Basel III joint regulatory constraints: interactions and implications for the financing of the economy

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Key findings

- It is very difficult to identify a unique regulatory constraint that exerts a dominant influence on bank behaviour.
- Core empirical challenge is that regulatory constraints are mostly non-binding for the sample of banks over the period considered – leverage ratio seems to be the best “candidate”
- Clear finding that growth in RWA in previous periods leads to lower lending growth
- Clear finding for sample that capital constraints do not exert a negative influence banks willingness/ability to lend – in fact authors find the opposite – concluding this likely reflects that regulatory constraints are not binding!

Assumptions made

- Risk conservation (Modigliani-Miller is ignored) impact on cost of capital (overall funding cost) not considered in the theoretical analysis
- Implicitly this means that the analysis ignores that banks likely take into account the impact of asset side changes on overall funding costs and hence profitability

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Questions and suggestions

- What happens if loan growth (or REA growth) is defined as relative to overall market?
  - An alternative could be to consider the market share aspect – a more direct alternative to the ***size*** variable choice currently used
- Is RWA growth a better measure of loan growth when considering (Tier 1) capital constraints?
  - Should be the risk-adjusted asset growth that matters for the Tier 1 constraint
  - Easy to check by using as the variable to be explained.
- Risk-profile of bank may matter
  - Could consider changes in the average balance sheet risk-weight as explanatory variable?
  - Could include total assets/risk exposure assets?
- Suggestion: introduce a broad measure of "regulatory room to manoeuvre" as explanatory variable
  - Essentially a metric that captures combined distance to regulatory constraints
  - Alternative to reliance on interactions terms.
  - Perhaps banks with more overall "regulatory room" to manoeuvre increase lending (REA) more?
- Suggestion: consider inclusion of level and change in profitability as explanatory variable
  - Highly profitable banks likely less concerned about impact of balance sheet growth
- **THE UNREASONABLE: Assume M-M and include in both theoretical and enrich empirical analysis**

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