NationalBank OF BELGIUM
Eurosystem

2007-10-31

PRESS RELEASE

Monitoring pro-cyclicality under the capital requirements directive:
preliminary concepts for developing a framework
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NBB Working Paper No 120 - Document Series

Pro-cyclicality in bank lending has traditionally been a concern for policy-makers striving to maintain macro-economic and financial stability. Recently, central banks have raised concerns regarding the potential costs of the additional pro-cyclicality in lending that may come with the Basel II Framework, as implemented in the EU via the Capital Requirements Directive (CRD).

Previous capital adequacy rules require banks to hold a minimum amount of capital for each loan largely independent of the risk involved in the loan. The CRD has the objective of making capital requirements more risk-sensitive. Therefore, by construction, the capital requirements under the CRD will be more cyclical, i.e. co-moving with the cycle, than under the previous rules. In a bad economic environment, banks that see their capital fall below the minimum required may decide to cut back on their lending activity. Conversely, an economic upturn may lead to some excess capital within banks, which may induce them to increase lending. Consequently, the use of risk-sensitive capital requirements may be reflected in more pro-cyclical lending behaviour, which may exacerbate the economic cycle. In order to monitor this closely, Article 156 of the CRD gives the European Commission and the ECB a mandate to analyse the impact of the CRD on the economic cycle.

This paper provides an overview of the questions that will need to be addressed in order to determine whether increased cyclicality in capital requirements will exacerbate the pro-cyclicality in the financial system. First, pro-cyclicality may have different sources. An analysis aimed at determining the extent to which cyclical lending behaviour depends upon capital requirements requires a good understanding of the various other possible sources of pro-cyclicality and of the developments in the financial sector, which may influence the importance of these sources over time. Second, does it matter whether regulatory capital requirements fluctuate more than before if banks' (lending) behaviour is driven by other capital considerations? If regulatory capital requirements are not the binding constraint, then any action to reduce the co-movements of the CRD requirements with the economic cycle will have no effect on banks' lending behaviour. Third, if regulatory capital requirements do pose a binding constraint, what are the likely consequences for the economic cycle?

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