Andreas Dombret: Heading towards a "small banking box" – which business model needs what kind of regulation?

Presentation by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the Bavarian Savings Bank Conference, Erlangen, 29 June 2017.

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1. Introduction

Minister President Seehofer

Mr Netzer

Ladies and gentlemen

Thank you very much for inviting me to come and speak at the Bavarian Savings Bank Conference today – it's really great to be here. The Bundesbank and the savings banks have built up a strong tradition of close interaction, and that is something that's important to me.

The topic of my presentation is the effects of regulation on smaller banks and savings banks. But I'd like to start by talking about confidence and trust. These are very crucial elements in the business models of banks and savings banks – smaller and medium-sized institutions are no exception here.

Confidence and trust play a very special role for these smaller and regionally based banks. The fact that private customers and companies place their trust in regional presence and long-standing relationships became very clear during the last financial crisis: while confidence in the financial markets faded in general, deposits with cooperative banks and savings banks grew at a rapid pace. I think this is a sign of strong faith in the sustainable business models of these locally based institutions.

But even these business models have challenges to face. This ties in with the name of this year's Savings Bank Conference: "Modern banking. Successful business model." Despite the strength of their business model to date, savings banks need to ensure they have a successful and modern business model in place. The challenges facing them can mainly be seen by the fact that branches are still closing and banks are still dying – and that includes savings banks and cooperative banks as well. Last year, the total number of German institutions fell by 72 to 1,888 – that's 3.7% fewer banks, which is not exactly a small number. While the decline in savings banks was not quite so serious, at 2.4%, it was still significant. Out of the 413 savings banks in existence in 2015, ten disappeared due to mergers.[1]

With all these banks falling by the wayside, many people are starting to get concerned – they're worried about a lack of diversity in the banking sector. Others realise that this reduction in numbers is a necessary evil for the German banking sector, which has been described as "overbanked". These people see a market consolidation as inevitable and essential.

As is so often the case, the truth lies somewhere in the middle. Sure, a certain loss of business is unavoidable and also makes sense in the current environment, but this doesn't necessarily mean that the number of banks and savings banks needs to drop; there's no reason why larger banks couldn't just get smaller.

A severely consolidated sector is surely not in our country's best interests – at least, that's the way I see it. I am convinced that a diverse banking system – made up of small, medium-sized and large institutions and with a range of different business models – is the best thing to guarantee stability and to make sure that the various customer needs are met.

That’s why I take it very seriously when banking regulation is cited as one of the main reasons banks are shutting down. If people think that regulation is creating competitive disadvantages for small banks, as an involved party, that’s not an accusation I can, or should, just brush aside.

And that’s why I’d like to talk to you today about the outcomes of the regulatory reforms since the financial crisis, and particularly, their significance for smaller, regionally based savings banks and banks. I will explain where I see the reforms adding real value, but I’d also like to explore whether and where the new rules might be asking too much of the smaller banks. I’ll finish by saying a few words about how we might be able to relieve some of the pressure on smaller institutions, focusing in particular on the “small banking box".

2. Banks and savings banks in a state of transition

But before we move onto regulation and supervision, let’s take a quick look at the challenges facing the German banking sector. Banks and savings banks are currently in the throes of transition. The overcapacity that has built up over the years needs to be reduced again, the business and market environment has become considerably tougher, and the drop in interest rates makes things much more difficult for those whose business models depend heavily on interest income. And finally, digitalisation is demanding a completely new level of efficiency and innovation.

In other words, the forces of the market economy and of progress are seriously challenging banks and savings banks.

But now I’m hearing more and more often that the new regulatory regime is the main problem facing banks and savings banks in Germany. I’ll put it bluntly: that’s pretty much the same as saying that the coal industry could be revived if only there were less government regulation again.

There’s no doubt about it: the banking sector is facing huge challenges – challenges that have nothing to do with regulation. And it’s highly likely that the sector will shrink even more.

This means two things. First, you, as heads and employees of these institutions have to do all you can to succeed in this changing environment. In some cases, this will mean reinventing yourselves and finding even better and more efficient ways of shaping your businesses.

And second, I think we supervisors need to identify areas where we could improve the regulatory regime. And as I see it, there’s one major step we can take here: we need to relieve small, regional, less risky banks and savings banks of the operational burden associated with regulations that were actually established with large international banks in mind. And this brings me to the focal point of my presentation today.

3. Strong regulation, weak institutions?

What I’d like to talk about now is what’s known as the “proportionality debate” – a topic that’s received a lot of attention over the past few months.

Let’s cast our minds back ten years: the financial crisis was ruthless in exposing all the holes in the regulatory regime at the time. These holes were systematically exploited and the result was a massive shock at the macroeconomic level. It has since become clear that it is not strong regulation that damages an economy, but weak rules.

With Basel III and the banking union, Europe now has the stricter rules it so desperately needed and a common European approach to supervision. So, to some degree, we can rest easier now.

