Andreas Dombret: Banking diversity and regulation – do we need more proportionality in banking regulation?

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the Banking Industry Conference of the People's Banks and Raiffeisen Banks, Berlin, 8 June 2016.

* * *

1. Introduction

Ladies and gentlemen,

dear Mr Hofmann

What do the Galapagos Islands and Germany have in common? Not the weather – that's for sure.

But both are hotbeds of diversity – areas in which a particularly diverse range of species live. Whereas the Galapagos Islands are a hotbed of biodiversity, Germany is a hotbed of banking diversity.

Diversity is a decisive factor not only in biological evolution but also for economic development. It means more new ideas, more competition to find the best approaches – and thus more choice.

Diversity is one of the German economy's selling points. During the past global economic crisis – and not for the first time – our world-famous Mittelstand was a bedrock of strength and constancy. Diversity can also be singled out as a feature which makes Germany a particularly healthy biotope.

Diversity in the German banking system, in turn, is a pillar of the economy. And this diversity presents many potential advantages: reduced vulnerability to crisis; more choice for customers; a more refined range of financial products.

Therefore, diversity is – and of this I am convinced – a key factor for the German economy and for its financial sector. It is therefore no surprise that, here in Germany, the debate on the burdens imposed by regulatory reform on smaller institutions is particularly heated. This is due to fears that the rules could overwhelm those banks, with only large banks being able to come to terms over the long run. The result, it is feared, will be more consolidation and thus less diversity.

This is being debated under the label of proportionality – or, more precisely, the lack of proportionality. I am here today to give you my opinions on this issue.

2. Where do the problems lie? Complexity and compliance

An expert opinion on proportionality[1] commissioned by the Federal Association of German People's Banks and Raiffeisen Banks can be singled out as a particular driver of the increased political attention being given to the debate on proportionality over the past few months. Both the European Commission and the recent joint proposal by the German and UK finance ministries to review the relevant EU rules have recently added fuel to the debate. The discussions are currently even going as far as to create a specific set of rules for smaller institutions. At the recent Bundesbank symposium, Ms Sabine Lautenschläger, the deputy

---

[1] Hackethal, Andreas and Inderst, Roman (2015) Auswirkungen der Regulatorik auf kleinere und mittlere Banken am Beispiel der deutschen Genossenschaftsbanken. Expert opinion commissioned by the Federal Association of German People's Banks and Raiffeisen Banks, 30 September 2015

chair of the Single Supervisory Mechanism for banks in Europe, voiced scepticism as to the feasibility of such a separate set of rules.

What is this debate actually all about? To the management and staff of all institutions – small and large alike – it is about the work created by regulation. It is about the one-off costs of, for example, procuring new software. But it is also about the running costs, ie the costs of keeping systems operational or of personnel. And it is about the time that needs to be devoted to these matters – which is time no longer available to deal with clients, to conduct credit analysis or to develop investment strategies.

Why does this take a greater toll on small institutions than on large institutions? After giving the issue some thought, we at the Bundesbank quickly diagnosed the source of the real problem. It is that the rules are becoming more and more complex and interconnected and that this is increasingly becoming too much for, in particular, small institutions with limited human resources to cope with. I must confess that I, too, am sometimes amazed at the detailed structure of regulation created over the past few years.

Where does this come from? There are three trends in particular which have made the rules more complex. Global harmonisation brought about by the Basel standards is one of these trends. These standards, created mainly for large international banks, are being applied to all institutions in Germany and the euro area. European regulation, which imposes an additional set of rules that need to be followed, is another source of complexity. And last, but not least, complicated rules are also an outcome of compromises that have to be made when developing regulation – especially where a large number of countries with a wide variety of banking landscapes are involved. Banks and saving banks, too, have often proposed changes which have not necessarily made the rules any more simple.

But what exactly is behind this increase in complexity? It is the vast number of rules, the increase in the degree of detail, the expansion of the already-enormous technical specification and the growth in the multiplexity of regulation. This has made compliance with the rules an increasingly costly, time-consuming and unwieldy undertaking. Such a complicated set of rules is all but bound to lead to a considerable increase in the costs of compliance.

A good example of this is the framework which governs remuneration systems. In Germany, we make a distinction here between general prudential requirements and specific prudential requirements – though smaller institutions do not need to meet the specific prudential requirements. According to the European Commission, however, pursuant to CRD IV[2] a small bank is likewise required to meet both the general and the specific prudential requirements. The following example shall serve to show how complex this would be. One rule says that part of variable remuneration is to be paid in "instruments", ie in shares or "share-linked instruments or equivalent non-cash instruments". However, small institutions have no such instruments, which means they must go to great lengths to create such instruments in the first place.

I think this approach is going too far and suggest amending it under this year's CRD IV review. Small institutions should be exempted from the specific prudential requirements.

