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Banking sector diversity: Business finance and proportionate regulation

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Economic and banking structures in the EU member states differ. In Germany, the financing of the economy, with its strong small and medium-sized business sector, takes place via a highly diversified banking landscape. The resulting form of business finance has proved stable in the recent past as well. A differentiated proportionality principle in banking regulation and supervision can take account of this diversity.

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A predominant feature of the German economy is its backbone of largely family-owned small and medium--sized businesses, known as the *Mittelstand*. This affects the form of business finance.

I. Role of banks in business finance

At just under 30% (in 2015), the average capital ratio of businesses in Germany is relatively high.[1] Yet, depending on the size of businesses, there are significant differences. On average, the rule is: the smaller [bigger] the business, the lower [higher] the capital ratio[2], and, as a result, the higher [lower] the debt financing requirements.

The option of raising finance – both equity and debt – via the capital market is used mainly only by large companies. The numerous family-owned small and medium-sized businesses avoid both the co-decision rights tied to taking on board outside investors (equity) and the transparency requirements associated with publicly traded bonds (debt). Bank loans therefore account for the lion's share (82%) of debt financing (in June 2017: EUR 873 billion in outstanding loans; EUR 156 billion in outstanding debt securities, based on the total number of businesses)[3]. Bank loans are generally preferred over bonds as a source of finance in the euro area, but in Germany this is particularly pronounced (see Chart 1).

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[1] Deutsche Bundesbank.

[2] Creditreform: *Wirtschaftslage und Finanzierung im Mittelstand*, Spring 2017.

[3] ECB.

As a rule, banks in Germany maintain a close, long-lasting relationship with business clients. This allows them sound risk analysis and long-term cooperation, also across business cycles. It, at the same time, includes the willingness to offer long-term finance. Around two-thirds of bank loans have a long maturity (at least 5 years).[4] Businesses usually also handle payments, export finance or risk hedging through their bank. This stable, holistic client-bank approach is therefore relationship-oriented, not deal-oriented.

Bank-based business finance has proved relatively stable over the years, including during the financial crisis. The ECB's Bank Lending Survey shows that lending standards tightened in Germany as well after 2008, albeit by less than the average in the euro area countries. Moreover, the situation for businesses improved again more quickly (Chart 2).

The reasons for this stability lie both with businesses and banks. For one thing, the German economy proved robust as a whole and businesses showed their resilience despite the sluggish global and European economies and despite their strong export orientation. For another, the banking sector as a whole – even with various losses – proved stable compared with other EU countries and was able to finance the economic upturn as usual after the crisis.

The diversity in the banking sector and the variety of business models play a major role in business finance. The European Commission distinguishes between small, medium-sized and large banks (see below). Under the definition used in this article (see below), 95% of all banks in Germany are small or medium-sized, with aggregated total assets accounting for 30% of the entire German banking sector. 82% of all banks are small (total assets equal to or less than EUR 3 billion), with aggregated total assets making up 14% of the banking sector. In Germany, particularly the export-oriented *Mittelstand* makes use of the global network and wide range of services provided by the medium-sized and large banks. At the same time, small banks also play an important role in business finance. Many of these banks, too, are private banks, i.e. they are not part of the savings bank or cooperative bank groups. Unlike the savings banks and cooperative banks, the private banks compete not only with banks from other sectors but also with each other.

The complex reform of banking regulation and supervision in recent years is aimed at strengthening the resilience of the financial sector. It is at the same time supposed to take place within an internationally coordinated framework and not restrict the financing of the economy (more than intended). To avoid jeopardising the diversity in the banking sector (including its benefits for business finance), a differentiated proportionality principle is called for. Banking sector diversity relates of course

Chart 1: Debt financing of non-financial companies, Q2 2017. Source: ECB.

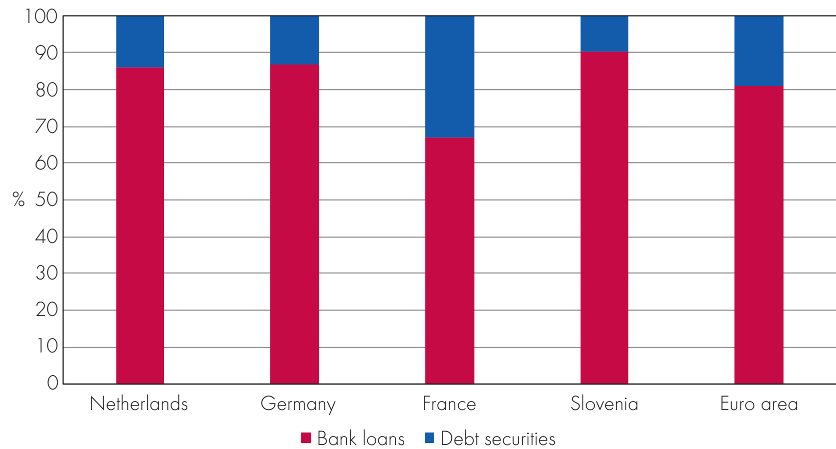

Illustration by the author

Chart 2: Bank Lending Survey. Source: ECB.

