Taking proportionality seriously – protecting the diversity of the banking sector

Twelve recommendations from the National Association of German Cooperative Banks for appropriate financial markets regulation for small and medium-sized banks

The eruption of the financial crisis marked by the collapse of investment bank Lehman Brothers on September 15, 2008 revealed serious shortcomings in the financial sector's legal and regulatory framework. Since then, politicians at international, European, and national level have introduced a swathe of regulatory measures. One of the ways in which the financial system is to be stabilized is by ensuring that banks' risks match their level of liability. Many of the proposals for eliminating the shortcomings – such as recapitalization, higher liquidity levels for banks, and caps on bonuses – were and are the right approach. The multitude of measures, however, raises questions about how targeted they are, whether the various pieces of legislation are compatible with each other at the different regulatory levels, and whether the costs of the regulatory requirements to the economy are proportionate to the benefits.

That is why the Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR) [National Association of German Cooperative Banks] commissioned Professor Roman Inderst and Professor Andreas Hackethal of Frankfurt's Goethe University to take a closer look at the impact of regulation on small and medium-sized banks within the context of a broad-based study, using all of the cooperative primary banks as an example. Almost seven years to the day since the start of the financial crisis, we therefore have a comparatively comprehensive study that scientifically analyzes the consequences of regulatory measures while also drawing on real-life examples. All of the 1,000-plus primary banks in the Volksbanken Raiffeisenbanken Cooperative Financial Network were included. The report was presented on September 30, 2015.

The survey of the banks produced clear findings: The average regulatory costs in relation to total assets are many times higher for small banks than for large institutions and are also higher in relation to income. The greater strain on small and medium-sized banks is putting increasing pressure on them to merge, creating extra work for employees and the boards of managing directors, and shifting the focus of activities away from the customer. The report shows that many of the measures breach the principle of proportionality. Paradoxically, small and medium-sized institutions are the most affected by regulation even though they are considered less significant to the stability of the financial system, including within the Single Supervisory Mechanism (SSM). Moreover, cooperative banks have never received government support at any time in their 170-year history.

The German banking market, in particular, comprises many solid regional institutions grouped into financial networks. They are a crucial factor in ensuring a broad basis of secure funding for small and medium-sized enterprises (SMEs) and advice for customers. Small and medium-sized banks are characterized by simple business models that are closely aligned with the real economy. In Europe, we should be attempting to further strengthen these institutions and not put them at risk with regulation that is unduly bureaucratic and sometimes inconsistent. During the financial crisis, it became clear that granularity and diversity in the banking sector make a considerable contribution to the stability of the system and the availability of credit. These positive systemic characteristics must not be jeopardized by 'one size fits all' approaches to regulation and oversight.

The BVR has summarized its recommendations for politicians and the banking regulators in the following twelve points:

1. Observe proportionality

Large parts of the existing rule set are not designed with proportionality in mind. The European Commission and European Banking Authority (EBA) have, in particular, stated that proportionality is only possible where the primary text of regulations and directives expressly and specifically allows for flexibility: The politically unquestionable principle of proportionality therefore cannot come into effect if the rules in a particular case do not make any corresponding demands of the European Commission, the EBA, or the regulators. The complexity of many of the legislative proposals (Capital Requirements Regulation – CRR, Capital Requirements Directive – CRD, Markets in Financial Instruments Directive – MiFID) means that proportionality aspects have not been taken into account to the necessary extent so far. Contrary to many people's expectations, general proportionality clauses, such as in the CRD, have a purely declaratory significance and do not allow the law to be applied proportionately on a case-by-case basis. The European institutions have to examine whether "opportunities for simplification and exemptions for institutions below a critical size" (quote from the report) can be defined.

2. Apply the subsidiarity principle consistently

The choice of a harmonized European or a single European solution also needs to be carefully considered in relation to financial markets. This is often a directional decision with broad implications. One example is European banking union. With regard to deposit protection, European lawmakers have so far deliberately opted for the harmonization route. A single European deposit protection system with cross-border rights of intervention and responsibility for third-party liabilities would create misguided incentives and represent a departure from current practice. With regard to the European Single Supervisory Mechanism (SSM), separation between direct and indirect oversight is planned. How the ECB implements this in practice must not lead to the establishment of what is essentially direct supervision of 'less significant institutions' by the back door. The advantages of subsidiarity need to be harnessed more effectively.

3. Conduct more accurate impact assessments

There has been little analysis of the effects of financial markets regulation and the compatibility of the various rule sets so far. The European Parliament should insist more strongly to the Commission that a meaningful impact study be conducted in the near future that takes account of the regulatory measures' compatibility and their consequences for the real economy . Proposed legislation should also be examined in terms of how it will impact on the structure of the markets, particularly in terms of the diversity of market players. The current Commission's agenda of 'better regulation' is a welcome approach, but it must put it into practice rather than just paying lip service. Moreover, sunset clauses could prevent a mass of uncoordinated individual measures building up.

4. Reduce the complexity and scope of requirements beforehand

Although each individual regulatory measure may appear justified in isolation, together they result in an excessive concentration of regulation and complexity. One such example is the impact on the market of the European Market Infrastructure Regulation (EMIR) and the Liquidity Coverage Ratio (LCR): a shortage of high-quality collateral. The rules governing securities business have also reached a level of complexity that is making this business increasingly difficult for local institutions to operate in owing to the myriad layers of organizational requirements. The report shows that, particularly in the area of reporting, the approach of collecting all data is putting a considerable yet avoidable strain on institutions, particularly small and medium-sized ones. The European institutions need to coordinate with each other more effectively beforehand. Avoiding unnecessary complexity should be a strict ancillary requirement of all regulatory measures.