What burdens are complicated rules imposing on smaller institutions? One of the most problematical areas lies in the human resource requirements and costs created by the need to regularly review whether the rules are actually being fully complied with.

This means that the problem is not so much the minimum capital or liquidity requirements but instead the high operational burden imposed by implementing these rules and following them. This overhead is high for all institutions – regardless of their size. However, small institutions, owing to their smaller staff sizes, are less able to spread the costs of compliance across their

2 Capital Requirements Directive IV.

employees and have to either hire additional staff or enlist external aid. This tends to lead to relatively higher burdens.

The problem, at its core, thus consists in the interplay of two aspects. The high operational requirements created by a multiplex set of rules, and the limited organisational capacity which is naturally at the disposal of smaller institutions. Intricate sets of rules thus cause particular duress for institutions with limited capacities.

Ultimately, the debate on proportionality is leading us to the following question: should we further simplify the rules for small institutions? I use the term “further” because the rules are already proportional to some extent. The design of the Basel framework, too, incorporates a sense of proportionality, by making a distinction between standardised and advanced approaches. But I will come to that later on.

3. No place for general criticism

There is no question that the cost of the new regulation is considerable. However, it is necessary to weigh these costs against the benefits to society as a result of financial crises being prevented. In this context, I believe the cost of regulation to be justified overall.

This means that, if you look at the proportionality debate from the perspective of society as a whole, it essentially goes beyond the burdens facing credit institutions. The crux of the matter is whether it is a viable option to graduate regulation relative to the size of a bank or savings bank without jeopardising the stability of the financial system.

It is therefore important, despite all of the well-reasoned criticism, to be realistic. All too often, the proportionality debate is used to wrap general criticism of regulation in politically correct packaging. But this criticism clearly goes too far on three accounts.

First, regulatory tightening in the wake of the financial crisis was the right move as (capital) requirements were too low prior to the crisis. At the same time, there was a high degree of deregulation – and we all now know where that led us. We must take care not to throw the baby out with the bath water in the face of justified criticism.

Second, it is wrong to assume that small and medium-sized institutions pose no risks. Crises also emanated from medium-sized banks, even in Germany – particularly from institutions with business models that included proprietary trading and capital market funding, for example. Even small banks, which all follow the same or very similar business models, pose risks to financial stability – that is to say, they are “too many to fail” instead of “too big to fail”.

Third, there is already an extensive degree of proportionality in banking regulation. This is true of both regulation itself, in which there are gradations such as the standardised approach, and the field of supervision, in which the application of the Minimum Requirements for Risk Management is largely proportional.

General criticism will therefore be largely unsuccessful because it is not justified. Without laws and regulations, a community – much less an advanced economy – does not work.

4. The form that “greater proportionality” should not take

And yet, unfortunately, there are also a lot of less convincing ideas being put forward. Before I come to the good ideas, I would first like to talk about the form that “greater proportionality” should not take.

Some proposals from the financial sector leave me wondering whether they actually represent the interests of the banks and savings banks, as well as their employees. This is because we see occasionally a contradiction in the proposals – the contradiction that institutions complain about having less and less time to devote to retail business as a result of regulatory requirements, on the one hand, while the lists of demands that they present largely focus on reducing minimum capital and liquidity requirements, on the other.

Instead, the proportionality debate ought to tackle the issue of operational burdens. In my view, this is the appropriate starting point for all other considerations.

Consequently, the concept of "greater proportionality" should not morph into an opportunity for institutions to present their wish lists. This means that we should systematically examine the areas in which regulation is not sufficiently proportionate and that we must consider how we can systematically improve this. What this does not mean, however, is that a patchwork of wish lists should be incorporated into existing regulation. Notably, simplifications of minimum capital and liquidity requirements cannot and will not be granted. In contrast to what is commonly argued, lower capital requirements do not automatically lead to elevated growth, nor do they only result in increased lending.

Furthermore, simplifications must never endanger financial stability. Medium-sized, highly systematically interconnected institutions – those referred to as "too interconnected to fail" – and those institutions with risky business models should not benefit from any simplifications. The recent financial crisis, during which many insolvent institutions had to be bailed out, is still fresh in all of our minds.

Additionally, institutions – irrespective of their size – must not be given systematic scope for regulatory arbitrage. In other words, exceptions to the rule must not create incentives for smaller institutions to conduct a greater volume of risky transactions. Proportionality is not intended to make it easier for small institutions to use highly complex procedures and adopt risky business strategies as a result of being shown leniency.

With that in mind, I would like to provide you with an example that applies to many institutions. Some institutions, despite being quite small in terms of their total assets and workforces and therefore running a relatively straightforward business, use advanced credit portfolio models that are complex in methodological terms. As you know, extensive expertise and compliance with high regulatory standards are required to apply such models. These requirements have, quite rightly, actually been tightened further in recent years. And this is precisely what some institutions and their associations are now rallying against.

