The principle of proportionality in regulation: a brief presentation of the EBI Working paper No. 20/2018 as an introduction to the roundtable.

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A paper calling for more

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Stability, Flexibility and Proportionality: Towards a two-tiered European Banking Law?

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- In our paper we move from an overarching and implied consideration that the principle of proportionality enshrined in the Article 5 TEU and Protocol No 2 is **not just a limit** to be exceptionally used by the CJEU in assessing the legality of regulatory and supervisory actions in banking, **but a principle that must inform the EU regulatory and supervisory system** and may require also **positive actions** to remove impediments to proportionate outcomes.
- Based on this, we discuss the fundamental choice, first at the time the Basel I Capital Accord of 1988 was transposed and then reiterated with CRD IV and CRR to apply the Basel standards to every European bank, with only a limited number of carve outs and adjustments grounded on size, systemic relevance or complexity.
- We argue that an **ad hoc, bespoke regime for small and simple banks**, beyond the additional (and welcome) adjustments promised, with its lighter approach to the modular regime, by the EC Risk Reduction proposals of 23 November 2016 would provide for **flexibility** and **proportionality** for a key part of the banking sector, while **maintaining stability**, unfettered **competition** within the industry and a suitable degree of **diversity**.

Why insisting on proportionality (and diversity) in European Banking regulation and supervision?

- We argue that:

a. the “one size fits all” approach hinders the development of smaller banks by creating competitive distortions and that the relief promised by the Risk Reduction proposals may be not enough (**positive action to preserve dispersed competition and to support dispersed economy**!)

b. a two-tier Banking Rule Book would better match with the models adopted in jurisdictions of similar or superior level of development (namely US and Japan: and Japan is of particular interest because of its similar structure of the banking system and its relation with national sovereign debt); In the US and Japan, as in Germany and Italy Tier 2 institutions provide most of the funding to small and medium-sized enterprises and finance the greatest part of the regional economy (**Japanese and US flexibility is key to protect local economy, community interests and overall social welfare**!)

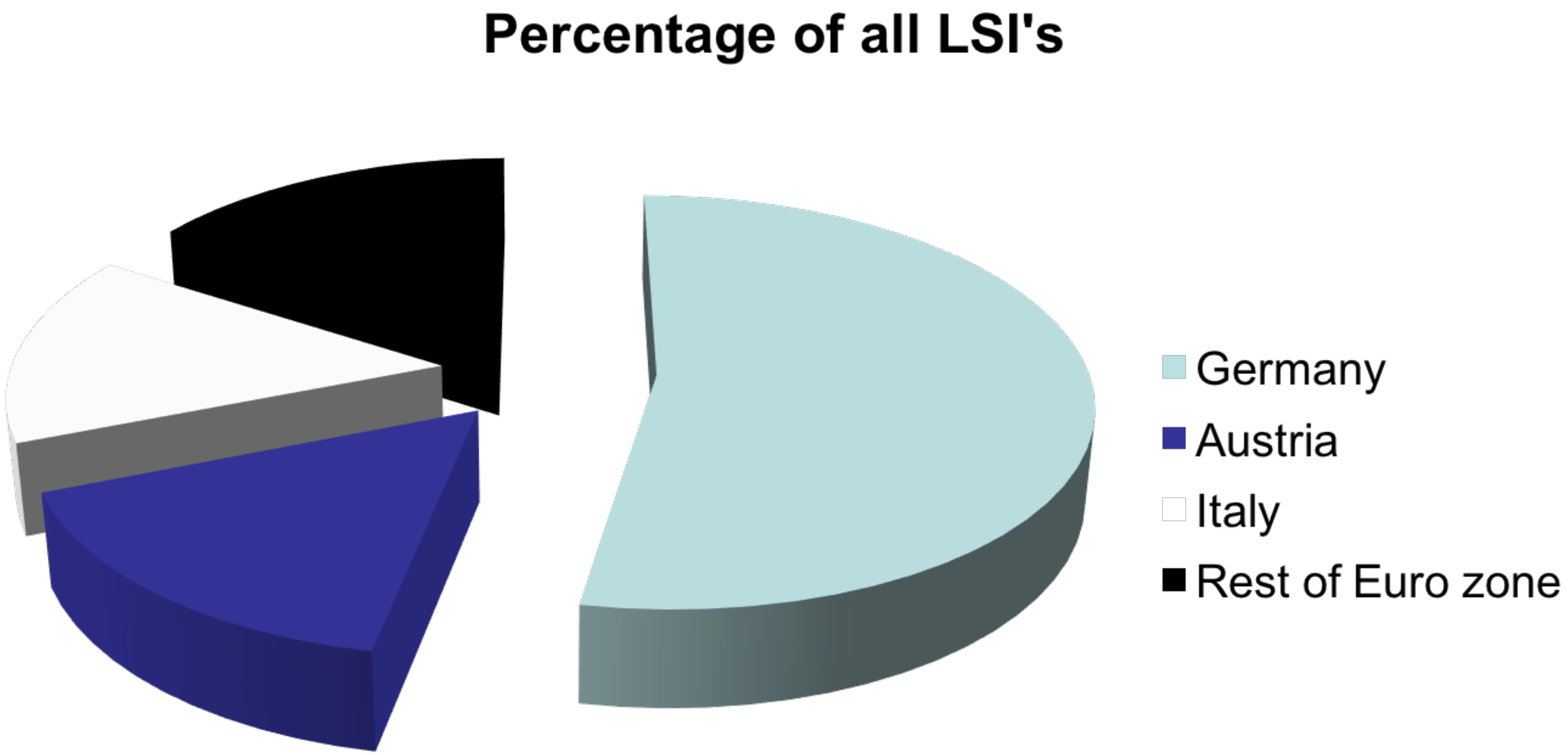
c. criteria to make a proper distinction between “small” (Tier 2) and “large” (Tier 1) banks in this context are already used in the Single Rule Book, albeit without uniformity of meaning and could be further adjusted and harmonized (**you know what a small bank is when you see it: call it Tier 2!**)

