Andreas Dombret: Sometimes small is beautiful, and less is more – a Small Banking Box in EU banking regulation

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at a lunch debate on proportionality in banking regulation at the Representation of the State of Hesse to the European Union, Brussels, 19 October 2017.

* * *

1. Introduction: Striking the right balance

Ladies and gentlemen

At the end of the day, regulation is always about striking the right balance.

Regulators are always torn between "the stronger, the better" and "sometimes less is more".

We need to strike the right balance – to find a middle ground – between too weak and too constraining regulation. Today, I want to focus on a very important – but frequently neglected – aspect of our balancing act: that between setting robust standards for global banks, on the one hand, and allowing different business models of the many small and medium-sized banks in Europe to co-exist, on the other.

We are not quite there yet. The core problem is that our regulatory architecture still lacks sufficient proportionality – in non-technical terms: the rules are too complex for small, locally oriented banks.

Today I want to explain why this is the case – and why Europe's decision makers should care. I will begin by outlining how the current regulatory regime of complex rules that governs virtually all banks in the EU came into being. Then, I will devote most of the rest of my speech to laying out a solution for the EU's banking sector: the Small Banking Box – a separate set of rules for smaller, locally oriented, and less risky institutions.

2. International, complex rules for small, local banks

But let me first outline the challenge at hand: All banks in the EU are subject to a single set of strong, but also complex and detailed, rules. These rules are derived from an international standard developed in a global forum. Why is this a problem?

International standards for the banking business are very important. In fact, they are a key element of global financial stability. That's why the Basel Committee, a global forum of regulatory authorities from the G20 nations, develops these standards.

But we need to keep in mind that these rules were originally designed to level the playing field for internationally active banks across the globe. And to prevent a regulatory race to the bottom among jurisdictions.

Naturally, they have therefore been fitted to the organisational structures, the business models, of such large international banks. Since the adoption of the international Basel II framework in 2005, the complexity of these rules has mushroomed.

The Basel III reforms launched in response to the last financial crisis – including the final elements of the Basel III package that we are currently negotiating in Basel – have made the rules even more detailed and complicated.

We have the guiding principle of the reforms to thank for this: risk-oriented governance and regulation are there to help banks allocate capital resources as efficiently as possible. But in order to prevent 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.

The Basel rules were made for large, internationally active banks – they were not designed with small banks in mind.

Yet, in Europe, we adopted these rules for all European credit institutions alike – including the thousands of small and medium-sized banks with simple business models and regional focus.

The motivation for this one-size-fits-all-regulation was to have a single set of rules for the single market. The EU's primary goal of a common, single market meant that one single set of rules was preferred over differentiated sets of rules. Proportionality – the principle that rules must be proportionate to the issue they address – played only a secondary role.

While this makes good political sense, it has had serious side effects – as it favours large, internationally active banks over smaller institutions.

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 as a source of income. Seen from a single-entity 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 European banks – around 7,000 in all – are smaller institutions.

The lack of proportionality is a serious concern. In my eyes, it entails at least three issues.

First of all, small banks simply do not have the resources to cope with the sheer volume of regulation. Employing another eighty employees for compliance is quite manageable for a large international bank. But to a small institution with only fifteen or twenty FTEs, another two administrative staff members might well no longer be affordable. Thus rules create distortions in banking business.

New regulation typically need not worry about such business distortions if it serves the greater good. Anti-smoking regulation, for instance, is actually intended to interfere with the tobacco market. But in the case of banking regulation, the situation is different. Some requirements developed for large international banks have proved ineffective for small credit institutions, simply because these enterprises are less complex, do not engage in comparable business fields and are thus exposed to fewer risks. Ineffective regulatory burdens are the second issue for smaller institutions.

The third concern is about potential financial stability issues. Due to their local focus, small institutions perform an essential function in funding small and medium-sized enterprises. And during the crisis years, small institutions have proven to be more robust – not least due to their simple and less risky business models. Thus one-size-fits-all-regulation threatens the healthy diversity of the European banking landscape.

3. Sometimes small is beautiful, and less is more: The Small Banking Box

This has spurred the European Commission to take action. In November 2016, it put forward its proposals for strengthening proportionality as part of the general overhaul of EU banking regulation. These proposals include important changes to the small print, and I am certain that we will be able to roll out a number of meaningful initial improvements.

That said, the proposals don't go far enough. Therefore, I strongly support more graduated regulation, including a simple set of rules for small and non-complex banks. I call this more fundamental solution the Small Banking Box.

