Andreas Dombret: Cui bono? Complex regulation and its consequences

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the 20th Banking Symposium of the European Center for Financial Services at the University of Duisburg-Essen, Duisburg, 7 September 2016.

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1. Introduction

Professor Rolfes,
Bernd,
Ladies and gentlemen

For me, Duisburg brings back memories of the infamous Inspector Schimanski from the TV crime series Tatort. Perhaps it's because, as a banking supervisor, I'm as unpopular as the police are among suspects.

However, unlike Schimanski, banking supervisors don't start throwing punches if a meeting with an institution breaks down.

Thankfully, banking regulation is not exactly rife with physical violence. Nevertheless, this symposium claims that "complexity kills".

And so we already have a perpetrator: lawmakers and supervisors. The murder weapon? Complex, detailed banking regulation. The victims: banks and their customers. Case closed, no investigation necessary. Splendid. Let's just call it a day.

But would an experienced inspector like Schimanski accept this at face value? I think this all-too convenient solution would leave a bad taste in his mouth and he would soon realise that something was missing altogether: a motive.

This is why I am today reopening the case of complex banking regulation and its consequences. Let's examine the evidence together. Who benefits, and who suffers?

2. Banking regulation today: optimised or muddled?

Banking regulation has become ever more intricate and complex in recent years. This presents a challenge above all to small institutions with limited human resources.

I must confess that I, too, am sometimes dissatisfied at how intricate the regulatory framework has become over the past few years.

But what exactly is behind this increase in complexity? It's the many rules and regulations which are becoming ever more detailed and technically specialised, as well as the multilayered nature of regulation as a whole.

Today, people still look back wistfully at the clear and simple Principle I, which set out capital requirements for Germany in a concise and straightforward manner. In 2004, Basel II ushered in an era of technical standards that not only ran into hundreds of pages but also included numerous calculation formulas and tables. And I daren't mention the annexes or background papers.

The reforms following the financial crisis intensified this trend further still. Basel III and the Capital Requirements Directive, or CRR, are even more detailed, heavier on formulas, and more complex.

Why is there this trend towards ever more complex rules? Five reasons stand out in particular.

First: Regulation has needed to keep pace – and still needs to keep pace –with ever more complex banking business.

Second: We are increasingly dealing with what is known as risk regulation. Here, historical data and statistical procedures are used to calculate the probability of dangerous events occurring – the rules and regulations then stipulate how banks must prepare for such scenarios.

Third: Global harmonisation brought about by the Basel standards. These standards were created mainly for large international banks, but are being applied to all institutions in Germany and the European Union.

Fourth: Complexity is also caused by European regulation, which imposes an additional set of rules that need to be followed. Furthermore, the relationship between European and national rules is often unclear.

And last, but not least, complicated rules are also an outcome of compromises. Compromises are a necessary element of regulation – especially where a large number of countries with a wide variety of banking landscapes are involved. Moreover, the changes proposed by banks and saving banks often haven't exactly made the rules any simpler.

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.

If such rules had been imposed on Inspector Schimanski and his ilk, Tatort would have been a much less exciting show. I personally wouldn't be thrilled to spend 90 minutes watching the inspector poring over implementing regulations. That's only something for masochists, and Götz George, the actor who played Inspector Schimanski, certainly wasn't one of those.

3. Disadvantages: high compliance costs

As I mentioned at the outset, the suspect's motive to cause harm to banks and their customers via complicated rules isn't very plausible. And the supposed sequence of events isn't exactly water tight either.

But one thing we do have to admit is that the complexity of banking regulation has made compliance very expensive for institutions – in two respects.

First, the regulatory requirements generate work for the institution's executives and employees. This includes one-off costs, such as the costs of procuring new software. But it's also about the overhead costs, ie the operational or HR costs. And it's 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.

This means that the problem is not so much the minimum capital or liquidity requirements but instead the high operational burden imposed by implementation and compliance.

Second, as a result of the complex regulations, it is becoming ever more difficult for new institutions to enter the market. This could significantly impact the competitive dynamics and innovativeness of the bank and savings bank sector.

That's all I want to say for now on the effects of complex rules on institutions. But this complexity affects supervisors, too, of course. One interesting take on the matter comes from a couple of experts at the Bank of England.[1] They believe that complexity fails to provide

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[1] AG Haldane and V Madouros (2012), The dog and the frisbee. Speech delivered at the Federal Reserve Bank of Kansas City's 366th economic policy symposium in Jackson Hole, Wyoming on 31 August 2012; D Aikman, M Galesic, G Gigerenzer, S Kapadia, K Katsikopoulos, A Kothiyal, E Murphy and T Neumann (2014), Taking uncertainty seriously: simplicity versus complexity in financial regulation.

absolute security, because gaps can always emerge elsewhere. In addition, regulation ties up human resources because of the dense blanket of rules that need to be enforced. In England it is recognised that there is therefore a danger of supervisors following a ticked-box approach rather than carrying out a critical examination.