But these rules are mainly geared towards large banks with international ties, which is not exactly surprising considering these banks were the ones at the epicentre of the crisis. Consequently,

the Basel Committee focuses its attention on precisely these institutions.

It is especially the case in Europe, however, that the international standards since Basel I are being applied to all banks. And thus, we now have a single rulebook for the EU. But since Basel II, this unity has come at a high cost to smaller and medium-sized institutions.

The Basel III reforms have made it even harder for these banks, as the rules are getting more and more complicated and explicit, and the list just keeps getting longer. We have the guiding principle of the reforms to thank for this: risk-oriented governance and regulation are there to help banks to allocate capital resources as efficiently as possible. But in order to prevent a state of undercapitalisation, this approach needs very specific rules. This increases the compliance workload – that is, the effort associated with meeting the requirements as well as demonstrating that they've been met.

Particularly for credit institutions that are able to strongly optimise their employment of capital in order to benefit from higher returns, this is worth all the effort. And it's worth it for especially large credit institutions because they can profit from economies of scale where fixed costs per product fall as the volume of business increases. This then also makes it easier to finance a larger compliance department.

Smaller, regionally based institutions, however, cannot normally rely on these economies of scale or a strong risk appetite for a source of income. Seen from an individual business perspective, the cost of regulation is similar or even higher for these banks, but their ability to take advantage of these complex strategies is somewhat weaker.

In other words, the complicated risk-oriented approach favours banks with a large organisation, whose activities are more complex and which take on greater risks. The reason we should be giving this more thought is that the vast majority of German banks and savings banks are smaller institutions; about 1,000 credit institutions in Germany recorded total assets of less than €1 billion in 2016; for a further 500, this figure was somewhere between €1 billion and €5 billion.

We therefore need to ask ourselves two questions. How appropriate are the new regulations for smaller, regional banks? And is there any way we can simplify or even get rid of requirements that are out of proportion?

4. Regulation: strict, complex and proportional?

Before I go on to discuss the solutions to these issues, let me first make one thing clear: I do not subscribe to the view that small banks and savings banks are put at a systematic and deliberate disadvantage – and that is because regulation and supervision have been proportionate in many areas for many years already. Furthermore, I don't believe that smaller and regional institutions are risk-free per se; instead, every individual credit institution requires robust regulation for the benefit of all.

What this means is that even small market players cannot expect a regulatory free pass – they, too, are not exempt from regulation. What this also means is that any alteration of the rules needs to meet the essential prerequisite of posing no risk to financial stability. However, within these bounds, I fully support the goal of lightening the disproportionate burden placed on smaller institutions.

Doing nothing is therefore not an option for me. As important and justified as the reforms were, we must also recognise that – as far as smaller institutions are concerned – they have, in large part, overshot their target.

This does not mean that I would propose easing the minimum capital and liquidity requirements for smaller banks and savings banks, be it by systematically reducing them or by introducing

unclear exemptions. For one thing, this would bring little relief to smaller institutions, the majority of which are well capitalised, and, for another, the set minimum requirements are already broadly balanced.

On the contrary, I suggest keeping the strict capital and liquidity requirements currently in place while factoring in some reasonable relief from complicated organisational and administrative rules. Simpler, but robust – to my mind, this is what regulation should look like for banks and savings banks that are not large, complex or risky.

As I see it, this means that we need to examine the rules more closely. I think that a review of the CRR and CRD IV, as is currently taking place in the EU, is a good place to start. For instance, in its proposal for a CRR II and CRD V, the European Commission expressed its intention to reduce the burden on smaller institutions in all reform areas. The draft consultative document contains various relief measures and de minimis thresholds, such as in disclosure and reporting requirements and in trading book regulation. Institutions below these thresholds would be subject to simplified rules, with some requirements even being abolished altogether. This would mean, for instance, that small institutions that do little proprietary trading would not be subject to the new, complicated rules.

I consider de minimis thresholds to be quite a reasonable approach to reinforcing proportionality in regulation.

But it isn't enough – this won't really do much to make the rules less complicated for smaller institutions. In my opinion, what we need is an entirely new and, if you like, more radical way to reinforce proportionality: a specific, independent set of rules for smaller institutions.

This new approach now has a name: the "small banking box". I believe that the small banking box is the approach best suited to systematically easing the operational burdens placed on banks and savings banks.

And that is why I'm also so pleased to see that this debate is gaining momentum and has even given rise to specific projects. In Germany, we at the Bundesbank have already worked in collaboration with BaFin and the Federal Ministry of Finance to draw up a concrete draft. This took place with the close involvement of the relevant associations. The Federal Ministry of Finance is pulling out all the stops to promote the project in the EU, while we at the Bundesbank are making the case for the small banking box wherever we can – setting our sights, first and foremost, on our fellow central bankers. The next step needs to be to gain broad support for the project – which, while undoubtedly a challenge, is by no means impossible.