d. A viable drafting technique to determine the rules applying to the Tier 2 banks is not overly costly to develop (**a Small Banks Package is no mission impossible**).

A two-tier approach mirrors reality: a snapshot of the European Banking Industry (I)

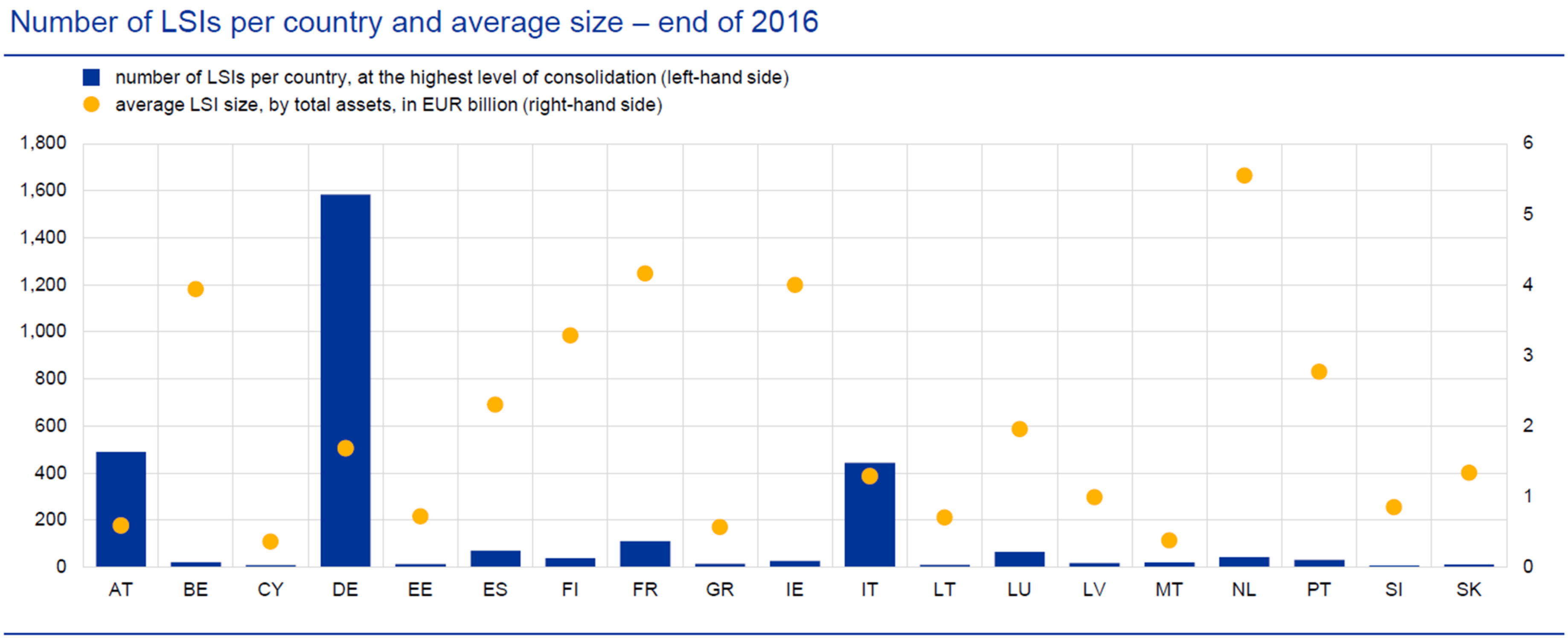
- In 2017, Europe was the home of 6,596 banks with 2.8 million employees. The Eurozone alone comprised 5,063 banks with 1.95 million employees. Within the Eurozone some 120 banks hold approximately 82% of the bank assets, the remaining 18% is held by a large group of approximately 4,900 banks.
- Within the Single Supervisory Mechanism, the first group of banks represent the significant institutions (“SI”) and the latter group the less-significant institutions (“LSI”). Most of the LSI’s are established in Germany (nearly 1,600 LSI’s), Austria (nearly 500 LSI’s) and Italy (some 420 LSI’s). The average balance sheet of LSI’s in these countries ranges from 1.20 billion euro for Germany to approximately 200 million euro for Austria and 400 million euro for Italy. In other Member States of the Eurozone, the average balance sheet of LSI’s is significantly higher, with the Netherlands being the Member State with LSI’s having the highest average balance sheet of some 1.65 billion euro in a jurisdiction which has a highly-concentrated banking sector and a very small group of approximately 30 LSI’s. Other Member States where the number of LSI’s is modest but average balance sheet totals are high are France (some 100 LSI’s and average balance sheet total of 1.25 billion euro) and Ireland (some 40 LSI’s and average balance sheet of 1.2 billion euro)