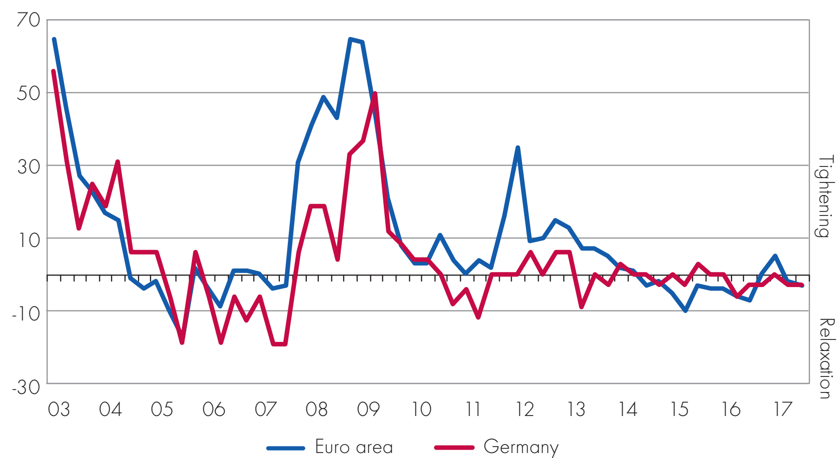

Illustration by the author

[4] ECB.

not only to the size but also to risk complexity. For reasons of simplicity, this article focuses on size as the distinguishing factor.

II. Banking regulation and supervision becoming more complex

In response to the financial crisis, the Basel Committee on Banking Supervision (BCBS) issued new recommendations aimed at generally improving banks' capital and liquidity levels (**'Basel III'**). These were implemented at European level by way of the Capital Requirements Directive (CRD IV) and the Capital Requirements Regulation (CRR). To supervise banks, the European Banking Authority (**EBA**) was set up.[5] Its primary task is creating uniform European supervisory standards. The so-called 'Banking Union' placed microprudential banking supervision under the control of the ECB. At the same time, the ECB was given additional powers in the area of macroprudential supervision. The **Banking Union** comprises a Single Supervisory Mechanism (SSM), a Single Resolution Mechanism (SRM) and a European Deposit Insurance Scheme (EDIS). It is designed to harmonise and improve supervision of banks in the participating countries, enhance financial stability in the euro area and loosen the tight bank-sovereign debt loop.

III. Proportionality in banking regulation

The numerous regulatory initiatives and measures have, overall, helped to strengthen the banking and financial system significantly. The scale and the accompanying complexity of banking regulation have increased enormously, however, and pose a big challenge to banks. Unlike in many other countries, regulation encounters a very heterogeneous banking market in Germany (described above). Especially small banks have been hit particularly hard by the administrative burden that regulation imposes. For small banks, regulatory costs weigh much more heavily in relation to total assets than for large banks. To even out this imbalance between large and small banks, banking regulation needs to be made proportionate.

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What does proportionality mean in this context? According to the German Federal Financial Supervisory Authority (BaFin), the proportionality principle holds that, when applying supervisory requirements, each bank's risk profile should be taken into account. The crucial factors in this respect are not only the size of a bank and the scale of its activities, but also its business model and risk complexity.[6] The principle of double proportionality entails that a balance must be struck between both the general regulatory requirements and the intensity of supervision on the one hand and the size, activities and risk profile of each bank on the other. Discussion of possible regulatory relief for small banks should be guided by the question: "What is the aim of regulation and banking supervision?" The main aim is safeguarding financial stability. The question that should be answered in every single regulatory initiative is how financial stability is affected by a small bank. Small banks and banks with less risk complexity can – as was demonstrated during the financial crisis – help to strengthen financial stability if they feature a variety of business models and compete with each other. Reducing the purely administrative burden on such institutions would not result in a bigger threat to financial stability, as these still have to apply the quantitative capital and liquidity requirements unchanged. The "same business, same risk, same rules" principle in this context stems from the Basel Committee. It reflects the Committee's acknowledgement that banks differ with regard to their size or business model and that differentiated rules on administrative requirements make sense.

