



RESPONSE TO THE EUROPEAN COMMISSION'S PUBLIC CONSULTATION ON THE POSSIBLE IMPACT OF THE CRR AND CRD IV ON BANK FINANCING OF THE ECONOMY

Capitalisation

- 1.1 What role has been played by the CRR and CRD IV requirements in the recapitalisation process, in terms of the timing and overall effect on the levels and quality of capital held by banks?**

The CRR and CRD IV requirements have played an important part in post-crisis reform to strengthen the resilience of the banking system. In the UK, banks had already begun to raise capital well ahead of the legislation (See Annex 1 attached, Chart 2), but with a view to the overall direction of travel.

- 1.2 How have market, supervisory and regulatory capitalisation demands interacted to make banks adjust the level of capital they hold to the current level?**

It is difficult to disentangle the impacts of each of these factors as they are not easily measurable and are likely to vary in prominence across different banks. Market requirements clearly put pressure on banks to strengthen their resilience in the wake of the crisis to maintain the confidence of counterparties, including in funding markets. UK banks have also been subject to a number of supervisory actions since the onset of the crisis, some of which were in anticipation of higher capital requirements under Basel III. The prolonged negotiation period for Basel III and CRD IV also made it possible for banks to anticipate future higher regulatory capital requirements. These factors have contributed to UK banks making progress towards the new CRD IV requirements faster.

- 1.3 Whilst these three factors may be interlinked, is it possible to identify which has/have played the most important role? (Select one: Yes, it is possible / No, it is not possible / I do not know)**

No, it is not possible.

- 1.3.1 Please rank these three factors in accordance to their importance: Market demands / Supervisory demands / Regulatory capital (Rate them 1st, 2nd, 3rd)**

This question will only show up if we answer "yes, it is possible" to the previous question .

- 1.4 Please explain you answer to whether it is possible to identify which has/have played the most important role?**

See answer to question 1.2

- 2. If you consider that capital levels go significantly beyond what is necessary in light of the level of risk incurred and posed by banking activities in certain areas, please specify those areas and back up your view with specific evidence.**

Annex 2, attached to this response, sets out a simple cost-benefit framework that relates the benefits of regulation in tackling market failures to the costs imposed by regulation on different types of bank. It shows that it is important to have a minimum capital requirement for all banks in the EU to reduce negative externalities that banks can impose on their creditors (including their depositors) and for the financial system as a whole in the event of their severe stress or failure. Additional capital requirements, beyond the minimum, should be proportionate to the externalities they aim to control for, and the costs that regulation imposes. Externalities in the form of spillovers to the financial system and the wider economy are proportionately larger for certain banks (Global systemically important institutions, for instance) than others.

3.1 What role have the additional capital requirements and buffers exceeding the harmonised requirements set out in the CRR played in the capitalisation process?

As set out in the response to question 2, such requirements and buffers partly reflect the proportionately greater impact that severe stress, or failure, of a large bank can have on the financial system and wider economy.

3.2 Are such additional micro- and macroprudential capital requirements and buffers commensurate to the level of risk incurred and posed by banks? (Select one: Yes / No / I do not know)

Yes.

3.3 Please back up your view with specific evidence.

(BLANK)

Regulation – a cause in the fall in corporate lending?

4.1 Have increased capital requirements influenced the overall capacity of banks to lend? (Select one: Yes / No / I do not know)

Yes.

4.2 Please explain your answer on whether increased capital requirements have influenced the overall capacity of banks to lend?

By repairing weak capitalisation, banks have become more resilient to shocks and that has improved their capacity to withstand future shocks and support lending. There is considerable evidence that weakly capitalised banks lend less during recessions. This is consistent with evidence of a positive relation between capital ratios at the onset of the crisis and subsequent bank credit growth (see, Annex 1, Chart 5). See also, for example, Stephen Cecchetti (2014) *The Jury is in*, CEPR Policy Insight No. 76.

4.3 Which factors, including demand-side factors, regulatory changes and other supply-side factors (such as the volatility of interbank and capital markets), contributed most significantly to the change in the volume of loans?

Conceptually, higher capital requirements may increase costs for banks in the short-term, which may impact lending during the transition to higher capital requirements. Lending was constrained after the crisis – increased risk-aversion and a need to repair balance sheets being among the factors. However, the Bank of England's assessment is that, in the years since the crisis, the marginal impact of higher levels of bank capital on banks' overall costs of funding has been less than other factors affecting the cost of funding. Weak lending volumes have to some extent reflected a fall in credit demand relative to pre-crisis levels, which has not fully recovered. Weaker demand has to a large extent been due to subdued investment over the period, but also, for larger companies at least, the availability of cheap capital market funding. In the longer term, repairing weak capitalisation makes banks more resilient which improve their capacity to withstand future shocks and support lending.

4.4 How do you think bank lending would have developed had regulatory changes to capital requirements not been introduced?

It is difficult to say. Conceptually, higher capital requirements may increase costs for banks in the short-term, which may impact lending during the transition to higher requirements. However, the Bank of England's assessment is that, in the years since the crisis, the marginal impact of higher levels of bank capital on banks' overall costs of funding has been less than other factors affecting the cost of funding.. Also – see answer to question 4.3.

