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Comment 1: The impact of tighter capital regulation on aggregate lending volume remains a subject of debate.

- 1.1 Thanks to government safety nets, banks can raise debt, such as deposits, at an effectively subsidised rate, and their funding costs do not fully reflect their risk-taking. At the same time, they face capital regulation.
- 1.2 Given this, banks tend to overvalue loans that will perform poorly when the bank is itself going south. This is because additional losses are effectively passed onto the taxpayer. Ignoring such downside, these loans look more appealing to banks than they should (from a social point of view). This mechanism is a well-known instance of risk-shifting (Kareken and Wallace, 1978).
- 1.3 However, for similar reasons, banks tend to undervalue loans that will perform well when the bank is in default. This is because, in such cases, the upside of the loans benefits the taxpayer (via a decrease in its exposure) and not the shareholders, as they are wiped out anyway (Bahaj and Malherbe, 2020).
- 1.4 Because of this, banks may pass on loans that would finance productive (i.e., positive NPV) investment, which is a form of overhang. Raising capital requirements decreases the likelihood of default, which reduces the overhang, and mitigates this phenomenon. As a result, tighter capital regulation may also generate increases in productive lending.
- 1.5 Of course, a key mechanism at play is that, with tighter requirements, banks bear more of the downside, which tends to reduce lending. Which effect dominates depends, in a complex way, on too many factors for theory alone to offer policy guidance. Our cautious conjecture is that

forces pointing towards credit expansion are unlikely to dominate generally, and it is therefore plausible that increased stringency of capital requirements would typically contract credit. However, expansion forces will still mitigate contraction forces. So, it is equally plausible that a contraction, if any, would be limited. Besides, tighter capital regulation reduces the scope for excessive risk-taking, which is certainly a plus.

- 1.6 All in all, we are sceptical that tighter capital regulation tends to impede economic growth.
- 1.7 Empirical research faces substantial challenges in isolating the effect of increased capital requirements on credit supply. Imperfect competition, general equilibrium effects, and asset heterogeneity among banks contribute to lending responses that are complex and difficult to estimate. Existing studies do not provide a definitive conclusion. For instance,
 - 1.8 Favara, Ivanov and Rezende (2021) study the effect of the so-called GSIB surcharge for the largest bank. They conclude that such banks contracted lending, but that the slack was picked up by smaller banks, so that real effects were likely insignificant.
 - 1.9 Gropp et al. (2019) study the EBA Capital Exercise in 2011: They find that affected banks reduced lending compared to non-affected banks.
- 1.10 Unfortunately, in this context, difference-in-differences estimates cannot be extrapolated to the aggregate level because of what is typically called a spillover bias (Bahaj, Lattanzio and Malherbe, 2025). Imagine that, *ceteris paribus*, banks affected by a policy contract lending by 2%. It is very plausible that, facing less competition, unaffected banks will pick up at least some of the slack. Say they increase lending by 1%. A difference-in-difference estimator would detect a 3% difference, but it would be completely incorrect to extrapolate and interpret this number as a correct estimator of the aggregate effect. In general, extrapolating results from such studies would lead to overestimating the aggregate effect of a policy.

- 1.11 Conversely, suppose one uses information about the market structure to infer the correct aggregate equivalent of an observed change in lending occurring after a policy change. In that case, one cannot filter out confounding factors and, even if the observed change is correctly aggregated, one cannot fully attribute it (in a causal sense) to the policy change. So, such an approach is generally considered a non-starter in academic circles.

Comment 2: Relative risk weights do affect the allocation of credit. Decreasing the risk-weight on a targeted category of loans would likely boost lending in that segment. This fact does not necessarily make such a policy desirable.

- 2.1 For the reasons exposed above, banks find it costly to finance loans with regulatory capital. They therefore tend to carefully allocate such capital to loans with downside risk that is well in line with the downside risk of the whole balance sheet.
- 2.2 Risk-weights affect both the minimum amount of regulatory capital that must be allocated to a loan and the calculation of the relevant downside risk for this loan (Harris et al., 2025; Bahaj and Malherbe, 2020). For both reasons, a decreased risk-weight on a loan category will make this category more appealing to the bank in its capital allocation exercise. The takeaway from the theoretical literature seems clear here: changing the relative risk-weight of two loan categories will imply a reallocation of lending towards the category that saw a relative decrease. Empirical evidence does provide support for such portfolio rebalancing (E.g., Behn et al. 2016). Note, however, that neither the theory nor the empirics provide a definite answer on the effects of such policies on aggregate volumes.¹

¹ Empirically, extrapolation to the aggregate level would suffer from the same type of bias as discussed above. Theoretically, some form of crowding out can potentially occur (see Oehmke and Opp, 2025).

- 2.3 We would not advise a government that desires to boost, say, SME lending to lower the risk weights on this category of loans to achieve such a purpose. We are of the view that explicit taxes and subsidies are more appropriate tools to redirect resources (and we do not take a stance on whether such reallocation is desirable per se).
- 2.4 If risk-weights are decreased for some categories of loans, this could lead to systemic-risk build-up (not only because this gives incentives to banks to increase risk concentration in this segment, but also because lending in such a segment could become excessive per se) and should, in our view, be compensated with more stringent stress-test scenarios for the corresponding segment.

Comment 3: Banks and non-bank financial intermediaries are both competitors and partners. The recent surge in non-banks likely helped fund productive investment, but it also led to greater risk concentration on banks' balance sheets.

- 3.1 Thanks to government safety nets, banks have an overall funding advantage. Capital regulation mitigates the advantage. As mentioned above, however, banks may be reluctant to fund some types of loans, namely those with a downside that is not highly correlated with that of the bank's balance sheet. This is an area where non-banks would most naturally be able to pick up the slack. One can interpret the situation as non-banks having a funding advantage, but the reality is more subtle.
- 3.2 Our first point is that there is nothing wrong per se with non-banks providing credit. Entry by non-banks is unlikely to result in an overall contraction of credit. If the pick-up-the-slack mechanism described just above is initially at play in the aggregate (perhaps because banks themselves have highly correlated downside risk, which is plausible), then entry by non-banks is likely to boost credit, and in a good way.
- 3.3 A continued trend is the heightened prevalence of risk-transfer mechanisms between banks and non-banks (securitisation has been

around for a while, but other forms of transfers, such as Synthetic Risk Transfers, have gained prevalence recently (IMF, 2024).

- 3.4 This type of financial innovation is likely to increase overall credit to positive NPV firms. This is because banks will be better able to concentrate their risk exposure, thereby reducing the overhang problem mentioned above, but also because they will likely compete more aggressively in their chosen segments (Lattanzio, 2025). The flip side, of course, is that heightened risk concentration inevitably increases taxpayer exposure and raises financial stability concerns.
- 3.5 Systemic risk transfer is a relatively recent innovation and is not a particularly transparent phenomenon. So, an additional concern is that its implications for financial stability are not well understood. It remains unclear how those contracts would unfold in an episode of systemic stress.

References

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