



The European Voice of Savings and Retail Banking

POLITICAL TOOLBOX ON PROPORTIONALITY



RETAIL

REGIONAL

RESPONSIBLE

Working Paper

1. INTRODUCTION

This document aims to gather ideas and suggestions on the potential political options in order to increase the political awareness of the proportionality benefits in EU regulation.

As part of the long-standing support of ESBG to the proportionality concept, its fine-tuning appeared as a logical follow-up to the EBA Banking Stakeholder Group (BSG) report issued in December 2015. For the record, in its report, the BSG argues that, in the interests of effective and efficient bank regulation, the principle of proportionality has to be recognised and applied at every step of the legislative and regulatory process so that existing and new legislation and regulations are applied to banks and financial institutions in a proportionate way.

The overall administrative resources and cost of new regulation – such as supervisory costs and new IT systems – have a substantial impact on all banking institutions, and an even more severe impact depending on criteria such as the size and complexity of institutions and their business models.

As a result, disproportionate regulation could inhibit in particular retail banks from providing finance to the real economy to support innovation and growth. Proportionality is related to complexity and to balancing costs and benefits of regulation: if regulation is not proportionate in relation to its objectives, the cost-benefit calculation is likely to be worsened.

The elaboration of these political messages is also part of the ongoing reflections launched in the context of Better Regulation by European Commission Vice-President Timmermans, in which most concrete illustration so far is the reporting workstream initiated



in the REFIT platform. During these discussions, the approach taken in the US was thoroughly analysed as food for thought.

Proportionality in the US has been applied under the concept of “tiered regulation” as opposed to the EU which follows the “Single Rule Book” for all entities. The American solution appears to be a useful source of inspiration and should be taken into consideration at least from the level playing field perspective.

In the US, a two-tier banking system has been implemented, which allows a network of community banks - roughly 4,000 - to offer traditional services to the local communities.

For the record, these community banks offer limited products such as checking accounts, saving accounts, and certain loans, on a not-for-profit basis, as well as insuring all bank deposits by the FDIC (Federal Deposit Insurance Corporation). The US system works so that these community banks are in one tier, allowing them to offer less-risky products (however, also lower interest rates), while larger investment banks fall into another tier which would be more regulated and supervised.

This tiered regulation can be defined as “imposing lighter or proportional regulation on certain institutions to minimise or reduce unnecessary regulatory burden”, and WSBI-ESBG member ICBA advocates continuously for it: Camdem Fine, their CEO, supported by many Congressmen often says “Regulatory and paperwork requirements impose a disproportionate burden on community banks thereby diminishing their profitability and their ability to attract capital, support the credit needs of their customers, serve their communities and contribute to their local economies.”

We recently received an impressive list of texts where the tiered regulation is enshrined: since 1975, there have been 23 texts which reflect the tiered regulation.

The United States’ approach to tiered regulation results in different thresholds, depending on the regulatory aspect at hand and does not consider additional criteria such as the riskiness of business models. Thresholds of \$10 billion and \$15 billion seem to apply most frequently, but regulators are introducing much higher thresholds as well to differentiate between Main Street and Wall Street.

As a very recent illustration, Federal Reserve Governor Daniel Tarullo announced changes to the annual stress test process for banks, including implementation of long-awaited new capital requirements for the eight largest institutions and relaxed standards for somewhat smaller institutions.

Banks with less than \$250 billion in assets will no longer be subject to the qualitative portion of the tests, which evaluates risk-management processes, as long as they do not have significant international or non-bank activities.

The Chair of the Federal Reserve, Janet Yellen, reiterated this and has told lawmakers that banking regulations should be tailored to different types of institutions, such as community banks.

Testifying before the House Financial Services Committee, Yellen said the Fed takes a risk-based approach to regulation that aims to target examination resources to higher-risk areas of each bank's operations.

2. GENERAL CONSIDERATIONS

A differentiation of regulatory regimes would help local banks to compete on an equal footing while ensuring compliance with standards being set at international level and help by curtailing the increasingly distortional effects of regulation.

This would allow for a level playing field, promote growth, and in turn contribute at EU level to the further development of the Single Market as well as to financial stability.

Increased level of political awareness:

ESBG is convinced that there needs to be an increased level of political awareness, so that all politicians understand the concept and reasons behind the proportionality argument.