Truth be told, I have little sympathy for such complaints. Why? Because there are simple and transparent procedures that are perfectly suitable for smaller institutions. Either an institution adopts a simple and transparent procedure – which is perhaps somewhat more conservative but easier to handle – or it must comply with stricter requirements for riskier transactions and complex approaches. The fact that solutions are provided by associations for internal risk measurement that institutions might wish to use for a variety of reasons need not be of any consequence to regulators and supervisors. Thus, if an institution wishes to pursue risky business strategies and apply highly complex processes, it should gladly do so – but it should not expect regulators and supervisors to support these endeavours by relaxing the rules and showing leniency during inspections. The upshot is either risk and complicated rules or less risk and simplicity – risk and simplicity together is, by contrast, a pipe dream.

In summarising, I would like to make two things very clear. First, only those institutions that are both small and have, above all, a sound risk profile, may be granted simplifications. Second, a reform would not only provide a range of simplifications; instead, it would also be accompanied by corresponding obligations – for example, a two-tier regulatory system with simplified requirements for smaller institutions would probably go hand in hand with increased capital requirements.

The Bundesbank will then be able to agree to greater proportionality in regulation if two principles are respected: no wish lists and no weakening of supervision that could be hazardous to banking stability.

5. The form that "greater proportionality" could take

There is no doubt that sweeping reforms were essential in the wake of the financial crisis.

However, now that such far-reaching reforms have been implemented, we need to honestly ask ourselves the following questions. Do they still make sense when considered altogether? Are the individual components of reform working together as a whole? This process of reflection has been ongoing for several months now. Politicians and authorities have started to examine the impact of and interaction between these individual components. And assessing the proportionality of the rules with respect to smaller institutions is a focal point of this review.

Against this background, I would like to briefly outline what I believe greater proportionality in banking regulation could look like.

Any true expansion of proportionality nowadays must begin at the European level. That's why I wholeheartedly condone the proposal recently put forward by the German and British finance ministries to review the relevant EU regulations – mainly the CRR and CRD IV,[3] but also other legal regulations. That review is lined up in the next two years. So you see, it's worth talking about good ideas.

Simplifications can primarily be granted to smaller institutions in two ways. The first is a details-driven approach that involves introducing special exceptions or adjustments for individual rules. A good example of this would be my proposal to do away with special requirements for remuneration systems.

Another, more radical approach would be to redraft the rules from scratch, thereby establishing new legal bases that introduce simplifications for smaller institutions in the case of all or a multitude of rules.

It's worth noting here that the details-driven and the basic approaches are not in any way mutually exclusive. However – lest I wear out my welcome – I will address the basic approaches in three areas.

One option would be to establish a set of EU-level rules which make a stronger case for proportionality while legislation and standards are still on the drawing board. Additional proportionality clauses could, for instance, be built into the wording of legislation. This would give the EBA and Commission a legal footing that makes it easier for them to incorporate simplifications into guidelines and technical standards.[4] Of course, this can only be achieved if clearly defined objectives are put in place.

Another option worth considering is the creation of an improved review process as part of the legislative procedure – a mandatory due diligence process,[5] if you will. This is already anchored in law in a number of countries including the USA and UK. So why can't we do it here in the euro area, too?

In this scenario, checks would have to be carried out whenever regulations are introduced or revised in order to assess whether the principle of proportionality has been given due consideration. Such checks could be performed before adopting a new regulation or after a trial period. The process-related requirements could be drawn up in the form of a joint directive passed by all of Europe's supervisory authorities.[6]

---

3 Capital Requirements Regulation and Capital Requirements Directive IV.

4 According to the EU institutions' reading, they are not authorised to make far-reaching exceptions to strengthen the principle of proportionality if those exceptions are not specifically provided for in the relevant part of the CRR, CRD IV etc. In this case, the subsidiarity and proportionality provisions of the EU Treaties are ineffective (since the CRR, being a lex specialis, takes precedence over the general legislation of the EU Treaties).

5 See also the BVR paper (cited in footnote 1) and European Banking Authority Banking Stakeholder Group (2015), Proportionality in banking regulation (pages 52–53)

6 The legal basis for this and for the Commission's work could be inserted in the CRR (and in the CRD IV, too, if appropriate).

The second area in which improvements need to be made for small banks is in the field of reporting and disclosure. Let me be honest, ladies and gentlemen: these days, you are being asked to report a very great deal of information, and I think it's right and appropriate to question just why that is. But we shouldn't forget that supervisors aren't the only recipients of those data – the bodies tasked with monetary policy and financial stability duties also expect to be kept abreast of the latest developments.