The blueprint for this idea was drafted in a German Expert Working Group. The aim of this group was to develop specific proposals on how to fundamentally alleviate the burden of regulation on small institutions with simple business models. And it delivered on that aim. The outcome is a "non-paper" which the Federal Ministry of Finance put before the competent expert group of the European Commission in June this year. Let me briefly walk you through the approach.

4. The "Who"

First, let me address the "Who?", namely the intended addressees of the relief measures. The proposal follows a three-tier approach.

At the very top are the systemically important and potentially systemically risky institutions – the smallest group in terms of numbers but extremely important in terms of risk. Nothing will change for these institutions. They remain subject to the full Basel III requirements, additional capital buffers, total loss absorbing capacity, and so on.

The second group includes institutions which are neither large and systemically important nor small and low-risk, which is why it is not possible to make extensive simplifications for them. Nonetheless, some targeted relief measures should be taken by making specific amendments to the current regulations.

Finally, the third group is made up of small and non-complex institutions – the banks that are most affected by the fixed costs of regulation. This group – the largest in number – would see its cost burden alleviated radically by means of a separate regulatory device: the Small Banking Box.

The burning question now, of course, is which institutions belong in which group – and particularly, which banks could be included in the Small Banking Box. These classifications have to be balanced carefully, and this should be part of a European-level discussion.

Importantly, size wouldn't be the only criterion. I've already said that not only do institutions in the Small Banking Box have to be relatively small, they also must not be too complex. This is why we will need additional criteria that prevent institutions with riskier business models from being part of the simplified regime.

Experience has taught us, however, that there will almost never be a perfect list of criteria that covers every eventuality. This is why the final decision should always rest with supervisors. Should they have serious misgivings, they can opt not to subject an institution to the simplified rules. They can also take into account the systemic risks arising from the connectedness of several small institutions – that is to say, small banks which are "too many to fail".

This set of options should not be a one-way street. I believe that institutions that would be considered eligible for the Small Banking Box should also nevertheless have the option of being supervised under the more complex rules.

5. The "What"

That leaves the second key question: what exactly might the box look like? Here we must aim right at the heart of the problem, namely, the paperwork which the complex requirements create in various areas.

Some of these requirements could be completely eliminated for institutions in the Small Banking Box. I could, for instance, imagine largely exempting small banks from disclosure requirements and abolishing remuneration rules for them. In addition, they could be absolved from recovery and resolution planning.

Full exemption from other requirements would be a step too far. But that should not prevent us from trying to make life easier for small banks. For example, reporting could be reduced to a core reporting process – a standardised reporting approach, if you will.

When designing the Small Banking Box we must weigh up the benefits for supervisors, i.e. ensuring financial stability, against the burden it creates for banks. As a rule of thumb, we can say that any rules that are dispensable for effective supervision are up for negotiation.

Conversely, however, that also means that a lot of rules are not up for de-bate. And that brings me to the limits of the Small Banking Box. Importantly, there can be no concessions regarding risk-based capital ratios, the leverage ratio or the short-term liquidity ratio. And the list goes on. Small banks' business models are neither per se simple nor automatically low-risk – and that is particularly true when looking at them as a whole. The new regime must therefore be simple yet robust. Whatever happens, financial stability must be guaranteed.

6. Conclusion

Ladies and gentlemen

Europe's banking sector is still struggling with the legacy of the financial crisis. Regulatory reform has made sure that this is done in line with clear, strong rules.

But: In 20 years, do we want Europe's economy to be served by 50 banks – all of them much too big to fail – and not interested in financing rural development? Or do we want a robust sector with several thousand institutions – with very different business models, serving the different needs of different customers? This future banking sector is what I imagine for a robust European economy – it is agile and it is resilient!

I am deeply convinced that it is worth to change regulations toward this end.

We need to strike a better balance between setting standards for internationally active banks and allowing for different business models of the thousands of small and medium-sized banks in Europe.

Clearly, we can only meet this task at European level. That's why we need to move forward with proportionality within the current review process of CRR and CRD IV. But we must also push for a more fundamental solution.

Therefore, I am calling on the Commission Expert Group on Banking, Payment and Insurance to give priority to the work on proportionality – the Small Banking Box is the most effective and efficient strategy to enhance proportionality.

More debate is needed on this topic. And that's why I am pleased to see that we have gathered such a diverse group of experts and stakeholders here today. I am now looking forward to hearing your views and discussing them with you.