The European Banking Landscape: diversity (II)



See Kitty Lieverse, *Stability, flexibility and proportionality: towards a two-tiered European banking law?*, 23 February 2018, EBI Third Annual Conference.

European Banking Landscape: diversity (III)



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Isn't it too late? For some Member States perhaps, but even there, it is worth the try!

a. **Spain** is a particularly interesting case. Currently, LSI's represent a very moderate portion of the Spanish market: **6%** of assets, in the balance sheet of only 78 institutions (including both domestic financial institutions and foreign branches), with 31,5% of those assets belonging to small domestic banks, 59,5% to very small rural credit cooperatives, and 1,18% to savings banks. This landscape is the result of the 2008 crisis. Before the global financial crisis, Spain had dozens of savings banks, which represented a dominating force. A flawed corporate governance system, arguably poor supervision and ineffective crisis management decisions brought about the almost complete elimination of a part of Spain´s financial sector with more than 100 years of tradition. Currently the savings banks (*cajas de ahorro*) represent less than 2% of the total amount of assets of LSI's and less than 0,12% of the total size of the financial market.

Isnt’t it too late? For some Member States perhaps, but even there, it is worth the try!

b. **Italy** is in transition: a significant consolidation is caused by the Banche di Credito Cooperativo (BCC) Reform Act which mandates in the establishment of one or more horizontal banking groups (two national, plus one regional, will include all but one cooperative bank). This will end the independent existence of 355 cooperative banks which account for 77% of the Italian LSI's and a total of 42% of the LSI assets. **Note however that when a multitude of small banks enter into mutual liability arrangements through IPS, cross shareholdings, integrated cooperative structures or horizontal groups, they might become systemically relevant, at least at national level and if the transition to this model is made in bad times when many of these banks are weak and the parent company is new in the role this may pose a risk to the financial system (a “consolidated version” of the “too many to fail” problem!).**

Why the modular approach followed so far is not enough? (I)

