Andreas Dombret: Can we manage with less? The debate on greater proportionality in regulation

Presentation by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, to board members of Baden-Württemberg savings banks, Stuttgart, 24 April 2017.

* * *

1 Introduction

Dr Herrmann,
ladies and gentlemen

Banks and savings banks have come under fire in the media again recently. Referring to "shock charges", "fee stings" and "piggish banks", it was as if the big daily newspapers were trying to outdo each other with their headlines. The reason? More and more banks and savings banks are introducing fees for services that were previously free – and they're becoming more open about it too.

These new fee structures have come about as a result of the banks' quest to find new sources of income. To a certain extent, it's entirely legitimate to do this – after all, banks need to make money somehow. And we consumers need to get used to the idea that we'll be paying for banking services in future because as we've been told, the "culture of freebies" is coming to an end.

The thing is, other sources of income that banks and savings banks could rely on in the past are drying up. In today's low-interest-rate environment, interest gains, which are so important to many institutions, are not as plentiful as they once were. And even after the period of low interest rates finally comes to its long-awaited end, danger will still be lurking in the form of interest rate risk.

But it's not just interest rates that are causing banks and savings banks headaches. Even though most institutions would probably put the interest-rate environment at the top of their list of pressing problems, I expect regulation would not be much further down.

Regulation is also the topic of my talk today – that's what I agreed with the organisers. Many institutions see regulation in general, and specifically the reforms of the past few years, as a constraint and a burden. Today I'd like to explore this viewpoint further and will also take the opportunity to explain why I'm convinced that we need the regulatory reforms anyway. I'd then like to talk about whether or where I see potential to revise the regulatory framework and how these changes could perhaps provide institutions with some degree of relief.

2 Regulation as a burden

But let's start with the idea of regulation as a burden. Why do we have strict rules and close supervision if they seem to cause so much trouble for banks and savings banks? No one can seriously argue with the fact that regulation and supervision present a challenge for institutions. Rules are restrictive, and there are costs associated with obeying them. And this burden has become even greater thanks to the reforms since the last financial crisis. Wouldn't it be better for banks to focus all their energy on financing the real economy instead of wasting their time trying to follow complicated rules?

After all, the services of banks and savings banks are crucial for a stable economic cycle, for growth and prosperity. Especially in bank-based economies in Germany and Europe, businesses and consumers depend on a functioning banking system. Banks and savings banks fund investments, they manage savings and deliver important services, such as processing payments.

But taking risks is also part of the banking business. And when you take risks, there's a chance you might fail. Plus, we have to remember that bankers are only human – and humans make mistakes. I guess given the increasing digitalisation in today's world, another point to add is that algorithms are just that – algorithms – and algorithms can be wrong. This is why the area of IT risks, in particular, is also worthy of so much attention these days.

The implications of a financial institution's failure are far-reaching – and I don't just mean for the institution itself, but also for its investors, for the real economy, and for us all. The financial crisis, which is just about to reach its tenth anniversary, has shown us that the failure of a single institution is on its own enough to trigger a chain reaction throughout the entire sector.

And that's why we need rules – even in the places they cause the most pain. Regulation and supervision help to keep the financial system in order. Smart regulation ensures that financial institutions can still pursue their business, but that they are appropriately protected against the biggest risks. This then safeguards the economy, consumers and the financial system itself against turbulence. Therefore, the reason we can't give banks and savings banks full rein is because of the important part they play in the economic cycle.

Smart regulation and close supervision are also desirable from the banks' and savings banks' point of view, as they prevent cost-intensive threats to their existence. There are more advantages for the sector as a whole. On the one hand, uniform rules ensure that the minimum requirements for risk identification and limitation are the same for all market participants, meaning that they can be assessed under fair conditions. On the other hand, rules establish trust. Trust which banks and savings banks desperately need to do business. Trust which many banks lost during the financial crisis. Trust which has since had to be painstakingly rebuilt.

3 Eliminate unnecessary burdens

Ladies and gentlemen, regulation and supervision are not expendable. This justifies a certain amount of burdens resulting from regulation. I am firmly convinced that regulation and supervision have a positive overall impact on the economy, consumers, and banks and savings banks themselves. That said, it is also clear that we should eliminate undesirably high burdens from regulation as far as possible, as I'm sure you will all agree. For that reason I would now like to talk about whether and where I can see such undesirably high burdens – and what we can do about them.

However, I am opposed to a broad-brush criticism of regulation. This applies in particular to internationally harmonised rules for large institutions. As you are all aware, we have undertaken extensive reform measures in the past few years and are currently working on the final details in the Basel Committee. Our work was and still is shaped by what we have learned from the financial crisis. One consequence of this is that the international rules have since become more extensive and complex. The increased complexity of the rulebook reflects the complexity of the global banking business, and is therefore completely justified.

But the new rules do not solely concern the very big institutions operating on a global scale. The framework of the Basel Committee affects rules at both the European and national levels. These rules ultimately define the framework conditions of smaller institutions, thereby affecting you and your employees.

In fact, this has resulted in burdens for smaller and medium-sized banks, some of which are undesirable and even harmful, because small institutions cannot utilise the economies of scale that large banks profit from when adhering to the rules. The regulatory framework has already partially taken this into account with gradations which vary according to an institution's size and business model. Yet necessary measures such as the procurement of new IT systems or the recruitment of staff who ensure that the rules are complied with are still leading to high fixed costs, which represent a large burden to smaller institutions.

