

Sabine Lautenschläger: Is small beautiful? Supervision, regulation and the size of banks

Statement by Ms Sabine Lautenschläger, Member of the Executive Board of the European Central Bank and Vice-Chair of the Supervisory Board of the European Central Bank, at an IMF seminar, Washington DC, 14 October 2017.

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The call for greater proportionality in banking regulation and supervision is growing louder – not just in the United States and Europe, but also globally.

To put it bluntly, proportionality involves applying a different set of rules to banks operating in the same market. Careful consideration must therefore be given to the various objectives pursued, and the costs and benefits involved.

On the one hand, this means that we need to assess the financial stability risks posed by individual banks and groups of banks. And we need to look at the implications of proportionality for local competition.

On the other hand, we have to consider the costs of regulation and supervision. Small banks face greater difficulties in complying with complex regulation. This may put them at a disadvantage and therefore reduce diversity in the banking sector. However, a wide diversity of small and medium-sized banks makes the banking sector more stable. Thus proportionality may be necessary to foster such diversity.

These are the kind of trade-offs we need to talk about.

But let me begin by talking about risks, as this is the starting point for regulation and supervision.

It can generally be assumed that the failure of a small bank poses a smaller risk to the financial system than the failure of a big bank. So it might make sense to apply a different regulatory and supervisory regime to small individual banks.

However, when many small banks with the same business model form mutual liability arrangements via institutional protection schemes, qualified holdings or integrated cooperative structures, they might become systemically relevant – at least at national level.

In the event of a failure, all these small banks taken together could pose a big risk to the financial system. This is known as the “too many to fail” problem. It deserves particular attention – and probably a response that goes beyond the standard microprudential supervision that we are here to talk about today.

As small banks are generally less risky, the costs and benefits of regulation and supervision may not be balanced for small banks in some areas. Applying to small banks the same approach that is applied to large banks would not be proportionate, as the costs, in particular of complex prudential rules, would be higher in comparison and the benefits would be smaller.

So there is a strong case for proportionality.

Looking at the European situation, the EU’s single rulebook already provides for such proportionality in many cases. For instance, reporting requirements for small banks are far less stringent than those for large banks: small banks have to report about 600 data points to supervisors, whereas larger banks have to report more than 40,000.

The question is whether more proportionality in banking regulation is needed?

Indeed, the discussion in Europe is currently focusing on changes in several additional areas which will enable banks to apply simpler rules and thus reduce compliance costs for smaller banks:

- ♦ One proposal focuses on the capital requirement rules for market and counterparty credit risk. Banks with small trading books below €50 million could be exempted from the obligation to have a prudential trading book. This would enable them to use the simpler credit risk framework.
- ♦ Banks with trading books below €300 million could use a simpler standardised approach to calculate market risk.
- ♦ Similarly, in the field of counterparty credit risk, banks with small derivative portfolios might be able to use a simpler standardised approach to calculate capital requirements.
- ♦ Another proposal looks at reducing the regulatory burden of small banks by softening reporting requirements. Some of the proposals discussed involve reducing the number of data points to be reported by using simplified templates and less granular data.
- ♦ Less convincing are proposals which involve less frequent reporting. This would not result in cost savings, as banks would still have to invest in setting up reporting structures. But it would mean that supervisors would have to work with outdated information.
- ♦ There are also suggestions to reduce the disclosure obligations for small banks, in particular non-listed ones. This would significantly reduce their administrative burden.
- ♦ And there are proposals to exempt smaller banks from some remuneration rules – something that is worth discussing.

A great many proposals have been put forward altogether – I will refrain from listing them all.

The critical question is: what do we want to achieve through the proportional regulation and supervision of small banks? Would it mean that these banks could hold less capital, less liquidity?

In my opinion, proportionality means simpler rules for smaller banks. But it does not mean that the rules should be generally less stringent, or that banks can hold less capital or liquidity.

Finally, a crucial issue is where to draw the line between small and large banks.

Depending on the objectives of proportionality, the line might be drawn according to the volume of total assets; or it could be linked to the size of specific business activities. It might also depend on banks' business models or on whether or not banks use internal models. And the size of a bank relative to the country's total banking assets could also play a role.

Both quantitative and qualitative criteria need to be assessed when considering where to draw the line between small and large banks.

To sum up, small banks are generally less risky than larger ones. So a proportionate approach to regulating and supervising small banks is indeed appropriate.

An approach that resulted in simpler rules for small banks could help to balance the costs and benefits involved – but it should not result in small banks holding far less capital, as they also need to remain resilient during an economic downturn in order to continuously provide credit to the economy.