Andreas Dombret: Prospects for, and obstacles to, greater proportionality in regulation – a supervisor's perspective

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the second Regional Banking Conference of the State of Hesse, Brussels, 21 February 2018.

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1. Introduction

Ladies and gentlemen

I would like to start by thanking you very much for the warm welcome and for inviting me to this event.

When I was asked to speak to you here today about the prospects for, and obstacles to, greater proportionality in banking regulation, I jumped at the opportunity – and I did so because this is a topic that is especially close to my heart.

Let's take a look back: when the debate first started in 2016, I sought to have the Bundesbank review whether smaller credit institutions were unduly burdened by regulation. And once we were able to show clear signs of this, I decided that the Bundesbank should be quick to turn the debate towards potential solutions.

This is all the more important to us because we regard diversity as a key attribute, not only in nature and our society but also in our economy and the banking sector. After all, diversity is crucial to economic development, too – it means increased competition for the best approaches, more choice in decision-making, and greater innovation.

Today, I have been presented with the task of talking about regulatory proportionality from a supervisor's perspective. As you have already heard what the credit institutions have to say, I need only give a rough overview of the reasons for greater proportionality and the burdens weighing on smaller institutions. Instead, I will focus on the prospects for, and obstacles to, greater proportionality, before wrapping things up by outlining what greater proportionality in the EU might look like.

2. Why do we need greater proportionality?

The arguments in favour of greater proportionality are myriad – you have doubtless spoken about many of the reasons for it at this conference already. And, as far as banking supervisors are concerned, too, there are strong arguments as to why greater regulatory proportionality is needed.

Now that the financial crisis is over, we have stricter rules and a common European approach to supervision in the form of Basel III and the banking union. 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.

In Europe, however, the international standards since Basel I have been applied to all banks. In this sense, we have a single rulebook for the EU that is designed to guarantee a level playing field. That's one side – the bright side – of the coin. On the flip side – the tarnished side, so to speak – this unity has come at much too a high cost to smaller and medium-sized institutions ever since Basel II.

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. This is increasing the

compliance workload – that is, the effort associated with meeting the requirements as well as demonstrating that they have been met. In fact, these rules are well suited to the lion's share of increasingly complicated banking business – but the reality is that not all banks and savings banks have as complex a set-up as is assumed under the new framework.

After almost a decade of regulatory reform, the international community of banking supervisors has been asking itself a number of questions for some time now. In which areas are reforms counterproductive? Where are they disproportionate? To come to the point straight away, we can only answer these questions if we start by looking at the excessive strain placed on smaller and less complex institutions.

3. Opportunities and obstacles: reduce operational burden, retain minimum capital and liquidity requirements

What, then, do the burdens faced by smaller and medium-sized institutions look like? There is one point I would like to make quite clear. The problem is not so much capital or liquidity requirements but rather the high operational burden as a result of implementing these regulations and complying with them. This burden is considerable for all institutions, regardless of their size. However, small institutions, owing to their smaller staff sizes, are far less able to spread the costs of compliance across their employees and have to either hire additional staff or enlist external help. This tends to lead to proportionally higher burdens.

The diagnosis is therefore clear: small and medium-sized institutions are, to a certain extent, groaning under the weight of increasingly complex regulation, which often goes above and beyond the level of complexity seen in their business models. But what is the right course of action? Before we administer any form of medication, I would like to outline three principles that need to govern treatment.

- First, financial stability must remain our primary concern. In concrete terms, this means that institutions that are systemically important or pursue a risky business model cannot expect any easing of requirements.
- Second, the concept of the rule of law means, in short, that all relief measures must conform to the principle of equal treatment.
- Third, treatment is likely to be most effective where discomfort is greatest – in other words, it should target the day-to-day burden for institutions with low-risk business models. Any easing of solvency or liquidity rules is out of the question.

Allow me to expand on the last point: virtually all smaller institutions already meet capital and liquidity requirements. Recently, when finalising Basel III, we saw to it that smaller institutions, in particular, would not be unduly burdened. While globally systemically important institutions are now subject to slightly stricter requirements commensurate with risk, small and medium-sized banks have scarcely been affected – in fact, requirements have been eased for many small German institutions.

To put it in no uncertain terms, sufficient capitalisation and liquidity is the most important line of defence for banking supervision and financial stability. With that in mind, there can be no leeway as far as this is concerned.

4. Greater proportionality in the EU

Within the framework of the principles I just mentioned, new treatments are providing considerable scope for banking regulation that is more proportionate for, and thus more reconcilable with, smaller and less complex institutions.

In the EU, work on this was kicked off in 2016 with an initiative launched by the finance ministers

of the United Kingdom and Germany. As this topic has also kept us at the Bundesbank very busy, we had our say a short time later by presenting initial concrete proposals for increasing proportionality in Europe. We have been working on improving and fine-tuning our proposals ever since.

As part of its general overhaul of EU banking regulation, the European Commission put forward proposals for strengthening the principle of proportionality. The European Parliament then produced a draft report, on which it was possible to submit comments until recently. While completing the report is not the final step, it's nevertheless an important step for the legislative process. At this point, I would like to say a special word of thanks to rapporteur Peter Simon for his excellent work. The proposals for eased requirements in the areas of disclosure and reporting are highly extensive and, to my mind, a very welcome development. Furthermore, we consider it a good thing that the thresholds are to be raised for trading book institutions. It is much to my regret, however, that a general approach – such as the small banking box – was rejected. I'll come back to this shortly.

