actually, the current surplus of capital acts as a true cushion.

4. Solvency, lending and growth

What is being put under question is if a significant capital increase could damage the lending capacity of banks and have undesirable effects on the real economy in the longer term.

Indeed, every regulatory measure entails benefits and costs for the stakeholders and ultimately for society. In the case of financial stability, there must be a certain optimum level of capitalisation, where the degree of stability is sufficient and the right balance of other economic variables is not distorted.

Special consideration should be regarded to the suggestions made by Mr Jacques de Larosière in a recent article¹, which calls for careful analysis of the changes in capital ratios and their significant consequences for the banking sector's propensity to lend and therefore for the financing of the real economy. This is especially important in the EU economy, whose private sector is particularly dependent on bank lending². Bank intermediation finances two-thirds of the European economy, whereas in comparison, this share is only one-third in the US, where capital markets are more developed.

There appears to be a transfer of tighter prudential standards to the rates and volumes of bank lending to businesses and households. In this regard, a recent study³ in the UK banking sector finds that a single percentage point increase in the capital requirements in 2002 would have reduced lending by 1.2% after four years.

¹ "Financial regulators must take care over capital" (FT.com, 15 October 2009).

² "In the euro area, bank loans have accounted for around 85% of the total external financing of the private sector in recent years" (European Central Bank monthly bulletin, October 2009).

"The euro area has traditionally had a largely bank-based financial system, with loans to the private sector that remain on banks' balance sheets amounting to 145% of GDP in 2007. By contrast, in the United States bank lending (with loans being originated and held by banks) to the private sector is much less important, and amounted to 63% of GDP in 2007" (European Central Bank monthly bulletin, April 2009).

³ "Bank regulation, capital and credit supply: Measuring the impact of Prudential Standards" (W. Francis and M. Osborne, September 2009).

On other hand, as a different point of view, the UK Financial Services Authority has recently conducted a study⁴ geared to find an approximate level of optimum capitalisation. This work concludes that increases in capitalisation and liquidity requirements could produce an increase in expected future GDP over time, thus would be welfare enhancing in the long run. However, it also recognises that there is some level beyond which the benefits are outweighed by costs. The study also indicates that higher stability contributes to increase the average GDP growth over time.

5. Level Playing Field

All in all, the capital requirements will be enhanced substantially, with an impact on the availability and price of lending. Therefore, imbalances in the level playing field would not only affect differently banks but, far more importantly, the access to credit of households and businesses in different jurisdictions. Hence, preservation of the level playing is essential in two regards:

- Between different jurisdictions, true convergence should be achieved in the prudential standards and the accounting rules.
- Between the banking industry and other economic sectors. If banks are compelled to raise a significant amount of capital in short, private investors might not be willing to subscribe if the industry's return on investment capacity has been undermined. And shortages of capital restrict lending activity.

6. Concluding remarks

- Capital requirements should be enhanced to strengthen the resilience of the banking sector.
- The overall level of the capital requirements enhancement and its implementation calendar should be determined on the observation of their impact over the real economy. In this respect, several economic studies are being carried out and should be ready soon.
- Finally, quite a degree of consensus should be achieved among stakeholders when it comes to strike a balance between the solvency of the banking sector, as an indicator of resilience, and the lending capacity of the banking sector, as a foundation for economic recovery.

⁴ Turner Review Conference Discussion Paper (UK FSA, October 2009).

Briefing notes are prepared by the Financial Industry Committee to the European Parliamentary Financial Services Forum. For further information on the subjects raised in the briefs please contact the Chairman, Members or Secretariat of the Financial Industry Committee.

Chairman Financial Industry Members

Guido Ravoet, *EBF Secretary General*
Rue Montoyer 10, B-1000 Brussels
Tel: +32 2 508 37 11 / Fax: +32 2 502 13 30
E-mail: g.ravoet@ebf-fbe.eu

Secretariat

Catherine Denis, *EPFSF Director*
Rue Montoyer 10, B-1000 Brussels
Tel: +32 2 514 68 00 / Fax: +32 2 514 69 00
E-mail: cdenis@epfsf.org

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