Andreas Dombret: Addressing proportionality in Europe

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the 13th BCBS-FSI High-level Meeting for Africa on "Strengthening financial sector supervision and current regulatory priorities", Cape Town, 24 January 2018.

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1. Introduction

Dear Fernando Restoy

Ladies and gentlemen

Welcome to the second half of the day. I am very happy to be here – both here to discuss with you, and here in South Africa.

It's no secret that speakers customarily try to set a good mood when they begin their remarks with a few nice words about the places they visit to speak. I'm usually not one of those persons – except in South Africa.

South Africa is truly one of my favourite destinations in the world, and I visit this country several times each year. Now it's not always fun and games: I usually have some work to do when I get here. But the fruitful interactions with my valued colleagues from the SARB and others from the African central banking and supervisory community have always made the trip worthwhile. Saying that, I am also looking forward to the discussion with you today.

Before the lunch break, Bill Coen and Adam Farkas already spoke, among other things, about Basel III. I would like to follow up on that and – given that, as a member of the Basel Committee, I was involved in the negotiations – say a few words from my own perspective as well. With that, I will lay the groundwork for the remainder of my talk, in which I will focus on implementation of the Basel rules and state my case for proportionality.

2. The long road to Basel III

Many observers of the Basel negotiations – journalists, politicians, industry representatives and fellow colleagues from the central banking and supervisory community – have repeatedly asked me the same question: Why did it take so long to finalise Basel III? After all, significant parts of the reform had already been agreed upon in 2010, yet it took us about seven more years to finalise the reform.

As I can understand this question very well, let me try to answer it. I see two main reasons why it took so long.

First, our task was extremely complex on a technical level. We had to balance multiple, intertwined goals – always with an eye on potential unintended consequences. There were plenty of open questions. Do the new rules distort risk-taking behaviour? Do they truly resolve threats – or simply shift problems? How can we level the playing field for a diverse global banking sector? And so on.

So the finalisation package was about achieving a balanced overall set of rules. This required us to study the details, to review every single rule with great thoroughness, often multiple times. And this is essentially what we did in the past years.

The second reason why finalisation took so long lies in the diversity of the views of the countries involved in the negotiations. Countries differ in the characteristics of their national banking

sectors, in their supervisory cultures, in their policy traditions. These differences lead to a mix of opposing opinions that are, by nature, difficult to reconcile.

Other members of the Committee and I were convinced that having common global rules is a crucial long-term investment in financial stability at both the global and regional level. This is the view we very much had in common. We agreed that even if agreeing to compromise sometimes hurts, there is great value to it.

This holds even more when we consider that many parts of the Basel agreements are implemented not only by the members of the Committee like South Africa, but by over a hundred countries worldwide. These include many other African countries, of course – countries as diverse as Kenya, Malawi, Egypt, Nigeria and Mozambique, to name just a few.

Therefore, I am convinced that the effort we have put into the post-crisis reforms and the compromise we have found will pay off for all of us. It will contribute to a healthier and more sustainable global financial order.

With respect to the regulatory agenda, it is now time to take a step back, to wait and see how the new rules play out. There are a few areas where action is called for, such as the regulatory treatment of sovereign bonds. But apart from that, we should not tighten the screws of regulation further. Financial institutions need regulatory certainty, and they need a period of respite.

We should use this break to thoroughly evaluate the impact of our recent reforms, and to amend and improve them where gaps and errors are found.

3. Getting implementation right

In parallel, we need to focus our energy on the comprehensive and consistent implementation of the Basel rules. Good rules are not worth the paper they are written on without good implementation. The success of Basel III depends crucially on whether or not we get the implementation right.

But what characterises good implementation? First and foremost, implementation must be full and consistent with the agreed standards. I say very openly that in the past, we didn't always get implementation right. Basel II, for example, was not fully implemented either in the US or in the European Union. And other member states of the Committee weren't fully compliant either.

We shouldn't repeat these mistakes. Implementing only what suits you – implementation à la carte, if you like – goes against the very idea of having a common regulatory standard. During the negotiations, my European colleagues and I insisted that the US commits to fulfilling all parts of Basel III. In return, of course, this means that the Europeans and every other member must consistently implement all parts, too. And the Bundesbank is interested in that this happens.

There is another central aspect to getting implementation right. It is that regional differences and local circumstances are accounted for.

Let me give you an example from Europe. The banking sectors of Germany and our neighbour France are more or less the same size in terms of total assets. But look closer and you will find that they are quite different from each other. Profitability of German banks, measured by return on assets at the end of 2016, was at .11 percent whereas their French peers reached .42 percent. Germany has about 1,700 credit institutions and foreign branches while France has fewer than 500. Germany has one global systemically important bank while France has three. The German banking system is very diverse – in particular, there are a large number of small banks. The French banking system is more dominated by large banking groups, similar to South Africa's.

The important thing is that, as supervisors and regulators, we must remain neutral towards such differences. No regulation, no supervision should aim to change the structure of the financial sector or put a particular sector, a particular business model or a particular size at a disadvantage. The shape of the financial sector should be determined by market forces only.

4. Complexity and proportionality

When I look at the European regulatory framework with this condition in mind, I see room for improvement. With some notable exceptions, we currently more or less apply the same rules and procedures to all banks, irrespective of their size and their relevance for financial stability. In practice, this puts small institutions at a disadvantage compared to their larger peers. It runs counter to the idea of a level playing field and creates problematic incentives in terms of uniformity and size in the banking sector. This needs to change. I am convinced that we need to strengthen the principle of proportionality in banking regulation.

Now some of you might want to stop me at this point and ask: How do you reconcile that with the full and consistent implementation of Basel III that you just advocated?