But let's confine ourselves to banking supervision and consider the best modus operandi going forward. I would propose a systematic approach that questions what information supervisors and other recipients really need and compares the findings with the data which institutions are currently required to report. This might also impact on the Implementing Technical Standard on Supervisory Reporting. Any excess reporting requirement identified would then need to be reduced in a targeted manner.

Another starting point would be to abolish disclosure requirements that have been rendered obsolete by the co-existence of European and German rules. I think unnecessary duplications in the collection of data should be eliminated by amending the German rules. Viewed from this angle, I see Germany's Liquidity Regulation one of the pieces of legislation that can be scrapped.

Yet another point I think is worth considering is to confine reporting duties for smaller institutions to a minimum data package which could then be used to monitor compliance with the minimum standards.

Disclosure is another field where requirements could be eased. We should investigate just how often disclosure reports need to be published, and we should ask how conducive this instrument really is to achieving the goal of market control and supervisory and adminstrative board control in the case of smaller regional institutions. In addition, we need to make sure that the disclosure reforms which were debated by the Basel Committee and are now being discussed in the EU bodies do not introduce any intrayear disclosure duties.

The third area is probably the most far-reaching of all. What I have in mind is the creation of separate regulatory regimes for smaller institutions on the one hand and large multinational banks on the other. This two-tiered proposal has met with a rather muted response so far, and I don't think it has much hope of being adopted at the political level. But I nonetheless think it is worth considering as a fundamental approach – one that would systematically address the excess burden placed on smaller institutions' operational capacities.

A two-tiered system could be put into practice by grading the Basel Standards for institutions that are neither multinationals nor large in size. A broadly similar set-up has been up and running in the United States ever since the Basel II regime was implemented. Any institution that exceeds a balance sheet threshold is subject to the Basel rules. However, it would only be possible to do the same here in Germany by creating rules at the European level.

In that scenario, only banking multinationals would be subject to the fully loaded Basel III requirements in the EU. That would be appropriate from a risk perspective: global banking institutions would be regulated according to a harmonised set of global rules, while smaller institutions and those operating within a certain region would be governed by graduated rules which do justice to their different business models and risk profiles by setting less complex requirements.

Now there are some who claim that transitioning to that kind of system is a flight of fancy. What these doubting Thomases mainly ask is where exactly the line should be drawn. I'll be the first to admit that this is a challenge, but it's anything but impossible. One way of tackling this problem would be to use a smart combination of selection criteria – for instance, combining a balance sheet threshold below which institutions would be subject to the simpler regime with a prudential decision based on the institutions' risk profiles.

But there are still many crucial details and potential pitfalls that need to be addressed before we can even begin devoting serious thought to an option of this kind. This is something I think we should consider with an open mind. A systematic approach, assuming it's feasible, is usually superior to an approach based on workarounds and emergency repairs.

The proposals in the three areas I have just spoken about – first, incorporating proportionality clauses in EU legislation, second, easing reporting and disclosure standards, and third, creating a two-tiered system – are just some of the options that are available. I feel we should explore these ideas, and others, in an even-handed and open-minded manner.

6. Conclusion

Ladies and gentlemen

A loss of biodiversity can have grave repercussions for the world. In biological terms, this can even go as far as to increase the prevalence of infectious diseases in less biodiverse ecosystems because they support the transmission of pathogens.[7] [7] This can pose a risk to the health of humans, animals and plants.

I think we've already made much more progress towards curbing these risks in the world of banking regulation than in the field of environmental policy. So we should proceed to review the points I have raised today in the calmest and most objective manner possible.

The reforms embraced in the wake of the last crisis were the right thing to do, but looking particularly at the needs of smaller institutions, now is the right time to review them.

In essence, it is all about reducing the burden on their operational activities. Wish lists are just as pointless as proposals that risk destabilising the system as a whole. Institutions with risky profiles shouldn't benefit from any simplifications, nor should we create any loopholes that end up being used by so many institutions that smaller credit institutions run into difficulties.

Whether and how the more complex rules should be balanced out by introducing simplified regulations for smaller institutions is a matter than now needs to be explored while the EU rules are being revised. Fundamental approaches should take precedence over purely details-driven initiatives.

I would say to bank representatives, bank board members and employees: step beyond general criticism and put forward the most specific proposals you can. Say exactly how the operational strains arise and how the day-to-day burden for smaller banks and savings banks can be mitigated in a way that does not weaken the regime as a whole. If we succeed in striking this balance, simplifications will be possible – that's something I firmly believe.

I now look forward to a lively and stimulating discussion with you. Thank you very much for your attention.

[7] F Keesing et al, Impacts of biodiversity on the emergence and transmission of infectious diseases, in Nature 468, No 7324, 2010, pages 647–652.