Designing an alternative prudential regime for simple banks

There has been a race between banks and regulators to add size and complexity to banking groups on the one hand and to regulations that cover such businesses on the other. It is questionable that smaller and simpler banks and their clients are best served by this development. At the same time, the financial system suffers due to a lack of diversely set up banks, with varied types of loans and interest rates on offer and with business models that are not prone to fail at exactly the same time.

If only it were possible to say in advance which banks will be dangerous in the future. In that case the solution would be simply to abolish most rules for the non-dangerous type. Crystal balls are in short supply, however, and time after time, both big and small banks have surprised regulators by being unpredictably safe, or unsafe, and if unsafe, by suddenly being systemically important (or politically important) at their point of failure. Legislators and supervisors do not like such surprises, and have responded by adding ever more detail to the Basel (and EU) capital framework and the Basel core principles for banking supervision. The original framework was drafted at a time when the 'big, diversified and internationally active banks' for which it was written were of the size that small banks are now, and capital markets and markets in financial instruments were relatively simple. Open borders in the EU single market (and around the world for some financial services) have since allowed a consolidation wave between banks operating in ever larger, more complex and interlinked financial markets, for which the original rules no longer appeared to suffice. This consolidation is then reinforced by the need for size to absorb the costs of stricter rules, and in times of crisis by supervisors begging relatively stable banks to take over relatively wobbly banks.

So now we appear to be stuck in a set of complex rules designed for complex banks and complex financial systems. And strangely, in many submarkets such bigger banks are behaving in exactly the same manner, dropping small borrowers as reviewing and monitoring them is too complex, dropping trade finance and

USA linked clients because there are too high AML or FATCA administrative burdens associated with them, targeting exactly the same profitable and asset rich clients to offer loans to, and offering depositors the same tawdry deals because for large banks the wholesale funding market is both simpler, more predictable and cheaper than managing a plenitude of surly savers. Especially if having such depositors means higher fees to be paid to deposit guarantee funds, resolution funds, supervisors fees, and likely to local tax authorities.

The traditional EU approach to the capital framework has been that all banks should be on the same level playing field, and that the so-called proportionality principle will provide for enough flexibility to allow smaller and simpler banks to thrive. But how to apply the rules proportionally, when it is not clear for smaller banks that their supervisors will accept anything less than perfection, and for supervisors that leeway granted to their banks will not come back to haunt them when that bank fails? There is no safe haven for either banks and supervisors to hide from liability or bad publicity if something goes wrong that could have been prevented if rules to calculate requirements or set up a check and balances system could have been enforced too.

Now, it could be defended that the complex rules serve a useful purpose for complex banks. Their business is driven by a need to reduce regulatory capital requirements, and to prevent innovative abuse or avoidance the regulators have to be equally innovative to think up new detailed rules or guidance. In the absence of minimum capital requirements their sheer size otherwise might mean that in the eyes of the financial markets they can get away with even more minimal safety measures as long as they appear to be profitable. This is not the case for relatively smaller banks, where the amount of capital needed to be able to attract wholesale funding is often higher than the amount of regulatory capital required under solvency ratio calculations. For these smaller banks, the absolute number of regulatory capital requirements is not so much the burden, but the sheer size of administrative and reporting measures that are needed to be able to calculate this via the solvency ratio. And this burden is difficult to make proportional to their business, as the main elements that support that calculation need to be present in the same manner in both big and small banks to be able to come to a trustworthy outcome of standardised or internal models on which the solvency ratio is based.

Creating a lot of lightly regulated shadow-competitors for banks (such as via emoney, payment institutions, venture capital or social investment fund rules) does not solve the fact that the traditional basis of banking, attracting deposits, making loans, providing facilities, and thus easing the functioning of the economy, is becoming the prerogative of ever larger organisations that can optimize the regulatory burden of solvency ratio calculations.