- We argue that:

a. **Pillar I** modular approach is not always consistently followed by supervisors and creates compliance costs even when rules do not apply to small banks, because identification of the applicable rules to the individual bank is not easily done; alleviation is promised by the Risk Reduction proposals but this does not eliminate any reporting duty (simply limits the frequency); qualitative capital requirements are set for all but clearly designed for large banks (small banks rarely use AT1 (Cocos), mostly capitalise with CET1, and if T2 is there, 75%/25%)

b. **Pillar II** requirements should in principle be governed by proportionality (Art. 74(2) CRD and EBA Guidelines on SREP, which categorizes 4 classes of banks). In reality, though, frequency and intensity of the scrutiny only slightly differ. **Pillar 2 capital adds-on** (under 103 and 105 CRD IV) to address systemic risk is problematic already for systemically relevant banks (other instruments like debt service to income ratio and loan to value ration caps are better to curb the cycle) and should be ruled out for small banks. Also a microprudential use of these adds-on should be proportionate (it seems not: opacity of the supervisory exercise on this)

Why the modular approach followed so far is not enough? (II)

c. **Pillar III** imposes disclosure requirements on all banks without distinction. The Risk Reduction proposal would differentiate along a sliding scale of 3 classes of banks (good, but it increases complexity on its own right, because clusters for Pillar II and Pillar III will be different!);

d. BRRD adopts proportionality as a guiding principle in Article 1 and provides for alleviation of requirements for instance in Article 4. M**REL is differently calibrated for small banks, because no recapitalisation amount is required.** However, SRM experience shows that the boundary between significant and less significant banks is more slippery than expected: what is significant at the stage of the resolution plan could be less significant at the PONV, if the public interest test is not met. Perhaps existing clusters under the SSMR and SRMR, while accurate at the extremes, are not carved into the stone in the middle (where the red line between large and small banks blurs)?

If we move towards a two-tiered regulatory regime, aren't we changing the competitive game? (I)

- We argue the opposite may be true.

a. Banks business models are many (ranging from non-complex retail domestic banks, mostly located in Italy and Portugal to complex retail domestic banks, mostly located in Germany and Italy, to diversified banks and investment banks) and **different business strategies already impact on competitive performance**. Profitability and risk exposure are to some extent specific to each different business model.

b. Commercial retail banking is, still today, quite parochial due to persistent home biases, despite the Banking Union. Unlike wholesale global banking (a segment highly concentrated on its own right), cross-border retail banking is offered only by a handful of major banking groups. **LSI's, which do not fall under direct ECB supervision, compete domestically and have a comparatively small balance sheet total: roughly 18% of the balance sheet total of the Eurozone banking system.** From a competition perspective, it is hardly credible that focussed, non-complex retail commercial banks can distort competition to the detriment of major financial groups and the banks with other business models.

If we move towards a two-tiered regulatory regime, aren't we changing the competitive game? (II)

c. An uneven playing field arises because large banks have more market power and access to cheaper funding than smaller ones or can take advantage from significant economies of diversification or risk dispersion. Cheaper funding usually is also the result of an implicit guarantee for "too-big-to-fail" banks'. A comparative assessment of the Monte dei Paschi recapitalisation, on one hand, and of the restructurings of several other small to medium-sized banks occurred in Italy from 2015 to 2017, on the other hand, seems to confirm that this force may still be in place.

d. IRB (and its advantages on standardised model) is also part of the problem. In the United Kingdom, it has been calculated that – due to the differences in the risk weights under the IRB and standardised models "*for every £ 1 of capital set aside to cover credit risk, a large bank can do 10 times lower LTV mortgage lending than a small bank or a building society. Put another way, for taking exactly the same credit risk, the smaller lenders have to set aside ten times more capital that the 6 biggest firms that [in the United Kingdom] control 80% of the mortgage market*". This is also conducive to adverse selection: small banks are pushed to write proportionally higher LTV mortgages (since they have to charge more than large banks for low LTV mortgage lending). **Only time will tell if the December 2017 Standards of the Basel Committee will be enough to redress this!**

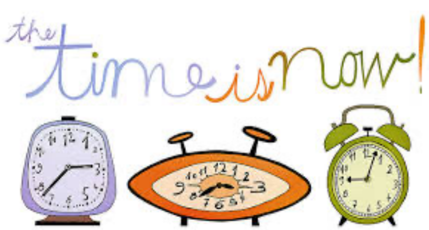
If we move towards a two-tiered regulatory regime, aren't we changing the competitive game? (III)

e. **excessive compliance costs threatens the competitiveness of local and regional banks. A survey conducted by Ernst & Young for Luxembourg in 2016** found that, on average, regulation accounts for 35% of the investment expenditure of the banks. The proportion reaches as much a 51% of expenditure for smaller institutions, which leaves little room for investment in business expansion or service improvements. These findings are consistent with those discussed in the recent past in the US: there are economies of scale in regulatory compliance and on this small banks are thus at a clear disadvantage.

