BANK OF ENGLAND

RESPONSE TO THE EUROPEAN COMMISSION'S PUBLIC CONSULTATION ON THE POSSIBLE IMPACT OF THE CRR AND CRD IV ON BANK FINANCING OF THE ECONOMY

ANNEX 2: The case for a more proportionate regulatory regime

Summary

1. Unlike other large jurisdictions, such as the USA, the EU applies the same rules to all its banks in seeking to achieve a level playing field.[1] Consistent standards are key to delivering safety and soundness in the financial system and thus the Single Market. That is particularly the case for large, internationally active banks. But a "one size fits all" approach of common binding rules for all banks, no matter what their size, complexity or level of cross-border activity, can cause distortions given that the costs of regulation tend to bear more heavily on smaller banks. Policy makers need to weigh the desirability of the same rules for all firms with wider objectives, including growth, financial stability and effective competition. More proportionate, differentiated rules are more likely to enable banks of different size and business model to compete on an equal footing across the EU than the same rules applied to all banks.

2. The costs of regulation must be proportionate to the benefits. The benefits and costs vary across banks of different size and business model. Often the benefits of regulation are proportionately bigger for larger or more complex banks, while to the extent that regulation imposes fixed costs those will tend to bear more heavily on smaller banks.

3. The financial stability benefits from regulation of large, internationally-active banks mean these firms should meet the global standards that are designed with such banks in mind. Broadly speaking, EU regulation already reflects the greater benefits from applying tighter requirements to such banks. For example, higher capital buffers are required for large, interconnected banks and recovery and resolution planning is also tighter. But aspects of EU regulation are not fully consistent with those global standards, partly due to the need to apply rules across all banks.

4. A differentiated approach would allow the EU to align regulation of larger banks more closely with global standards, thus supporting financial stability. But it can also recognise the lower benefits, and sometimes higher costs, from regulation of smaller banks. More

[1] The term 'bank' or 'firm' is used throughout this document to refer to credit institutions covered by the CRR/CRD IV.

proportionate rules can help to promote competition and growth. That, in turn, can enhance the resilience of the banking system: lower barriers to entry foster competition, allowing new banks to substitute for any loss in the provision of finance by less resilient firms, while growth improves loan performance, supporting profitability. While there are clearly challenges in putting a more proportionate approach into effect, including defining the boundary between groups of banks to which different rules might be applied, these have been overcome in other jurisdictions, such as the United States which applies a narrower set of regulatory rules to smaller banks, and only applies global standards to large, internationally-active banks. The gains for the EU of adopting a similar approach could be material.

5. A more proportionate approach could be adopted for many aspects of bank regulation. For example, there is a case for ensuring that regulatory reporting requirements do not go beyond what is necessary for effective supervision of smaller banks. Regulation could also be tailored to business models: the benefits from the prospective application of the Net Stable Funding Ratio should be larger for banks that rely more heavily on wholesale funding. Differentiated approaches should be carefully designed to avoid unintended distortions: there is a need to reduce the competitive imbalances that exist between firms using model-based approaches for estimating mortgage risk weights relative to firms on standardised approaches. These imbalances can have unintended effects on the safety and soundness of banks by encouraging banks on standardised approaches to compete for riskier mortgages, where the capital differentials are less marked. Finally, remuneration policy should also be proportionate to the risks the policy is meant to mitigate and the cost it imposes on a firm.

Framework for assessing the proportionality of regulation

The benefits of bank regulation

6. We regulate banks to offset market failures that can surface in the event of their distress or failure. Banks tend not to take sufficient account of the negative effects that their failure can have on creditors and the financial system. The impact of failure on a bank's creditors tends to vary with the size of a bank, suggesting the need for a common basic level of regulation across all banks. But some market failures, such as spillovers to the wider financial system from bank stress or failure, are more apparent for larger banks,

for banks that play a key role in certain markets, and for banks that provide critical services to the wider financial system or economy.

7. While spillovers from the failure of individual small banks may be modest, problems arising in small banks can be systemic in aggregate. For example, if small banks were to face problems simultaneously - as has been seen in some previous financial episodes, such as the US savings and loans crisis - the combined effect could be much more material. This point reinforces the need for minimum standards even for the smallest banks.