If regulators and the remaining smaller and simpler banks are truly interested in more competition between banks, more choice for clients (both lenders and borrowers), more diversity in the banking sector, more effective rules, or at least less complex rules, then substantial changes in the prudential regime should be considered. Though it is easy to be married to the status quo of the Basel capital accord, it should be remembered that it is a relatively young framework of barely 40 or 50 years of age, that has been growing organically, and was never intended for the simplest banks, but for the most systemic banks of its day and age. And there are alternatives that still are based on available experience in the way banking was structured in the past, or how it is structured for state licensed banks in the USA, or how supervision is structured in the insurance sector.

In order to be contemplated by regulators, however, any alternative regime will need to be more effective than the current regime in preventing harmful fallout of a banks' failure. Though the existing set of complex rules has a dismal track record during various crisis, there is a belief (though that belief possibly only exists in press releases) that the various untested add-ons of the last few years will work better in limiting the potential for future crisis. This even though for instance the much admired bail-in instrument has the potential to cause contagion in the bailed-in creditors, and harsher market risk requirements risk reducing the liquidity of markets in certain financial instruments. While waiting for the jury report on the effectiveness of the new add-ons to arrive during the next crisis, that belief in their sturdiness is a political reality. If an alternative simpler regime is even to be contemplated, the alternative simpler banks subject to it should thus be even more 'safe'. Preferably, any legislator and supervisor that replaces part of the current regime for a simpler alternative should be able to honestly say that they do not care to have e.g. full control and complex data over the bank, because the public interest is fully managed in another way. In my opinion, this other way could be found by making the failure of such simple alternative banks irrelevant for the protection of their clients, and irrelevant to the financial system in which they operate. This will only work if the banks' full failure hurts no one except the bank itself and its equity providers, not even if similar or related banks would fail at the same time. So if we would like more diversity in the banking sector, and allow some banks to compete on different conditions without undermining safety nor a level playing field, a new balance would need to be struck by deleting the most onerous obligations of the current regime for simple alternative banks, and replacing them with equally safety enhancing but more simple alternative measures.

Smaller and simpler banks appear to suffer most from the calculation, supporting organisational requirements, and pillar 3 and regulatory reporting requirements that relate to the solvency ratio. For non-complex banks, as indicated above, these requirements actually do not even result in a credible minimum capital level in the opinion of the banks themselves and/or the markets (small banks operate at higher capital levels than the minimum required). These solvency ratio calculations thus appear to be surplus to annual accounting calculations. While these regulatory requirements do not bind them, they still induce costs and force banks into specific business models. But ditching the solvency ratio requirements and all adherent organisation and reporting burdens, would be a large shift from the current regime, and would force supervisors out of their comfort zone. Even when the results of imposing the solvency ratio are thus far underwhelming and their limitations badly understood; their usefulness as one of the few means of control and – even if ex post – verification is at the moment not paralleled by other measures.

Nevertheless, I would propose deleting the solvency ratio calculation and all supporting requirements in full for a subset of simple alternative banks, subject to a range of conditions. Any tinkering with the solvency ratio – which evidently is in the comfort zone of regulators and supervisors – would not result in a measurable reduction in burdens, while only adding to the small forest of trees cut down to be able to print the so-called single rulebook now. The conditions for escaping the solvency ratio obligations should be simple and at the same time compensate for its loss, and prevent abuse. They should thus include the majority of the following:

- Personal liability of all current and (recent) past members of management and anyone ‘owning’ or ‘controlling’ the bank e.g. by having a stake of more than 10% of equity. Introducing collective responsibility in this manner would make banks again more similar to the out of fashion partnership-based banks, and force key influencers to face up to potential negative consequences of their or their partners' decisions. An alternative could be a non-profit bank with mandatory low salaries and a prohibition on dividends and bonuses, but this would require some talented people to be willing to work for a fraction of their commercial salary solely for idealistic reasons.