IV. Thoughts on proportionality from a European perspective

CRD IV and the CRR must be applied by all banks, regardless of size and risk complexity, although the underlying Basel rules were essentially intended for large international banks only. A general proportionality principle[7] is, it is true, anchored

[5] Besides the EBA, there are also the European Securities and Markets Authority (ESMA) and the European Insurance and Occupational Pensions Authority (EIOPA). The three institutions are referred to collectively as the 'European Supervisory Authorities (ESAs)'.

[6] See BaFin (2017): https://www.bafin.de/SharedDocs/Veroeffentlichungen/DE/Fachartikel/2017/fa_bj_1704_Interview_Roeseler_Proportionalitaet.html (downloaded on 29.8.2017).

[7] See Recital 46 of the CRR.

in the CRR and the legislator also sought to implement proportionality requirements in some sections.[8] But, overall, these arrangements appear much too inadequate to create an appropriate level playing field between large and small banks and not to overburden small banks with excessive regulation. A further problem is created by the establishment, as described above, of the new supervisory structure in Europe with its various institutions and the resulting requirements, guidelines and the like (issued by the EBA, for example). Many of the provisions currently in place make sense.

A number of rules and regulations, however, impose (excessive) obligations on banks and confront customers at the same time – and even supervisors – with a virtually unmanageable flood of information in some cases. Complexity does not result in this respect from individual regulatory measures, but from the vast number and intricacy of rules and regulations. While this also poses a problem for large banks, small banks are affected to a disproportionate extent, e.g. because of their lower manpower resources compared to large banks.

Reporting can be highlighted here as an example of excessive regulation for small banks in particular. The "one-size-fits-all" approach imposes a disproportionately heavy burden on small banks, as regulation and associated reporting lead to high costs, though they are of little importance to supervisors particularly where small banks are concerned. ECB Regulation (EU) 2015/534 will require less significant institutions as well to report supervisory financial information (FINREP) as of 2017, imposing a substantial implementation burden. Because of the common reporting templates for current accounting standards, any change to IFRSs has to be subsequently entered in the 'national GAAP' tables, although institutions drawing up financial statements in accordance with the German Commercial Code (HGB) are not affected.

On top of the disproportionately heavy burden imposed by existing rules and regulations, small banks are also put at a disadvantage by the Supervisory Review and Evaluation Process (SREP), focusing on adequate risk measurement and management. Supervisors' interpretation practice in this respect does not allow for enough differentiation in application of the proportionality principle, as often the approaches adopted by large banks are set as benchmarks.

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V. 2016 CRR/CRD review

The proposals presented in November 2016 within the framework of the CRR review indicate the European Commission's objective of further expanding the proportionality principle. To this end, banks are classified for the first into three categories depending on their size and complexity (large, small and other institutions).[9] The 'small' category comprises institutions whose total assets are on average equal to or less than EUR 1.5 billion over the four-year period immediately preceding the current disclosure period. The 'large' category comprises systemically important institutions and institutions whose total assets are equal to or larger than EUR 30 billion, plus institutions which fulfil certain criteria with regard to their size in the banking sector of the country of their establishment. Institutions which are classified as neither large nor small fall within the 'other' category. A further distinction is made based on whether an institution has issued securities that are admitted to trading on a regulated market of an EU member state.

Based on the categories described above, the draft CRR lays down the scope and frequency of **disclosure** for individual groups of institutions (Art. 433a–433c of the draft CRR). The smallest scope of disclosure applies to small, non-listed institutions. Relief with regard to the frequency of supervisory reporting is envisaged for small institutions.[10] Institutions whose total assets are equal to or less than EUR 1.5 billion will only have to submit COREP and FINREP reports annually.

Even if the Commission's desire to achieve improved proportionality is evident and must be welcomed, the proposals nevertheless appear cautious and fail to do justice to the Commission's self-declared aim of better recognition of the proportionality principle. They are merely selective adjustments that are, moreover, geared to an extremely low total assets figure.

[8] See, for example, Article 99 of the CRR.
[9] See Art. 430a of the draft CRR.
[10] See Art. 99 of the draft CRR.