5. Avoid inconsistencies and duplication within the rule set

Particularly in the area of financial markets and capital markets, new regulation has resulted in a wealth of inconsistencies and duplications that are making business unnecessarily difficult for the sector. One example is the EMIR disclosure requirements: The requirements for reporting to the trade repositories were not thought through and came into force in February 2014 before individual queries had been answered. Global coordination of the disclosure requirements – a major part of the regulation of derivatives aimed at improving transparency – is only now taking place and indirectly, rather than by aligning the matching criteria in the trade repositories as carried out by private-sector companies. The entire area of reporting is placing a huge burden on banks, particularly small and medium-sized local banks. This was also one of the report's findings.

6. Ensure a level playing field in capital markets union

As Germany's experience with the SME bond shows, capital-markets-based corporate finance is only a feasible alternative to a bank loan for companies above a certain size and only in exceptional cases. Long-term economic growth in the EU therefore requires not only the establishment of capital markets union but also measures to improve bank lending.
Capital markets union must therefore be achieved applying the 'same risk, same rules' credo, so that competition is not distorted in favor of capital markets finance. Regulatory exemptions for capital-markets-based finance must therefore be accompanied by regulatory exemptions for bank finance.

7. Set realistic implementation deadlines

Considering the complexity of the new rules, the deadlines for implementing them are frequently too tight and put institutions, particularly small ones, under significant pressure. Implementation deadlines must be realistic and coordinated with each other to provide a reliable basis for planning and capital investment. This also means better interaction between the standard-setting body (the EU) and the lawmakers implementing the standards at national level; it also gives the affected sector the chance to plan the implementation. Premature revisions to laws are also inadvisable. The revision process often starts too soon: before the new rules have been fully implemented and before the impact on the market can actually be assessed. There should be ample time before revised provisions are introduced, unless the rules start to adversely affect the market within a short space of time.

8. Reconsider the role of the European supervisory authorities (ESAs)

Transferring the task of defining the technical details of the level-1 legislation to the ESAs was a very logical step aimed at creating effective, efficient, and harmonized rules. However, European legislators are giving the ESAs too many mandates. It is now almost impossible to maintain an overview of the multitude of ESA standards and guidelines. Compared with other jurisdictions, such as the United States, the EU runs the risk of being too caught up in a web of bureaucracy and harming its own competitiveness. Furthermore, subsidiarity and proportionality must have priority in all of the ESAs' activities. However, the ESAs are not achieving this satisfactorily. There are generally no exceptions or special rules, even for small and medium-sized banks. Rather, the ESAs are predominantly following a 'one size fits all' approach that only varies in minor aspects. And, the ESAs cannot act without democratic control. That is why their work should be examined by European lawmakers both ex ante, i.e. before new standards and guidelines are considered, and ex post. This is essential if European regulatory measures are to be adequate and efficient. However, there must not be a loss of democracy in this regard.

9. Create stability union rather than transfer union

Because the stark differences in the size, concentration, stability, and performance of individual banking systems within the eurozone did not just start with the outbreak of the financial crisis, any mutualized deposit insurance system would inevitably entail a transfer union between banks, for example the deposit guarantee schemes. Stable and efficient banking systems and their protection funds would have to assume liability for unstable systems without having any influence over other countries' risks. Mutualizing liability risk among banks means that all deposit insurance schemes forced to show financial solidarity with a crisis-hit country would potentially be weakened. This is a recipe for spreading one country's system risks throughout the eurozone and triggering negative responses from financial markets as a result. It would inevitably impair the safety of deposits in Germany and other EU countries and, consequently, weaken depositors' trust. Acceptance of the EU by its citizens would also continue to decline. Crisis-hit areas can only be stabilized if problems remain regionally contained and do not spill over into other protection systems. National protection systems are still needed, above all to promote greater stability. Any mutualization within the eurozone would have an especially negative impact on small, risk-averse institutions.

10. Strengthen rather than hinder finance for SMEs

We welcome capital markets union as a further element in strengthening European integration and its focus for the future on more growth and employment in the European Union. Ideally, companies in all eurozone countries should have access to a wide range of financial services (bank loans, leasing, factoring, trade credit, development loans, and capital market instruments) in order to meet their different funding needs. The banks and capital markets are thus two sides of the same coin. That is why the integrity of the financial markets should always be judged from the perspective of those that they serve, namely companies and investors. The relationship between SMEs and their principal bank has proved especially crisis-resistant. Equal consideration should therefore be given to the finance provided by these principal banks to SMEs. The crucial factor is to permanently retain special capital requirements for loans to SMEs and to exempt development lending and financial network liquidity from inclusion in the leverage ratio.

11. Create realistic investor protection

If excessive investor protection makes it virtually impossible for the market to viably offer products, then nobody wins. The report shows that, particularly in small banks, the running costs for the securities business may make it a loss-making business. Especially when it comes to consumer protection, the focus must be on whether the measures serve their purpose (e.g. transparency, relevance, organizational requirements, obligations, prohibitions, voluntary undertakings). The cost-benefit ratio has to be right (for consumers and for financial service providers).

12. Make 'better regulation' a permanent principle

The trend toward larger entities, which had in fact begun before the financial crisis, will continue if new regulatory requirements – whether because of their scope, complexity, or cost – drive consolidation in the financial sector. This poses a risk for a diversified banking landscape in Germany and Europe. The BVR is not calling for an end to regulation but for more moderation. Regulation is not an end in itself. The European institutions in particular must keep their promise of 'better regulation'. If the administrative costs of regulation cannot be contained, the availability of regional banking services will suffer and there will be disadvantages for both consumers and the economy. Europe urgently needs greater economic growth in order to overcome the many different challenges faced by its member states. One of the ways to achieve this will be to ensure that the design and impact of banking regulation live up to the principles of 'better regulation'.