# The Effect of Higher Capital Requirements on Bank Lending: the Capital Surplus Matters

Discussion

NÁRODNÁ BANKA SLOVENSKA
EUROSYSTÉM

Pavol Jurča

Národná banka Slovenska
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# Main takeaways

- In the Czech banking sector,
- In times of growing phase of the financial cycle:

**Higher capital requirements  decrease loan growth for banks with lower surpluses, while no significant impact on lending by banks with higher surpluses.**

The upper estimation of the decrease in lending volume is approx. 1.7 % in short-term and cummulatively 7 % in long-term, implying basically **full partial transmission** of rising capital requirements to lending market

- 1 pp increase represents an increase of capital requirements by roughly 7 %
- Implicit RW decreases by 0.4 pp (i.e. 1.3 %) or does not change significantly
- Hence: full transmission would be around 6 %-7%

# Main take away

**Empirical model covering many important aspects:**

- ✓ Capital requirements instead of capital levels
- ✓ Level of capital surplus
- ✓ Financial conditions of individual banks
- ✓ Intented vs unintented capital surpluses

etc.

# Potentially important considerations

**Relevant factors for impact on lending**

- Ability to increase capital  (rebuilt capital surplus)
  - Higher e.g. for profitable subsidiaries operating on a growing market (ROE > COE, positive risk adjusted yields)
    - Economically meaningful for parent companies to increase capital instead of decrease credit growth
  - Empirical evidence in SK:
    - All major banks (subsidiaries) increased retained profits or obtain fresh capital
    - LSIs struggled more, in some cases decreasing credit growth

- Presence on other bottlenecks
  - Liquidity, leverage, non-profitable business model (bank specific?)
  - Negative long-term prospects, market saturation, demographic trends

- Factors behind the decrease of the surplus
  - Capital buffer in times of a credit boom
  - Pillar 2 requirement in times of rising risks
  - Losses in times of a recession

# Potentially important considerations

**Relevant factors for impact on capital surplus**

- Level of capital – with higher CAR and capital requirements, bank's internal desired optimal level of surplus might decrease

**Relevant factors for impact on (implicit) RW**

- Changes in the structure of demand, monetary conditions

**Reaction channels**

- Higher  lending rates – difficult if strong competition is present
- Shifts in portfolio composition – higher focus on retail (housing loans) than on corporates

# Policy implications

If the main objective is resilience:

- Start to impose buffer early in the cycle if banks have sufficient capital surpluses
- Need for transparent strategy to gradually build the buffers (to prevent pay-outs of the surpluses)

The impact on lending market can only be a viable objective if capital surpluses are already sufficiently low

Open question: Linearity of the model implies an opposite reaction to lower capital requirements – this however remains untested on real data