Proportionality in banking regulation

In response to the international financial crisis of 2007–2009, supervisory standard setters tightened the regulatory framework for banks at the global and European level, making banks and the financial system more resilient to exogenous shocks. In accordance with previous reforms, in the European Union the scope of the standards that the Basel Committee on Banking Supervision (BCBS) had designed for large, internationally active banks was extended to all credit institutions based on single market considerations. This, in turn, has led to an intensified discussion about the proportionality of the regulatory framework, the fundamental question being if and how to adapt the regulatory requirements for small banks with a business model of low complexity and, in particular, little or no international business.

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1 Why proportionality in banking regulation?

The principle of proportionality is new neither to bank regulation (i.e. the establishment of rules for banks) nor to banking supervision (i.e. the enforcement of rules in ongoing banking supervision). In fact, the Basel Committee on Banking Supervision (BCBS) has taken proportionality into account for many years. The 2006 Basel II framework already provided banks with a simplified standardized approach to calculate capital charges for market risk and credit risk in addition to the use of more complex internal model-based approaches[2]. Furthermore, the BCBS introduced a principles-based approach to Pillar 2 under which the supervisory authorities, in their assessment of banks, have to consider among other things the size, complexity, business model and risk profile.[3] Since 2012, the BCBS has also explicitly referred to proportionality in its Core Principles for Effective Banking Supervision[4].

The principle of proportionality is also reflected in EU legislation – more generally in the Treaty on European Union[5] and, specifically with reference to banking regulation, in recital 46 of the Capital Requirements Regulation (CRR)[6], i.e. the implementation of the 2011 Basel III[7] framework into EU law. For banking, the principle of proportionality means in particular that establishing and applying regulatory requirements must take into account not just the size and scale of a bank's operations, but also an institution's complexity and risk profile.

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[2] *See BCBS (2006).*

[3] *Compare also Castro Carvalho et al. (2017), p. 4.*

[4] *See BCBS (2012), p. 11: "Principle 8 – Supervisory approach: An effective system of banking supervision requires the supervisor to develop and maintain a forward-looking assessment of the risk profile of individual banks and banking groups, proportionate to their systemic importance; ...".*

[5] *See European Union (1999), Article 5 (4): "Under the principle of proportionality, the content and form of Union action shall not exceed what is necessary to achieve the objectives of the Treaties. The institutions of the Union shall apply the principle of proportionality as laid down in the Protocol on the application of the principles of subsidiarity and proportionality."*

[6] *See CRR (2013), recital 46, in particular the first sentence: "The provisions of this Regulation respect the principle of proportionality, having regard in particular to the diversity in size and scale of operations and to the range of activities of institutions.".*

[7] *See BCBS (2017).*

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In the CRR, the EU broadened the scope of application of the Basel provisions to include virtually all EU banks with the objective of establishing a single rulebook. Yet the CRR also contains a number of requirements based on proportionality, among other things with regard to market risk (e.g. derogations for banks with a small trading book) and disclosure (reduction of the content and frequency of disclosure for smaller, non-listed institutions).[8]

The ongoing supervision of banks also allows for proportionality, in particular under Pillar 2, that is, assessment of the adequacy of banks' internal risk measurement and management process. As a case in point, the European Banking Authority (EBA) has recognized the principle of proportionality in its guidelines on common procedures and methodologies for the supervisory review and evaluation process (SREP).[9] Additionally, proportionality has also been enshrined in the area of recovery and resolution planning through the establishment of "simplified obligations" for smaller institutions.[10]

The scope of regulatory requirements has expanded substantially since the Basel Capital Accord (Basel I) was first implemented.[11] Whereas Basel I addressed only credit risk and was just 30 pages long, the Basel framework has since been supplemented by a complex three-pillar regulatory framework that takes into account credit risk, market risk and operational risk. Additionally, the framework stipulates capital requirements, a leverage ratio and the regulation of short- and medium-term liquidity risk. The respective rules comprise standardized and rules-based approaches (Pillar 1) as well as principles-based approaches that have supplemented banks' internal approaches with supervisory review (Pillar 2). To ensure market transparency, banks must moreover meet comprehensive regulatory disclosure requirements (Pillar 3) in addition to the standard accounting and transparency obligations. Apart from the Basel framework, updated and supplemented by the recent agreement on Basel III reforms,[12] banks must comply with numerous additional specific international rules and standards.[13]

Above and beyond the Basel framework, EU prudential requirements reflect various national particularities that make EU supervisory legislation all the more intricate. Moreover, institutions must also fulfill common EU and some national securities, capital market, accounting and consumer protection requirements. These developments have made in particular the European implementation of the Basel framework increasingly complex, with small institutions finding it particularly difficult to keep pace with these developments.

