Capital requirements and lending

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CEBS

Committee *of* European Banking Supervisors

Overview

- Why are we talking about adequate levels of capital?
- What are the functions of banks' capital?
- What can be done to maintain/strengthen banks' capital?
- Need for capital versus new lending to the economy

Why are we talking about adequate levels of capital?

The relevance of adequate capital levels for banks has been vividly demonstrated during the current financial crisis:

- A significant number of banks - although regularly still operating above the regulatory minimum requirements – were confronted with the fact that their levels of capital were insufficient to cover the risks they had taken on and were forced to seek fresh capital, either from the private sector or from government rescue plans.

- In addition, in order to restore confidence in the banking sector, national regulators as well as the market itself expected banks to hold significantly higher surplus capital above the regulatory minimum requirements than before the crisis.

What are the functions of banks' capital?

Capital is the backbone of a bank's business:

- covers the risks banks take on and enables banks (under normal circumstances) to suffer losses without immediately jeopardizing their existence;

- determines the limits for a bank's business (minimum capital requirements, LE limits);

- its ratio allows conclusions on the bank's ability to take on further risk;

- adequate levels of capital are crucial for maintaining confidence in a particular bank as well as the banking sector as such.

Any considerations regarding the adequate level of capital should keep these points in mind.

What can be done to maintain/strengthen banks' capital?

What is the "right" level and how can it be reached?

- The most obvious response to the latter would be to increase the regulatory minimum requirements. The more difficult question is the determination of the adequate level…
- Strengthening of capital does not necessarily mean requiring more capital but could also mean requiring better capital…
- Both quantitative and qualitative aspects should be taken in account…

What can be done to maintain/strengthen banks’ capital?

Quantitative aspects (1)

- Review of Basel II/CRD minimum capital requirements (MRC)
  - Recalibration of the current minimum requirement of 8%?
    - complex and time-consuming process
    - requires empirical data which may be difficult to collect given the short time since the full implementation not clear whether review would provide evidence for a higher minimum requirement.
  - Improve risk-adequacy of Basel II/CRD framework
    - review of the risk weights assigned to certain positions, in particular where preferential treatment is granted (e.g. securitisation positions)
    - coverage of all relevant risks and introduction of further capital charges (e.g. incremental risk charge)
      - respective proposals for CRD amendments are currently under discussion (in line with parallel considerations in Basel)

What can be done to maintain/strengthen banks' capital?

Quantitative aspects (2)

- Mitigate pro-cyclical effects of the risk-based capital requirements
  - ongoing analysis of potential pro-cyclical effects (*Joint CEBS/BSC task force*)
  - development of counter-cyclical **capital buffers above the MRC** which are build up during good times and can be consumed in a stressed situation
    - *CEBS is working on a Pillar 2 tool that calculates capital buffers on the basis of re-scaled PDs.*
  - introduce **dynamic provisioning** *(on CEBS agenda for 2009)*

- Introduction of non-risk based supplementary measures (leverage or other ratio)
  - *Joint EBC/CEBS working group to prepare legislative proposal by end 2009*

What can be done to maintain/strengthen banks' capital?

Qualitative aspects

- Strengthen the quality of capital components (in particular their ability to absorb losses)
  - Common definition of core Tier 1 capital
    - On CEBS agenda for 2009
  - Implementation of stricter requirements for Tier 1 hybrid capital instruments
    - New CRD requirements based on CEBS advice will be applied by 1 January 2011
    - Additional CEBS guidance under way
- Review the composition of regulatory capital
  - Are minimum 50% Tier 1 capital/25% core Tier 1 still adequate?
    - Even if MRC remains unchanged one could reflect whether there is a need for a higher minimum (core) Tier 1 rate.
  - What will be the future role of Tier 2/Tier 3 capital?
    - Some voices plead for an abolition of Tier 2/Tier 3 capital as it is less loss absorbent than Tier 1 and played basically no role in the current situation.
    - The question is however whether this also means that it has no longer any relevance in normal times.

Need for capital versus new lending to the economy

- Current situation
  - Capital injections by governments were granted under strict conditions

- Future prospects
  - Any changes to the current capital rules will potentially affect banks’ lending policies
  - Higher minimum requirements or the requirement to hold of a larger share of capital of the highest quality will make lending more expensive
    - Consequences: smaller margins for banks or restricted access to loans in particular for unrated or less highly rated borrowers

Thank you very much
for your attention.

Questions?

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