8. There are also benefits from regulation in a cross-border context. Regulation can mitigate spillovers across borders arising from bank failure, and can help ensure that jurisdictions do not engage in a 'race to the bottom' by lowering regulatory standards to favour national interests. These benefits tend to be greatest for large, internationally-active banks.

Costs of regulation

9. Regulation entails various private costs for banks – for example, the costs of maintaining capital and liquidity ratios at levels above those that a bank might choose absent regulation and, not least, costs involved in understanding and complying with regulatory requirements. To the extent that these costs are fixed, they tend to bear more heavily on smaller banks. While EU bank regulation already recognises the greater benefits from applying tighter requirements for some banks, it does not adequately reflect the relatively higher costs that regulation imposes on some firms. Parts of CRR/CRDIV do allow some exemptions for certain firms, but in general there is limited tailoring for smaller banks which means the costs of regulation may not always be proportionate to the benefits.

10. It should be noted that even regulation that is designed to reflect differences across banks can lead to unintended secondary distortions. An example is credit risk, where regulation provides for both simple standardised approaches and internal models. However, big differences in capital requirements between the two approaches undermine competition between small and larger banks. Work to reform these approaches is underway in Basel.

Developing a more proportionate regulatory regime

11. This cost-benefit approach has several implications:

(a) it highlights the need for common minimum capital requirements for all banks to mitigate the negative externalities that banks can impose on their creditors;

(b) it supports the higher regulatory standards for larger, systemically important banks, and banks that are systemic in certain markets; and

(c) it points to the need for greater consideration of the private costs of regulation.

12. A more proportionate approach could be adopted for many aspects of bank regulation. Examples include:

- **Regulatory reporting** should require information to be reported to the extent that it is necessary to obtain a comprehensive view of the risk profile of a bank's activities and of the systemic risks posed by banks to the financial sector and the real economy. It is likely that smaller banks are currently reporting more information than is necessary to meet this aim, at disproportionate cost. Reporting should be more tailored to bank size.

- The **Net Stable Funding Ratio** (NSFR) is not part of the current regulatory regime but may be introduced in the future to tackle risks associated with over-reliance on wholesale funding, which has played a major role in many financial crises. Applying a "one-size fits all approach" for the NSFR could mean disproportionate costs relative to benefits for banks whose business models do not involve wholesale funding. In this case, regulation might be tailored by bank business model.

- CRR/CRDIV does provide for differentiated approaches for **credit risk** across different groups of banks, by allowing both standardised and model-based approaches to be used to calculate capital requirements. However, internal models tend to generate significantly lower risk weights on average than the standardised approach for certain exposures. For example, models in the UK deliver risk weights of between 3% and 15% for mortgages with loan-to-value below 80%, compared to 35% under the standardised approach. Although large banks face additional capital buffers and are subject to leverage ratio requirements, this differential creates an uneven playing field between different sized banks. It can have unintended effects on the safety and soundness of banks by encouraging smaller firms to compete for riskier mortgages, where the capital differentials are less marked. This underlines the need to reform standardised

approaches to allow for greater risk sensitivity and ensure that internal models are adding risk sensitivity based on genuinely better and more robust information.

- **Remuneration policy** should also be proportionate to the risks the policy is meant to mitigate and the cost it imposes on a firm.

Conclusions

13. In differentiating rules across banks - by size or business model – it would be important to avoid rules that create 'cliff effects' in regulation that would impede effective competition and inhibit the growth and development of banks. A more proportionate regulatory regime must also account not only for the size and business model of banks but also for the extent of cross-border activity.

14. While there are clearly challenges in putting a more proportionate approach into effect, these have been overcome in other jurisdictions, such as the United States which applies a narrower set of regulatory rules to smaller banks, and only applies global standards to large, internationally-active banks. The gains for the EU of adopting a similar approach could be material. Differentiated regimes could allow both for closer alignment of EU regulation of larger banks with global standards, and more proportionate regulation of smaller banks. That in turn can promote competition, growth and financial stability.