5.1 What are the effects of increased capital requirements, such as they are? (Select one: Generally temporary and transitional / Structural / Both temporary transitional, but also long-term structural / I do not know)

Both temporary transitional but also long-term structural.

5.2 Please explain your answer on the effects of capital requirements.

See answer to questions 4.1-4.4.

5.3 Has the requirement to hold higher levels of capital increased the cost of funding banks? (Select one: Yes / No / I do not know)

(BLANK).

5.4 Has the per-unit cost of bank capital decreased as banks have become less risky? (Select one: Yes / No / I do not know)

I do not know.

5.5 Please justify your answers to questions 5.3 and 5.4?

(BLANK)

6.1 Have increased capital requirements affected the market for some categories of assets more than others? (Select one: Yes / No / I do not know)

Yes.

6.2 Which are these categories of assets and how have their markets been affected?

The application of standardised and internal model-based approaches for calculating credit risk has created a distortion between banks. Internal models deliver significantly lower risk weights on average than the standardised approach for certain exposures. For example, models in the UK deliver risk weights of between 3% and 15% for mortgages below 80% LTV, compared to 35% under the standardised approach. Although large banks face additional capital buffers and are subject to leverage ratio requirements, this differential creates an uneven playing field and can have unintended effects on the safety and soundness of banks by encouraging smaller firms to compete for riskier mortgages, where the differentials are less severe. Further work is needed to ensure standardised approaches allow for greater risk sensitivity and internal models are adding risk sensitivity based on genuinely better and more robust information. Work to reform these approaches is underway in Basel.

6.3 Which of the provisions contained in the CRR, apart from those establishing capital ratios, are likely to have created the effects experienced by specific markets and/or exposures?

See answer to question 6.2.

7 Do you think the phase-out of the transitional provisions under CRR could have an incremental impact on future lending decisions?

No.

7.1 Please explain how, according to you, the phase-out of the transitional provisions under CRR could have an incremental impact on future lending decisions?

(BLANK)

Lending to SMEs

8.1 To what extent has this provision been effective in supporting lending to SMEs? (Select one: Very effective / Effective / Slightly effective / Not effective / I do not know)

I do not know.

8.2 Could you provide any evidence, preferably quantitative, of the change in lending to SMEs due to the introduction of the supporting factor as from 2014?

During the global crisis, tighter lending supply particularly affected small and medium-sized enterprises (SMEs) in the UK. On average credit conditions facing SMEs have improved since mid-2013, but less than for large corporates (see Annex 1, attached, Charts 3): for example, indicative

measures of SME lending rates are now 35-45 bps below mid-2012 levels, according to Bank of England data and around 77% of small UK firms that have applied for loan and/or overdraft funding in recent years have received it, according to the SME Finance Monitor (see Annex 1, Chart 4). There is no clear evidence, however, that this improvement in SME credit conditions has reflected the SME support factor. An EBA discussion paper on SME funding finds no real trend effect after the SME supporting factor was introduced.

9.1 What specific difficulties do banks face when lending to SMEs, compared to when lending to larger corporates? Are they related to the CRR?

One of the main difficulties that banks face when lending to SMEs is not related to CRR. A number of independent reports have identified that a lack of information on smaller businesses, and issues with access to existing data, may be constraining the provision of credit to SMEs from a more diverse range of sources, including from alternative finance providers and capital markets. Additionally, there is often limited sharing of information between lenders, which can act as a barrier to entry for newer lenders and, as a result, competition in SME credit markets is reduced. The UK has recently passed the Small Business, Enterprise and Employment Act 2015 which contain a set of provisions which will improve the availability of SME credit data amongst lenders to make risk assessment more effective and transparent and foster greater competition. These provisions will be become effective in 2016.

9.2 How could the CRR and other prudential regulations contribute to addressing some of these difficulties in other ways than by adjusting rules for SMEs?

As discussed in Annex 2, attached to this response, a more proportionate approach to bank regulation could support competition in the sector. That may have a powerful effect in stimulating competition in lending markets for SMEs.

9.3 Do these difficulties need to be resolved by some other means? (Select one: Yes / No / I do not know)

Yes.

9.4 If these difficulties need to be resolved by some other means, what other means would be adequate?

As discussed in question 9.1, improved sharing of credit information can support SME lending.

Lending to infrastructure

10.1 Has the CRR influenced the capacity of banks to provide loans to infrastructure projects? (Select one: Yes / No / I do not know)

10.2 I do not know Which provisions are most relevant?

(BLANK)

11.1 What are the specific difficulties that banks face when lending to infrastructure projects? Are they related to the CRR?

(BLANK)

11.2 How could the CRR and other prudential regulations contribute to addressing some of these difficulties?

(BLANK)

11.3 Do these difficulties need to be resolved by some other means? (Select one: Yes / No / I do not know)

(BLANK)

11.4 If these difficulties need to be resolved by some other means, what other means would be adequate?

(BLANK)

12 Should infrastructure projects continue to be treated as loans to corporate borrowers?

(BLANK)

12.1 Please specify why you think infrastructure projects should not continue to be treated as loans to corporate borrowers.