Regulatory initiatives taken since 2008 predominantly reflect a reaction to the experience of the 2007–2009 financial crisis, and they have markedly helped boost the banking system's resilience to exogenous shocks. As a corollary to the reinforced resilience of the banking sector, compliance and back-office resources have been increased, entailing higher regulatory costs.[14] Whereas the basic

[8] *See CRR (2013), Article 94 and Article 431 ff.*

[9] *See EBA (2014).*

[10] *See BRRD (2015), Article 4 and Article 11 ff.*

[11] *See BCBS (1988).*

[12] *See BCBS (2017).*

[13] *For a comprehensive overview, see https://www.bis.org/bcbs/publications.htm.*

[14] *See Hackethal and Inderst (2015), p. 4 ff.; EBA Banking Stakeholder Group (2015), p. 7 ff. as well as Genossenschaftsverband Bayern (2017).*

development of the regulatory framework must be welcomed from the prudential stability perspective, the cost imposed by regulation – which is in relative terms larger for smaller banks for economies-of-scale reasons – may trigger unintended externalities. This includes in particular impacts on the structure of the banking sector, such as greater pressure on banks to merge or higher market entry barriers because of regulatory costs or complexity. Especially against the background of progressive digitalization of financial services, the size and complexity of the existing regulatory framework as a market entry barrier for new actors could inhibit financial innovation and could ultimately have an impact on the cost of financial intermediation. Generally speaking, the basic orientation of banking regulation should thus be structurally neutral.

These externalities hence raise the issue of whether there are regulatory or supervisory ways and solutions to achieve the objective of maintaining financial stability by increasing cost efficiency and reducing the complexity of requirements without at the same time affecting the effectiveness and soundness of the overall system. That is the pivotal issue in the discussion about the application of the principle of proportionality in regulatory and supervisory practice.

Inadequate proportionality may lead to an unjustifiably high resource burden not just on banks, but notably also on the regulatory authorities themselves. By extension, the importance of containing costs and achieving high efficiency in the public sector calls for a more proportionate and risk-oriented deployment of supervisory resources.

Achieving a suitable balance between various aspects in the context of proportionality is crucial for upholding fair competition while at the same time ensuring financial stability. Critics have pointed out in connection with proportionality that smaller banks are not per se less risky.[15] Therefore, proportionate regulations should not create negative incentives in the sense that they induce regulatory arbitrage or result in lower supervisory quality and thus affect financial stability.

Another factor to take into account is that proportionate rules could in fact increase the regulatory burden rather than reduce it, especially if a separate framework is created for a particular group of banks. Establishing a parallel regime, or even several regimes, would increase the complexity of regulatory requirements and make competitive conditions even less transparent. However, complexity increases even within a single framework if proportionality is applied to many specific requirements based on different criteria.[16] To prevent such negative effects, it is paramount to uniformly define which banks are eligible for proportionate treatment in specified areas and to base this definition on clear-cut criteria. This definition should preferably be used throughout the entire regulatory framework, with a set of fundamental, simple rules being applied to all banks.[17] Conversely, potential proportionate treatment could depend on the respective requirement

[15] *As a case in point, data from the Federal Deposit Insurance Corporation indicate that from 2000 to 2017, most failed banks were small banks (according to the U.S. definition, these are institutions with total assets of less than USD 30 billion). See www.fdic.gov/bank/individual/failed/.*

[16] *Compare section 3.2 on the existing proportionality rules in the CRR and the discussion about increasing them in section 4 below.*

[17] *On this issue, see the Pillar 1+ proposal of the FMA and the OeNB, which is presented in section 5 and which takes precisely these aspects into account.*

itself, so that the criteria do not necessarily have to be identical in all areas. Once again, it is important to strike a balance between proportionality in the individual case and the least possible complexity of the entire framework.