To answer this, let me point to the original idea of the Basel rules. The task of the Basel Committee was, from the outset, to create globally harmonised rules for large, internationally active banks to ensure that they are stable and operate on a level playing field. Over time, and especially with Basel III, this resulted in an increasingly complex regulatory framework – a reflection of the mounting complexity of the global banking business.

This complexity is warranted for large, interconnected banks, and the sector's global players are certainly in a position to get to grips with the complex rules. But in actual fact, the bulk of these rules, especially in Europe, apply not only to major multinational institutions but to every single bank including small savings banks and the majority of cooperative banks. And that has turned out to be quite a problem. Because small and medium-sized institutions do not benefit from the same economies of scale that their larger rivals can harness. For example, small institutions face much heavier costs, relatively speaking, when they invest in ITinfrastructure or hire additional employees for their compliance department.

The implementation of the Basel framework in European regulation today already takes account of proportionality to a certain degree. But in practice, I repeatedly encounter situations where, in my view, the existing gradations are inadequate. So the proportionality principle is nothing new, but it hasn't been anchored deeply enough yet.

I am very convinced that proportionality is important – for several reasons:

- It ensures fair competition on a level playing field.
- It prevents the unwanted side-effect of structural policy through regulation.
- It strengthens the principle of risk-oriented supervision.
- It prevents regulation from unnecessarily hampering efficiency.

All in all, I think that proportionality is necessary to safeguard the original goals and spirit of the Basel framework.

5. Addressing proportionality in Europe

The European Union is acknowledging this, and we are taking action. The process started back in 2016 with an initiative launched by the finance ministers from the UK and Germany. As we at the Bundesbank also felt strongly about the topic, we went public with the first set of specific proposals for addressing proportionality in Europe shortly afterwards. Since then, we have been working on enhancing and refining our proposals.

At the European level, we have seen the European Commission likewise table its proposals for strengthening proportionality as part of the general overhaul of EU banking regulation. The latest development is a draft report by the European Parliament, to which amendments could be made up until today and which I expect to be finalised in the near future. This will not be the last step, but it will be an important one in the legislative process.

Without pre-empting the final result of the legislative process, I want to give you an idea of how we will be approaching proportionality in the European Union. I will address the “Who", the “How” and the “What".

Let’s start with the question of “Who", namely who are the relief measures intended for. I have already said that we are targeting small institutions, meaning that the targeted group should consist of institutions with a moderate amount of total assets. However, what qualifies as a “moderate amount” is different in each of the member states of the European Union. To account for this heterogeneity, we will probably combine an absolute threshold for total assets with a relative one that takes the size of the national GDP into account.

This quantitative threshold should be supplemented by additional criteria that prevent institutions with riskier business models from benefiting from simplified rules. For example, banks that qualify must not use internal models. They should have a small trading and a small derivatives book. And they must not engage in any notable capital market or cross-border activities. And because experience has taught us that there will almost never be a perfect list of criteria that covers every eventuality, the final decision should always rest with the supervisors.

When it comes to the question of “How", you basically have the choice between two alternatives for improving proportionality. One is to change the fine print, that is, to introduce simplifications to and exemptions from individual rules. The other is to create a whole new framework tailored to small and low-risk banks. I personally believe the latter approach to be the more appealing, as it is the more fundamental and clear-cut alternative. The Bundesbank has been involved in the development of a concept for such a framework, and we call it the “Small Banking Box".

It remains to be seen whether the Small Banking Box will be the way forward for the European Union. At the moment, we seem to be steering more towards the “fine print” approach, which the Financial Stability Institute calls the “specific standard approach".

But in the end, it’s not the name that matters, and the form is only of secondary concern. What matters is the content, i.e. the question of “What". And here, the most recent European Parliament report is promising.

Importantly, the focus lies on reducing the administrative burden. We will aim to literally reduce the paperwork the complex regulatory requirements create in various areas for small and low-risk institutions. Among the measures we are looking at are exemptions from disclosure requirements, reductions in the granularity of reporting requirements, and a simplified form of the net stable funding ratio (NSFR). All of this is very close to what the Bundesbank has proposed and supported in the past.

When assessing potential areas for simplifications, we must weigh the benefits of regulation – that is, ensuring financial stability – against the burden it creates for the private sector. As a rule of thumb, we can say that any rules that are dispensable for effective supervision are up for debate.

Conversely, however, this also means that a lot of rules are not up for debate. Most importantly, there can be no concessions in terms of 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. A proportional regulatory regime must therefore be simple yet robust. Financial stability must not be put at risk.

6. Taking proportionality to the international level

Ladies and gentlemen, I am convinced that proportionality is a highly relevant topic – for Europe as well as for other countries and regions.

For this reason, I welcome the fact that the Basel Committee, too, recently addressed this topic. The Committee has reaffirmed two important things. First, it will stick to its original purpose of being a standard setter for the regulation and supervision of large, internationally active banks. Second, it considers proportionality as being a relevant topic.

Therefore, the Committee wants to examine the topic further, for example by conducting a stocktake of existing proportionality approaches. This will provide us with greater transparency as to how banking regulation works for smaller institutions in different countries including non-members of the Committee.

I welcome this approach. We should try to learn from each other and turn the differences between our financial sectors and the different perspectives resulting from them into an asset.

The Financial Stability Institute has already carried out an insightful cross-country comparison on proportionality in banking regulation. I am sure that Stefan Hohl will tell you more about it in a few minutes. Let me just say that I highly value this work of the FSI, and that I would appreciate to see more such work on proportionality from the FSI or the Basel Committee in the near future.

Now I am looking forward to your questions, and to learning from your perspectives on proportionality.

Thank you for your attention.