I think this reasoning touches on a rather sore point – it is, of course, true that complexity ties up vast amounts of our regulatory resources. Sometimes a simple rule would perhaps be just as effective, but less costly.

However, overall I come to a different conclusion. Namely, that complex regulation with multiple safety nets – such as the risk-weighted approaches and the debt ratio – are a good alternative to simple rules.

At this juncture, Schimanski would probably conclude that while the supervisor's attack was perhaps a little heavy-handed, it wasn't deadly. And, what's more, the supervisor's self-interest in having complex rules is very limited, so this scarcely cuts the mustard as a motive for murder. Inspector Schimanski would therefore have to carry out further investigations. To this end, let's take a look at the advantages of complex banking regulation.

4. Advantages: providing stability and innovation

There is no question that the cost of the new regulation is considerable. However, this must be weighed against the benefits to society of preventing financial crises. In this context, I believe the cost of regulation to be justified overall.

It is therefore important, despite all of the well-reasoned criticism, to be realistic. All too often, the debate is used to wrap broad-brush criticism of regulation in politically correct packaging. But this broad-brush criticism clearly goes too far. Regulatory tightening in the wake of the financial crisis was the right move as, with hindsight, capital requirements were too low prior to the crisis. At the same time, there were quite substantial regulation gaps – 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 reasonable criticism.

Moreover – and I think it very important to emphasise this – it is not just society and the economy which benefit from the new rules. Institutions, too, gain from complexity to a certain extent.

They do so in two ways. First, regulators recognise the institutions' internal models and therefore enable them to use internal procedures for regulatory purposes as well. This is not self-evident. Second, this system leads to low capital requirements by historical standards. This, too, is undoubtedly an advantage that we should not ignore.

5. A second-best solution that we can live with

Ladies and gentlemen, the case can be closed: bank supervisors are not murderers, and complexity is not a murder weapon.

Nonetheless, complexity can only ever be a second-best solution. If we could go back to the drawing board and create the banking world afresh with the experience we have gained over the last few decades, we would probably choose simpler rules. However, that is not currently a realistic option. What is more, this approach would have its weaknesses, too: for example, less complicated requirements would probably entail higher capital requirements.

That's why we must now accept the complex set of rules as the new status quo and work with them. For us regulators, this means subjecting the reformed rules to a systematic review. For institutions, it means they must review and realign their business models.

These are the challenges that I would now like to address.

6. Implications for supervision: reviewing the rules with regard to proportionality

Let's start with supervision. There is no doubt that sweeping reforms were necessary 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 as a package? Are the individual components of reform working together as a whole? Precisely this process of reflection has been ongoing for several months now, and the Bundesbank is playing an active role in these discussions. Politicians and authorities have started to examine more closely the impact of and interaction between these individual components.

Assessing the proportionality of the rules with respect to smaller institutions is a focal point of this review. This issue is particularly close to my heart, which is why I would like to outline what I believe greater proportionality in banking regulation could look like.

To do this, let's return briefly to our point of departure: complexity. What burdens are complex rules imposing on smaller institutions?

The compliance burden 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 employees and have to either hire additional staff or enlist external aid. This leads to relatively higher burdens.

How might we change this? Any expansion of proportionality must begin at the European level. That is why I endorse the proposal recently put forward by Wolfgang Schäuble to review the relevant EU regulations with a view to achieving greater proportionality. This mainly applies to the CRR and CRD IV,[2] but also other legal regulations. That review will take place sometime in the next two years. So you see, it's worth talking about good ideas.

These are two particular ways to give relief to smaller institutions. The first is a details-driven approach that involves introducing special exceptions or adjustments for individual rules.

Another, more radical approach would be to rewrite the rules from scratch, thereby establishing new legal bases that introduce relief for smaller institutions regarding some or all of the 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 confine my remarks to the basic approaches in three areas.

One option would be to establish a set of EU-level rules which make greater allowances for proportionality while legislation and standards are still on the drawing board. Additional proportionality clauses could, for instance, be built into the CRR and CRD IV. This would give the EBA and the European Commission a legal footing that makes it easier for them to incorporate simplifications into guidelines and technical standards.[3] 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,[4] if you will. This is already

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2 Capital Requirements Directive IV.

3 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 sections of the CRR, CRD IV etc. This would also render the subsidiarity and proportionality provisions of the EU Treaties ineffective (since the CRR, being a lex specialis, takes precedence over the general legislation of the EU Treaties).