Without wishing to anticipate the final result of the legislative process, I would like to paint a picture of how we, as German banking supervisors, need to tackle the issue of proportionality in the EU. With that in mind, let's turn our attention to three key questions: who, how, and what?

Let's begin with "who", as in who should be subject to eased requirements. As I have already mentioned, we are focusing on small institutions. In other words, the target group comprises institutions with a manageable level of total assets. The problem is that the definition of "manageable" varies from country to country in the EU. In order to account for this heterogeneity, we will probably set an absolute threshold value for total assets combined with a relative threshold value that takes national GDP into account.

This quantitative threshold value will be accompanied by additional criteria in order to prevent institutions with riskier business models from benefiting from simplified rules. Thus, banks to which reduced requirements apply are not permitted to use internal models; they ought to have a small trading book and carry out derivatives transactions to a limited extent only; and they may not participate to any meaningful extent on the capital market or in cross-border activities. But as experience has taught us that it is all but impossible to draw up an exhaustive list of criteria covering all eventualities, the final decision must rest with the supervisors. And, of course, banks should ultimately also have the opportunity to reject their classification as such an institution.

Now let's turn to "how". There are basically two potential ways of improving proportionality here. First, we could take a small-scale approach and introduce simplifications and exceptions for individual rules. Second, we could create a whole new framework that is specifically tailored to small banks and low-risk institutions. The second solution would be further-reaching and clearer-cut. But at present, the majorities in Europe appear to favour the small-scale solution.

And then we still have to consider "what". It is important the emphasis lies on reducing the administrative workload and minimising the red tape. The measures we are currently reviewing include exceptions to disclosure requirements, reductions in the granularity of reporting requirements and a simplified form of the net stable funding ratio (NSFR).

In deciding which areas could potentially be simplified, we must weigh up the benefits of regulation – that is to say, the preservation of financial stability – against the costs generated for the private sector. Essentially, all regulations that are non-essential to effective supervision are up for discussion.

Conversely, that also means that many rules are not up for debate, however. As I have already mentioned, no concessions can be made, in particular, when it comes to the risk-weighted capital ratio, the leverage ratio or the short-term liquidity coverage ratio.

One other aspect, I believe, is particularly crucial. The business models of small banks are neither generally simple nor automatically low-risk – and that is especially true when seen in their entirety. A supervisory system that works according to the principle of proportionality therefore needs to be simple but also robust. Financial stability must not be jeopardised under any circumstances.

5. Finalised Basel III standard must be implemented proportionately

For the same reason – that is, to strengthen financial stability – it is very important that we implement the recently finalised Basel III package fully in the EU. After all, that's no less than we expect of the US and the other member countries of the Basel Committee.

But as I see it, full implementation of the Basel III rules doesn't mean that all banks need to be affected by these highly complex rules to the same extent. To recap, the Basel standards are primarily aimed at internationally active banks.

In this regard, member countries of the Basel Committee are free to apply other rules to smaller banks that are only active in their own home markets and do not pose a threat to international financial stability. And this is the framework we should largely use when revising the EU rules.

For instance, when it comes to a review of the trading book, we at the Bundesbank are in favour of retaining the simple, standardised approaches that are currently in place for small institutions with small trading books. Although the new, complex standardised approach is all well and good for institutions that engage in substantial trading activity, I don't think they are suited to locally based savings banks or people's banks.

We also support the idea put forward by the European Commission and the European Parliament of excluding development banks from the scope of the CRD/CRR regulatory framework. Given, above all, the particularities of the business models of German development banks and their public mandate, I fail to see why these institutions should be subject to complex international regulation. In this respect, we at the Bundesbank strongly support the concept of a criteria-based exemption rule for development banks. We are also calling for institutions with total assets in excess of €30 billion to be covered by an exemption. In doing so, we are going beyond the European Commission's draft proposal. The report published by the European Parliament, too, follows a similar train of thought under certain conditions – which means that it's now up to the German negotiators in Brussels to set the right course.

So what I am saying is that when implementing the Basel III reforms in the EU, the rules must be applied in full to internationally active banks. But when it comes to smaller banks that are not internationally active, first, we should focus specifically on reducing the operational burden by scaling back or removing inappropriately complex rules. And second, we need to check whether it would be possible to exempt entire groups of institutions such as development banks from the European regulation.

6. Conclusion

Ladies and gentlemen, the euro area is experiencing impressive economic growth again for the first time in a decade. A differentiated banking system is a key pillar of the economy – and I am convinced that this diversity makes our economy more dynamic and more resilient.

And we must be careful not to burden this differentiated banking system unnecessarily through regulation. For us, as supervisors and regulators, this means addressing parts of the banking regulation that have become overly complex.

We should not place any disproportionate obstacles in the way of small institutions and savings banks. It is now up to the European Parliament, the EU Council of Ministers and the European

Commission to pave the way for substantial improvements.

Together with my banking supervision colleagues at the Bundesbank, I will continue to strive for greater proportionality in banking supervision. The current developments in Brussels give us reason to be optimistic.