I have a clear goal in mind here: a set of rules that makes demands on small banks without placing an unnecessary burden on them. By unnecessary burden, I mean provisions such as far-reaching reporting requirements or a framework for rules on remuneration. Of course, it will be impossible to fit all of the rules on the back of an envelope – but at least the list of requirements would be much shorter and considerably easier to understand, and complying with the rules would become a much less time-consuming exercise for small institutions.

5. Simple, but effective: the small banking box

This is what the small banking box sets out to achieve. But what form might this box take? It sounds as though it would be necessary to establish an entirely new set of rules. But it doesn't need to be all that difficult – a separate, short passage in the CRR would suffice.

The two cornerstones of the box are establishing a definition of those institutions to which a simplified set of rules could apply and, of course, determining the areas in which the rules would be eased.

Let’s start by establishing a definition. I previously spoke of a set of rules for small institutions. An initial criterion for determining whether a bank or savings bank would be subject to simplified rules would therefore be a comparatively low level of total assets. A reasonable threshold under which simpler rules could be applied to an institution would be around the low single-digit billion range, although the level at which this threshold should ultimately be set is up for debate for the time being. Still, if the threshold were set at total assets of €3 billion, for instance, this would affect 82% of all institutions in Germany but only 14% of aggregate total assets.

However, an absolute threshold on its own could lead to a situation in some EU countries in which many or all institutions would then be subject to the simplified regime. To stop this from happening, a second, relative size criterion should probably be considered: namely that an institution is not bigger than a certain share of the gross domestic product or banking market of the member state in which it is domiciled.

These criteria make it feasible to establish an initial sensible, workable definition of a small institution. But they are still not enough as they could, for example, result in institutions with risky business models also coming under the simplified rules. This needs to be avoided, which means that it would make sense for these criteria to be accompanied by a raft of tough secondary conditions as follows.

- First, only institutions that would be subject to insolvency proceedings in the event of resolution may be part of the box.
- Second, candidates for the small banking box may not undertake any notable capital market or cross-border business.
- Third, they should have, at most, a small trading book and only a small derivatives book.
- Fourth, instead of internal models, they may only use the standardised approach.

By adopting this list of requirements, institutions with riskier business models can be excluded from the very start. What’s more, we should not forget the systemic risks arising from the connectedness of many small institutions – that is to say, they are “too many to fail".

In the end, the final decision should always rest with the supervisors. Should they have serious misgivings, they can opt not to subject an institution to the simplified rules.

Incidentally, this ability to choose should be anything but a one-way street. I believe that credit institutions that would be considered eligible for the small banking box should also be given the option of opting to be supervised pursuant to the more complex rules.

What I wanted to show to you is that it is perfectly feasible to establish a sensible, workable definition of institutions that are eligible for relief measures. But the second all-important question remains unanswered: what in the box actually needs to be simplified?

In some areas, relief could be provided by completely exempting institutions in the small banking box from certain requirements. For instance, I can imagine small institutions being largely exempted from disclosure requirements and remuneration rules being abolished.

But I also think that we should consider easing requirements in other areas. For example, the reporting process could be reduced to a core reporting process – a standardised reporting approach, so to speak. In Pillar 2, which covers the supervisory review process for institutions, reviews could be scaled back in terms of scope and level of detail. I also see scope for relief in some areas of corporate governance.

Much could be achieved by taking these steps. Political perseverance is now required, as these changes need to be incorporated into the revised version of the CRR. Such a move needs majority backing across the EU, and we all know how difficult it is to pull that off.

But several lines need to be drawn in the sand with respect to the reforms. First, capital and liquidity requirements, which were only recently tightened, must not be undermined. Second, requirements cannot be eased for systemically important institutions. Third, only institutions with sound business models and risk profiles should benefit from the simplified rules – in this regard, medium-sized institutions should be viewed with caution. From the Bundesbank's perspective, these are lines that cannot be crossed.

6. Conclusion

Ladies and gentlemen, the regulatory reforms implemented in the wake of the financial crisis are a major accomplishment – it would be a serious mistake and go against the public interest to undermine them. However, we need to systematically examine the areas in which regulation is disproportionate for small institutions.

The small banking box represents a highly promising solution to the issue of establishing greater proportionality.

But, as I have previously stated, the success of this project is anything but certain. Nevertheless, it stands a realistic chance: when I started drumming up support for this project over a year ago, most people still deemed it highly unrealistic. But that is no longer the case – we have now reached a point where it is more than worth the effort to put the project into action.

Let's combine our efforts to win the backing of Brussels for such a project – let's objectively demonstrate why this would bring with it major benefits, not only for the German economy but also for the European Union.

Let's present a united front on this issue and all pull together.

Anyone who wants to preserve the diversity of the banking landscape ought to have the courage to graduate regulation – at least to a certain extent. We now have an excellent opportunity to make this happen. Let's use it.

Thank you for your attention.

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[1] Here we are seeing a continuation of a long-term trend, as the past few years had already shown a clear decline. In the past 20 years, the number of German credit institutions has dropped from over 3,000 to considerably fewer than 2,000. This decline has primarily been among smaller savings banks and cooperative banks, with savings banks falling by one-third from more than 600 to around 400.