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Higher capital requirements: It's the firms that end up suffering

61 European banks were scheduled to increase their capital cover by 2012 to provide a sufficient buffer for future crises. As the study by the research group chaired by Reint E. Gropp at the Halle Institute for Economic Research (IWH) – Member of the Leibniz Association shows, the banks did implement these requirements – not by raising their levels of equity, but by reducing their credit supply. This resulted in lower firm, investment, and sales growth for firms which obtained a larger share of their bank credit from these banks.

The banks' core capital ratio must increase. That was the unanimous belief of EU politicians and the European Banking Authority (EBA) after the financial crisis. In order to handle fear of the crisis flaring up, the EBA carried out an initial stress test in summer 2011 as well as an 'EU capital exercise' at the end of the same year. With the latter, the supervisory authorities identified a total of 31 European banks whose capital ratios were notably still too low. A 9% core capital ratio was required by 2012 to provide a buffer for future crises. What initially seems perfectly uncomplicated and absolutely necessary, however, could be altogether questionable. 'This has never happened before,' said IWH President Gropp. 'The impact of a substantial increase in the core capital ratio on the real economy has largely been unclear.'

Banks generally have several options to increase their core capital ratio: raise their levels of equity or reduce their credit supply, which must be secured by their own funds. It could be a problem for the real economy if several banks simultaneously reduce their credit supply and other parts of the financial system cannot step in, for instance.
In order to reduce their risk capital, banks can also replace loans with government bonds, which continue to benefit from preferential treatment and have a risk weight of zero. As a rule, banks do not need to provide equity for government bonds issued by the countries in the euro area. However, it remains to be seen whether this will not only lead to credit supply problems, but also the emergence of new stability risks in the financial sector.

The research group chaired by Reint E. Gropp used the EBA's increase in the Tier 1 capital ratio to examine how banks fulfil these requirements and how the banks'

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corresponding behaviour affects the real economy. They were able to show that EBA banks raised their core capital ratio by 1.9 percentage points more than the control group. However, they achieved this by primarily reducing their credit volumes by 16 percentage points rather than increasing their levels of capital.

But what were the end consequences for the firms that depended on larger loans from the EBA banks? ‘Five percentage points less firm growth, six percentage points less investment growth and five percentage points less sales growth,’ according to Gropp. ‘If policy-makers increase the capital requirements on banks, but allow the banks themselves to decide how they achieve that, it can have a clear negative effect on the real economy. A better goal would therefore be to set the amount of equity rather than the core capital ratio.’

Publication

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