When regulation makes size an advantage, this can clash with the goal of creating a stable financial system. After all, it was the large institutions in particular which played the tragic leading role in the crisis about ten years ago. Gradual harmonisation of the financial sector would not be in the customer's interests either. The German banking and savings bank sector in particular is characterised by its great diversity and its close customer proximity. Last but not least, excessive burdens in smaller institutions contradict the idea of a level playing field, in other words, ensuring that competitive conditions are the same for all banks and savings banks. With regard to the creation of fair competitive conditions, rules which excessively burden certain institutions are simply wrong.

4 We can manage with less

That is why I believe regulation must be made more proportional. Many of you are aware that I have felt strongly about this for a quite some time, so I am pleased that we have made solid progress in the meantime. In this vein, the European Commission put forward a proposal last November concerning how the Capital Requirements Regulation, or CRR, and other European rulebooks such as the Capital Requirements Directive, or CRD, are to be revised. Some of its suggestions relate to proportionality.

The Commission's suggestions are a good start. Naturally, some points need further discussion. However, I am confident that we will be able to make meaningful minor improvements.

I use the term "minor improvements" because the amendment of a few rules is unlikely to solve the problem of excessive burdens among smaller banks. This is why I support a more basic approach: the creation of separate regulatory frameworks for smaller institutions on the one hand and for large multinational institutions on the other.

This approach is often referred to as the small banking box. This would not necessarily make a completely new rulebook essential, although it might sound that way at first. A single short section in the CRR would suffice. But how might the box look in concrete terms? I would like to outline its basic features for you, focusing on two essential characteristics in particular: firstly, defining the parties which could be subject to a simplified rulebook, and secondly, the areas in which I believe it would be feasible to ease the burden.

Let's start with the definition. I've talked about a set of rules for small institutions. An initial criterion for deciding whether a bank or savings bank comes under simplified rules would therefore be comparatively small total assets. A sensible limit beneath which an institution could use simpler rules would be, say, a low single-digit billion figure. Whatever figure is finally chosen can be up for discussion for the time being.

An absolute threshold value on its own might lead to systemically important institutions in some EU countries becoming part of the simplified regime. To rule out that possibility, a second, relative size criterion should be incorporated, namely that an institution is no larger than a given part of the GDP of the member state in question.

These criteria result in a practicable and prudent initial assignment to the category of small institutions. They are not enough, however, as they could also lead, for example, to institutions with risky business models coming under the simplified rules. This has to be avoided under all circumstances; and a series of hard additional conditions has to be set.

- First: only institutions subject to insolvency proceedings in the event of insolvency may become part of the box.
- Second: candidates for the small banking box should not have any significant capital market

- or cross-border activities.
- Third: they should have a small trading book as well as a small derivatives book.
- Fourth: they should not be using any internal models.

Taken together, this list of requirements will result in institutions with riskier business models being excluded from the outset. Above and beyond that, we also must not forget systemic risks that can stem from the interconnectedness of a large number of small institutions – the "too many to fail" problem.

And, when all's said and done, the final decision – even if all the criteria are fulfilled – should always be up to the supervisors. If they have serious objections, they can refrain from supervising an institution under simplified rules.

This possibility of choice should not be a one-way street, by the way. I take the view that even institutions that are potential candidates for the small banking box should still be able to opt voluntarily for supervision under the more demanding rules.

A sensible and practicable definition of the institutions for which simpler conditions are possible is therefore quite feasible. This only leaves the second key question: What is it exactly that should be made simpler?

In some areas, a simplification could be achieved by institutions in the small banking box being entirely exempted from certain requirements. I could imagine the smaller institutions being freed largely of the disclosure requirements as well as the remuneration regulations being abolished.

But we should also give thought to making things simpler in other areas. The reporting system could be limited to a core reporting system, for example – a standard approach in the reporting system, so to speak. In the second pillar, in other words the prudential monitoring of the institutions, there could be a reduction in the scope and depth of detail in the audits. And I can see potential in some places in the field of corporate governance.

So, there is no shortage of possibilities for making things simpler. To avoid any misunderstanding: what I have outlined here is, for the moment, a collection of ideas and not a ready-made plan. It is still too early for that. Nevertheless, we at the Bundesbank together with BaFin and the Ministry of Finance are already working on a concrete, detailed draft. We shall shortly be entering into a dialogue on this with the associations.

But it should be clear from the outset that a small banking box has its limitations. What is especially important is that capital and liquidity requirements are not lowered or watered down.

5 Conclusion

Ladies and gentlemen, the idea of a small banking box cannot be put into practice overnight. However, and this is important for me: the approach can indeed work. As a systematic and comprehensive solution, it could restore the requisite measure of proportionality in regulation. I am therefore advocating an open debate.

It is no less important to me that this debate should not be exploited for a general critique of regulation. Prudent, but also strict regulation and supervision are indispensable for both fiscal and macroeconomic stability.

I am asking you all as institution representatives for nuanced contributions to the debate on more proportionality. Make specific detailed proposals to the supervisors; let us know where you perceive unnecessarily high burdens. In that way, we can work to together to achieve a balanced solution. Thank you.