Proportionality and subsidiarity:

Proportionality should always be confronted with the objectives, i.e. is the rule proportionate to the objectives sought? Such analysis should be a crucial element in the impact assessment.

Proportionality should be enshrined in the first place at Level 1 which benefits from a democratic procedure. It should be ensured that Level 2 abides by Level 1, including regarding the use of legal instruments such as the guidelines (which should also be proportionate according to for instance Article 16 2. of the EBA founding regulation).

The concept of proportionality is not a loophole in the Single Rule Book which aims to provide a single set of harmonised prudential rules which institutions throughout the EU must respect and will ensure uniform application of Basel III in all Member States. Proportionality should be applied in accordance with the Single Rule Book spirit, but without neglecting the subsidiarity principle which remains key in the Treaties.

3. CRITERIA

While the approach chosen by US regulators is intriguing for its simplicity, it may not necessarily be adequate for Europe.

The European banking sector is arguably much more diverse than its US counterpart and the clear distinction between Main Street and Wall Street is lacking in Europe.

ESBG would therefore advocate to opt for a more prudent approach than the one-dimensional, size-only differentiation chosen by US regulators. To this end, narrower rules should be limited to those credit institutions that do not pose significant (systemic) risks to the financial system.

There are many different criteria which could be used to determine whether the principle of proportionality should be taken into consideration when applying legislation to banks and other financial institutions.

These criteria should be applied in a non-cumulative way. ESBG proposes to make use of the following criteria:

Size:

The concept of proportionality must be valid for all banks regardless of size (especially local banks that make up a large banking group). The size (small or large) could be in some specific cases specified by a quantitative threshold.

Business model:

The business model could also be used as a key criteria, as proportionality should be applied depending on the characteristics of the subject.

Proportionality could be understood on the basis of the business model and, consequently, in particular on the risk profile.

ESBG proposes a concept of proportionality that takes into account the proportion of different banking activities - retail banking, wholesale banking, and trading activities - and taking into account the number of countries relevant for the profits considered in each activity.

This would allow entities to be grouped based on their business model and, consequently, complexity and risk profile and means that reporting, disclosure, technical and capital requirements should be proportionately determined.

The CRR review for instance could be a good legal vehicle for the introduction of this concept.

Complexity and interconnectedness:

The complexity of regulation and its application can, in some cases, result in excessive costs of compliance. The size of an organisation seems in the majority of cases to be the critical element in the creation of the cost burden.

Excess complexity means that regulation may become more complex than is needed to meet its objective and/or to appropriately address market failures. It also generates higher compliance costs, which could be disproportionate for some banks depending on their size and organisation.

It should be considered whether the same regulatory objectives could be achieved, and with the same degree of effectiveness, with less complex regulatory requirements.

SREP:

Further to the aforementioned quantitative criteria, a qualitative assessment could be envisaged, for instance based on the outcome of the SREP (Supervisory Review and Evaluation Process).

Proportionality should be implemented at level 2 at the discretion of the national supervisory authority, which has carefully reviewed the qualitative assessment and the quantitative data.

4. LEVEL OF APPLICATION

We propose the level of application to be set at both solo and consolidated level, that means proportionality should also apply within consolidated groups regardless of whether they are based on equity participation or on contractual arrangements.

5. SCOPE OF APPLICATION

Proportionality, further to the subject to whom it applies, should also take into account the scope of application, in particular the products. For example, a rule regarding product governance of banking products may be needed, provided that it is adapted to the product to which it applies.

6. IMPLEMENTATION

The regulators both at level 1 and level 2 should take into account this necessity to draft legislation in accordance to the principle of proportionality, based either on internal guidance (such as the staff paper which is being prepared by the EBA) or on the recommendations given by stakeholders (e.g. EBA Banking Stakeholder Group report on proportionality in bank regulation, input being prepared by ESBG in the context of the call for evidence).

Proportionality should also be part of Pillar 2 requirements, i.e. applied by supervisors. The ECB, as the new European supervisor for the significant institutions, will also have to square the circle between harmonisation and application of the principle of proportionality.

7. STRUCTURAL STEPS

In order to ensure that there is no overregulation, there should be the possibility for Member States to set up at national level a committee ("a watchdog committee") with a wide representation in order to control that the proportionality principle is respected; this committee should complement the independent committee(s) already suggested in the EBA BSG report.

