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

Discussion
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 cumulatively 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