- A leverage ratio based solely on comparing existing annual account information set at a high number (e.g. 10% or more, to be calibrated at the high capital levels smaller banks now have), combined with an FDIC style prompt corrective action tool. This could be supplemented by other indicators of health, but only if those are based on already available public annual accounts data.
- Limiting the asset side of the bank, by reintroducing the habit to issue limited banking licenses. For instance licensing such banks to be focused on SME finance, or on trade finance, or on infrastructure investing, or on mortgage loans. This is still an existing feature in the insurance sector, where the main type of insurance written by any specific licensed entity has to quite similar, e.g. limited to car insurance, or to fire insurance. Apart from their specialisation on the asset side, their business should only consist of deposit taking and offering payment accounts. This would clarify their transformation function, and ensure that their management can be focused on a specific business.
- General demands on management, valuation and bookkeeping sufficient for annual accounts and conduct of business purposes could remain in place.
- No deposits or credits should be accepted that are not fully guaranteed by a public deposit guarantee fund; or that are fully collateralized/insured by repo's, covered bonds, credit default swaps or by other credit insurance. It could be contemplated to prescribe that a proportion of the deposits should be term deposits, though any simple alternative bank with a personally liable management is certain to keep a good liquidity buffer if they have immediately redeemable deposits.
- The maximum market share of such simple alternative banks in each specified banking activity they can be active in under their licenses, should be set at a level that ensures that both the deposit guarantee fund and the financial system could relatively easily absorb the net losses that will be suffered due to their potential for – even collective – failure (in a more strict version of the USA concentration limits).

- Such a bank should have all its activities within the same legal entity. It should be prohibited from having subsidiaries, should not be allowed to make loans to group entities, and should only be allowed to outsource to non-related entities that would not fail in case of its failure. If it is part of a group (e.g. a automotive group, or even a financial group), such a license can only be issued to one simple alternative bank per group. It should be supervised solely on a solo and stand-alone basis, and the parent group should be ignored except as an ex-post suable party in case of the demise of the bank. The equity share in a alternative simple bank by any 'normal' parent bank should be weighed solely as a capital investment both for solo and consolidated supervision purposes on its parent bank (to avoid solvency ratio requirements landing indirectly at the alternative simple bank).
- Instead of a supplementary pillar 2 regime, it should have a stand-alone annual obligation to write a business plan with its main business options and risks, and what it plans to do on both accounts.
- Its resolution plan should be simple: full liquidation, repaying the deposit guarantee fund for protecting its depositors, combined with the liquidator maximising the size of the estate by suing the liable persons within its structure for any deficit in repaying the DGS and other (collateralized) creditors.
- They should be identified by a separate name that highlights frailty (bank light, mini bank, high risk bank, or even alternative simple bank).

If the bank or its equity providers want to abandon these restrictions, they can of course opt into the solvency ratio regime, perhaps with even the liability for new obligations incurred after the transfer slowly tapering off (though some form of collective liability of all key influencers would be good at any bank). For new start ups, this would have the benefit that by the time they would like to do so, they have had the chance to build up both their organisation and their expertise up to the required level to be able to work in that more complex environment. During a try-out phase for this new regime, it could be envisaged that such alternative simple banks should not operate on a cross border basis. Anything longer than during a try-out period would, however, irreparably damage the concept of the EU single market.

Whether such a regime-change is credible remains to be seen. It is out of the comfort zone of EU and Basel regulators (no more solvency ratio?) and latter day bankers (liability?). If banks and regulators are indeed serious in their concerns about the current regime and its impact on the way the banking sector performs its functions to the benefit of all of us, it should nonetheless be considered.

Also see:

Are EU Banks Safe?

Actal advice to the Dutch Minister of finance, Regulatory burdens on credit, 23 July 2015, plus the accompanying EY report of May 2015 (both in Dutch)

CEBS, results of the comprehensive quantitative impact study, 16 December 2010, www.eba.europa.eu. Also see BCBS, An Assessment of the Long-Term Economic Impact of Stronger Capital and Liquidity Requirements, August 2010, www.bis.org.