4 See also Hackethal, A and Inderst, R (2015) Auswirkungen der Regulatorik auf kleinere und mittlere Banken am Beispiel der deutschen Genossenschaftsbanken. Expert opinion commissioned by the

enshrined in law in a number of countries, including the USA and UK. So why can't we do it here in Europe, 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 requirements could be drawn up in the form of a joint directive passed by all of Europe's supervisory authorities.[5]

The second area in which improvements need to be made for small banks is in the field of reporting and disclosure. Ladies and gentlemen, I am aware that these days, you are being asked to report an awful lot of information, and it's right and appropriate to question just why that is. We shouldn't forget, though, that supervisors aren't the only recipients of these data – monetary policy and financial stability decision-makers use this information as well.

So, what's the best plan of action with regard to banking supervision going forward? I would propose a systematic approach that checks what information supervisors and other recipients really need and compares the findings with the data which institutions are currently required to report. This might impact on the Implementing Technical Standard on Supervisory Reporting, for example. If it turns out that a disproportionately large amount of information is being collected, then we need to focus on ways to reduce this burden.

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 as a candidate for the chopping block. And it will, in fact, be eliminated at the start of 2018, once the LCR has been fully implemented.

Yet another point I think is worth considering is to slim down smaller banks' reporting requirements to a minimal data package. Then, only compliance with the minimum standards would be monitored.

Disclosure is another field where banks could be given a break. Here, we should investigate just how often disclosure reports need to be published in order to supervise smaller regional institutions. In addition, we need to make sure that the disclosure reforms do not introduce any intra-year disclosure duties.

My third suggestion for achieving greater proportionality is probably the most far-reaching of all. What I have in mind is the creation of separate regulatory frameworks for smaller institutions, on the one hand, and large multinational banks, on the other. Even though the response to this proposal has been tepid so far, 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 through a graduated set of 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 whose balance sheet exceeds a certain threshold there 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.

Federal Association of German People's Banks and Raiffeisen Banks and European Banking Authority Banking Stakeholder Group (2015) Proportionality in Banking Regulation (52 f).

[5] 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).

In this scenario, only banking multinationals would be subject to the fully loaded Basel III requirements in the EU. This 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.

Of course, 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 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 into EU legislation; second, easing reporting and disclosure standards; and third, creating a two-tiered system – are just some of the options that are available. Before any relief of this kind can occur, fundamental conditions need to be met.

I think it's particularly important that the focus remains on reducing the burden on operational activities – an easing of minimum capital and liquidity requirements is not on the table. 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.

Accordingly, the idea is not to sew a patchwork of wish lists for easing minimum capital or liquidity requirements into existing regulations.

And what's more, relief must never endanger financial stability. Medium-sized, highly systemically interconnected institutions – those referred to as "too interconnected to fail" – and those institutions with risky business models should not be provided any relief. The recent financial crisis, during which many insolvent institutions had to be bailed out, is still fresh in all of our minds. We also need to be careful not to create any loopholes that end up being used by so many institutions that smaller banks run into difficulties.

7. Consequences for banks: adapting business models to fit the new reality

Ladies and gentlemen, rules must be developed, reviewed, adopted and implemented. Following the regulatory reforms' implementation, banks and savings banks will now have to adapt to the new reality over the coming years.

I realise that these costly and challenging processes can be frustrating, especially for those working at banks that played little or no part in the pre-crisis excesses.

But what we are talking about here are transitional processes which involve high one-off costs and greater compliance expenses in the long term. In light of the important role of credit institutions in the economy, they are absolutely justified.

Many of the problems stem not from regulation but from the fact that some institutions are still clinging to their old business models despite finding themselves in a new world. But the old world of unrestricted financial markets has gone – for good.

Like many other European banks, some German institutions are still searching for business models that are competitive, viable, and yet sustainable. This is clear, amongst other things, from the fact that German credit institutions have the worst cost/income ratio in the EU, and also lag behind in terms of other profitability ratios.

I'm not going to pretend, however, that finding the solution to this problem is a piece of cake – profitability cannot and must not focus on the short term. After all, this was one of the causes of the most recent financial crisis. Sustainable business models must be well-conceived and must also enable banks to weather difficult phases. If credit institutions change their strategic focus as a result of the new rules, as we have actually already seen in a few cases, this is not necessarily a negative side-effect of regulation. It may actually be proof that the new rules are working – that is, that they are encouraging banks to adopt sustainable business models.

8. Conclusion

Ladies and gentlemen, to conclude, I have some good news and some bad news. Let's start with the bad: banking regulation has admittedly become a very complicated matter. And we all just have to accept this new status quo. And now for the good: we actually have the potential to improve on this status quo.

We supervisors can achieve this by looking at any negative implications that arise and identifying where small institutions are being unreasonably disadvantaged.

Institutions, on the other hand, can achieve this by accepting the fact that their business models – in many instances – were not sustainable in the past and will never become so in the future barring fundamental changes.

I am confident that we can manage both. Let's keep exchanging ideas on this matter – and unlike Schimanski, without resorting to fisticuffs.

On that note, I'd like to congratulate this conference on its 20-year anniversary and now look forward to some lively debates.