- **The reality is, thus, that the regulatory burden seems to be a powerful force which is driving small and medium sized banks out of the market, in this way causing significant changes in the market structure. The number of small- and medium sized banks is visibly declining both in the US and in Europe, but changes in the market structure to the detriment of small banks are much stronger in Europe.**

What to do, then? (1)
Go first in search of the right definition of small and large

- According to Sabine Lautenschläger, “proportionality involves applying a distinct set of rules to banks operating in the same market”; the question then is how to frame such a Two-Tiered Banking Law. **There are probably too many definitions of ‘less significant’ banks that should be better aligned and harmonised.** We suggest that the methodology to allocate banks in one of the tiers should focus on (i) complexity and (ii) the absence of systemic relevance, with the size of the bank´s balance sheet serving as the first proxy to determine classification. Banks that are assessed as being G-SII or O-SII obviously also fall in the first-tier bracket. Banks with a complex business model or offering specialised services (for instance they are clearing member and participant in clearing of financial instruments), should also be classified in the first tier.








What to do, then?
(2) Develop an independent regime for small institutions

- Two regulatory approaches are equally possible and they are both voiced in the current discussions.

a. increase the number of *special* exceptions and adjustments for individual rules to the benefit of small banks.

b. identify “from scratch” a proportionate Small Banks’ Package

- (a) is path dependent and easier to develop but usually ends up being less ambitious than necessary. (b) would better invite to a fundamental reconsideration of the Single Rule Book, but could prove costly to develop and politically too ambitious to achieve.
- A compromise solution, in our view, would be at point here: **the rules should specify which provisions in the Single Rule Book are *explicitly applicable* to small banks**. This would counter the creeping and inertial expansion of the unitary (“one size fits all”) approach: a risk witnessed even in the US. **Apply to small banks what is expressly made applicable to them**!

What to do, then?
(3) Look at Japan and bundle a more lenient Small Banks Package with a more intrusive supervision (with resident teams)

- The principle of proportionality in banking encompasses both regulatory and supervisory aspects. So far, between these two dimensions of proportionality the relationship has been linear. A bank of small size and with a simple business model (non-complex retail domestic banks) calls in principle for the application of a simplified set of rules (regulatory proportionality means less).

We argue that, if a Small Banks Package is developed, a more intense supervision may counterbalance simplified legal requirements. Very many regulatory simplifications could be granted to small banks if risk management and regulatory compliance were supervised on an ongoing basis by resident oversight teams. This would partly subsidize compliance costs for non-complex retail domestic banks, to redress the competitive level playing field. This approach would also fit well within the decentralised implementation of banking supervision on LSI’s within the Banking Union, nicely factoring all proximity advantages and regional specificities at the level of national competent authorities.

Indeed, Japan has something to teach us!

- Japan is a frontrunner in this, and for good reasons. The degree of supervision of Japanese domestic banks is intense. The reason is, apart from the factual banking sector-sovereign relationship, the existence of relatively lenient regulatory requirements in terms of capital (with the exception of the G-SIBs). The Japanese rule book differentiates between internationally active and purely domestic banks: the capital requirements of the latter are *half those of the former*. Domestic banks have thus lower capital levels to trigger early action by the FSA. This comparatively “risky” approach (riskier than the American, and much riskier than the preventive action system of the BRRD) brings about a reinforcement of the supervision: there is a trade-off between regulatory and supervisory requirements, so that the less stringent the capital requirements, the more closely supervised must the banks be. This is, on the face of it, a transfer of rents from the public sector (FSA) to the banking sector, since the former must increase their investment in staff and controlling mechanisms, while the latter may enjoy a larger percentage of funds than its American or European counterparts.