VI. Further proposals from a German perspective

Because Germany regards the proposals made by the European Commission as inadequate, an alternative proposal was drafted by the German Federal Ministry of Finance (BMF) in consultation with BaFin, the Bundesbank and all banking-sector associations. Under this proposal – similar to the Commission's approach – banks are classified into three different categories: (1) small or non-complex institutions, (3) large or systemically important institutions and (2) other (medium-sized) institutions. Whilst large/systemically important institutions should continue to fulfil all the relevant requirements, small/non-complex institutions and medium-sized institutions should be subject to graduated requirements.
The 'small/non-complex' category (1) is defined by means of quantitative and qualitative criteria. For one thing, it includes all banks whose total assets are equal to or less than EUR 3 billion. So that, for instance, banks supervised directly by the ECB from smaller EU countries do not fall within this category as well, a relative threshold that could be based on, for example, the BIP of the respective country or its total banking assets would have to apply in parallel. For another, to fall within this category, banks would not be permitted to use any internal models to determine their capital requirements and would have to be subject to normal insolvency proceedings should they fail (i.e. no recovery plan as provided for in the Bank Recovery and Resolution Directive (BRRD)). Should such a definition be used in Germany, more than 80% of banks would fall within this category, though they would only have a 14% share of the aggregated total assets of all banks.

The 'large/systemically important' category (3) should comprise, among others, banks supervised by the ECB and potentially systemically important institutions as defined in the BRRD. The 'other (medium-sized)' category (2) would comprise those banks that cannot be assigned to either of the other two categories.
The competent supervisory authority should, in addition, be entitled to place a bank in a higher category based on an assessment of its own.
Banks in the 'small/non-complex' category (1) should be fully relieved of the following administrative burdens:

Small banks predominantly pursued an appropriate remuneration policy.

rules on *disclosure*[11], *remuneration schemes* and *recovery planning*.
Disclosure reports are designed to enable investors to obtain a better picture of banks' financial situation and thus to make the right investment decision. This is intended to give banks an added incentive to control risks to which they are exposed and to manage those risks efficiently (creating market discipline). Where non-listed banks are concerned, there are, however, no capital market investors requiring such information. Moreover, interest in disclosure reports is minimal (take, for example, the low number of hits for reports available online). In contrast, banks (particularly small ones) face the enormous burden of having to prepare disclosure reports, since the European legislator has introduced the disclosure rules equally for all banks on a mandatory basis.
The *remuneration requirements* set by CRD IV are due mainly to the negative consequences of misguided incentives during the financial crisis, particularly in the area of variable remuneration. This concerned only a very small number of banks, however. Small banks predominantly pursued an appropriate remuneration policy. Employees of such banks do not rely (to any significant extent) on variable remuneration. As implementation of the remuneration rules is highly complex, it would be appropriate to exempt small banks from these rules or at least reduce their burden significantly.
As far as **recovery planning** is concerned, it should be noted that small banks are subject to normal insolvency proceedings. Resolution tools such as bail-in (participation of creditors) are thus not used at all, i.e. there is no need for a recovery plan. For this reason, such banks should be fully exempted from the recovery and resolution planning requirements.
With regard to **reporting**, the introduction of so-called 'core reporting' makes sense. This means defining a heavily reduced set of metrics for minimum capital and liquidity requirements, compliance with which should be reported and monitored through strongly simplified reporting arrangements in terms of scope and frequency. As supervisors can, for example, make a sound assessment of the stability of the refinancing basis via existing reporting arrangements and the liquidity coverage ratio (LCR)

[11] Provided the bank is non-listed.

[12] In the view of the German Banking Industry Committee (DK), fully exempting medium-sized, non-listed banks as well from reporting makes sense. The same goes for the rules on remuneration schemes.

and by, if need be, using the loan-to-deposit ratio from FINREP reporting, completely dispensing with the net stable funding ratio (NSFR) or at least applying a simplified one with fewer data fields makes sense.

The 'other (medium-sized)' category (2) comprises a large number of banks and business models. Applying the proposed relief for small banks across the board to this category would therefore be inappropriate. Yet, as this category does not include any systemically important institutions and many banks are only slightly larger than the banks assigned to category (1), more proportionate rules should apply to it as well. That goes for relief with regard to reporting (e.g. by reducing redundancies), disclosure (e.g. by publishing a stripped-down set of information), the rules on remuneration (e.g. by dispensing with identification of risk carriers where the bank applies a bonus cap), the NSFR (through fewer data fields) and recovery planning (e.g. through simplified requirements).[12]

VII. Conclusions

Diversity in the banking landscape is a characteristic feature of the German financial sector and has proved beneficial for the – equally diverse – financing needs of businesses. Besides international coordination and the 'same risk, same rules' principle, the benchmark for banking regulation and supervision must be proportionality so as to take account of the variety of business models, risk complexity, and the highly differing bank size. The proportionality approach presented and reasoned in this article could help to preserve diversity both in Germany and in other EU member states. In countries with high levels of concentration in the banking market, where a few large institutions dominate the market, this proportionality approach could encourage bank start-ups and growth of small and medium-sized institutions, promote competition in this way and, through more diversity, help to enhance financial stability and ensure business finance.