(BLANK)

12.2 What common features of infrastructure projects or their subsets would justify a separate treatment from loans to corporate borrowers?

(BLANK)

Proportionality

13.1 Should the provisions contained in the CRR allow for more differentiation in how they are applied to banks of different sizes or with different risk-profiles?

Yes.

13.2 How can they do this without compromising the objective of achieving financial stability and creating a level playing field within the single banking market?

The “one size fits all” approach of CRR/CRD IV for all banks in the EU might have contributed to some aspects of EU regulation not being fully consistent with global standards. It is possible that a more differentiated approach (as in other jurisdictions, such as the USA) might enable the global standards to be applied more consistently for large internationally active banks, where we really want strong rules in place for both financial stability and single market reasons (due to e.g. cross-border spillovers). These do not lead to a level playing field and effective competition, as the costs of meeting regulation bear more heavily on smaller banks to the extent that regulation imposes fixed costs. A more differentiated approach could lead to more effective competition, stronger growth and enhanced financial stability.

13.3 Are there any provisions that could potentially be applied with greater differentiation? (Select one: Yes / No / I do not know)

Yes.

13.4 If there are any provisions that could potentially be applied with greater differentiation, what are these provisions?

Yes. See answer to question 13.7.

13.5 Provided application on a differentiated basis is desirable, what considerations could be relevant to make such a differentiated application?

Annex 2, attached to this response, sets out a simple framework that allows for an assessment of the market failures regulation is supposed to correct for and the costs regulations impose on banks and the economy. These are likely to vary across banks both by size and business model.

13.6 Are there any concrete changes desirable in this context? (Select one: Yes / No / I do not know)

Yes.

13.7 If any concrete changes are desirable in this context, what are these changes and the associated costs and benefits?

A more proportionate approach could be adopted for many aspects of bank regulation. For example, there is a case for ensuring that regulatory reporting requirements do not go beyond what is necessary for effective supervision of smaller banks. Regulation could also be tailored to business models: for example, applying a “one-size fits all approach” for the NSFR (when agreed and implemented) could mean disproportionate costs relative to benefits for banks whose business models do not involve wholesale funding. In other words, regulation might be tailored by bank business model. Differentiated approaches should be carefully designed to avoid unintended distortions: there is a need to reduce the competitive imbalances that exist between firms using model-based approaches for credit risk weights relative to standardised approaches. Finally, remuneration policy should also be proportionate to the risks the policy is meant to mitigate and the cost it imposes on a firm.

Scope for simplification

14.1 Which areas of the CRR could be simplified without compromising the Regulation’s objective of ensuring prudence, legal certainty and a level playing field?

Annex 2, attached to this response, sets out a simple framework that allows for an assessment of the market failures regulation is supposed to correct for and the costs regulations impose on banks. Simplification is one way of varying regulation. Other ways are adjusting levels of requirement, or allowing exemptions from some regulation. Any simplification of regulatory requirements should be measured against the costs and benefits of regulation and the alternative ways of varying regulation. Examples are included in the answer to question 13.7.

14.2 Are there areas that could be simplified, but only for specific types of bank or business models?

See answer to question 13.7.

14.3 Would it be useful to consider an approach where banks that are capitalised well above minimum requirements or that are less exposed to certain risks could be subject to simplified obligations? (Select one: Yes / No / I do not know)

Yes.

14.4 Please explain your answer on whether it is useful to consider an approach where banks that are capitalised well above minimum requirements or that are less exposed to certain risks could be subject to simplified obligations?

See answer to question 14.1.

14.5 What would be the risks with such an approach (where banks that are capitalised well above minimum requirements or that are less exposed to certain risks are subject to simplified obligations)?

One of the key risks associated with applying a differentiated approach for certain banks is that it may fail to reflect macroprudential risks stemming from these firms in aggregate. While spillovers from the failure of individual small banks may be modest, small banks can be systemic in aggregate. For example, if small banks were to face problems simultaneously, perhaps reflecting common exposures, the combined effect could be similar to that of a larger bank. That points to the need for minimum standards to tackle market failures and support resilience even for the smallest firms. Also see discussion in Annex 2 attached.

Single Rulebook

15.1 What additional measures could be taken in the area of prudential regulation to further promote integration and enhance a level playing field?

Further research into the area of what market failures banks of different size and business models pose to the wider financial system, and of the various costs that regulation imposes on different types of banks is needed. This can enhance the understanding of how a more differentiated regulatory approach could ensure financial stability and resilience of firms in the single market,

without creating an uneven playing field - thereby ensuring effective competition and growth, and enhancing financial stability.

15.2 Can you indicate specific examples and evidence of discretions that affect the cost and availability of bank lending?

No.

Additional Information

Should you wish to provide additional information (e.g. a position paper, report) or raise specific points not covered by the questionnaire, you can upload your additional document(s) here.

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