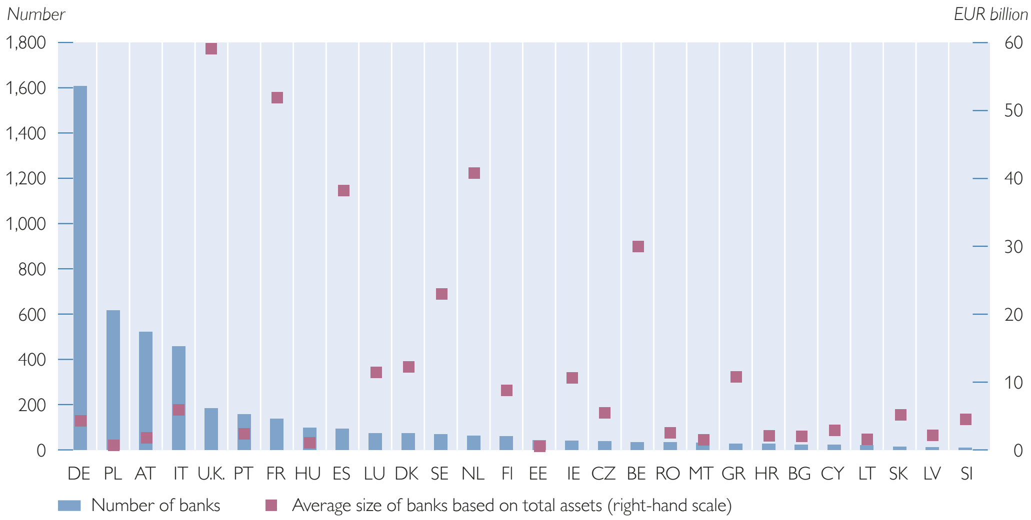
Against this backdrop, we present an overall assessment regarding the current structure of the European banking sector through the lens of proportionality. We highlight existing approaches to implementing regulatory proportionality in various countries as well as relevant measures under discussion at the European level. Finally, we also look at the Austrian supervisory authorities' stance on proportionality.

2 The heterogeneous structure of the European banking sector

The European banking industry continues to be characterized by a comparatively large number of banks. At the end of 2016, there were 4,144 banks in the EU as a whole,[18] with a high degree of variability across individual EU Member States. Some countries have a large number of small banks and a handful of large banks, whereas the banking sector in other countries is dominated heavily by just a few very large banks.

Chart 1

Number and average size of banks in the EU



Source: ECB consolidated banking data (CBD) statistics.

Note: For SSM countries, the number of banks is based on the list of supervised entities published by the ECB for 2016 (2017a).

Germany accounts for the lion's share of EU banks – some 1,600 institutions – followed by Poland, Austria and Italy; more than two-thirds of all banks in the EU are located in these four countries. By contrast, most other EU countries have (significantly) less than 100 banks each. The heterogeneous structure of the European banking sector is also reflected by the average size of banks in each EU Member State in terms of total assets: whereas average total assets were below EUR 5 billion in Germany, they are, at over EUR 50 billion, considerably higher in the U.K. and France, countries that are comparable with Germany in terms of

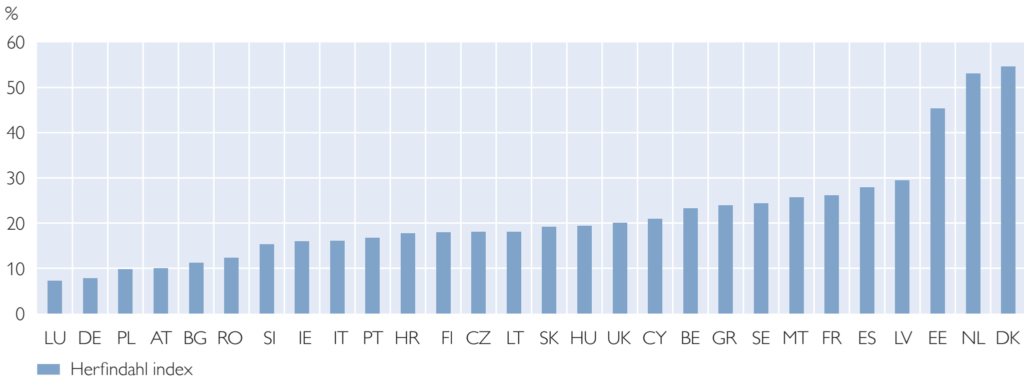
[18] *Consolidated view based on the ECB's consolidated banking data (CBD; i.e. banking groups and banks that are not part of a banking group), see https://sdw.ecb.europa.eu/browse.do?node=9691533.*

banking sector size. The disparity in the average size of credit institutions is even larger when smaller EU Member States with similarly sized banking sectors are compared. In Austria, banks' average total assets fall short of EUR 2 billion, whereas they are (significantly) higher than EUR 40 billion in the U.K., France and the Netherlands.

The disparate historical development of banking sectors in individual EU countries is at the heart of the large range of average total assets. The number of banks in relation to the size of the respective banking sector in an EU Member State largely accounts for these differences, but this is not the only reason, as the chart below based on the Herfindahl index (HI)[19] shows. The banking structure is also characterized by the size distribution of banks.

Chart 2

Banking industry concentration in the EU



Source: Authors' calculations based on data from S&P Global Market Intelligence (formerly SNL Financial) and national reports.

While banking sector concentration is very high in some EU countries, with the Netherlands and Denmark at the top of the range, it is partly markedly lower in other EU countries. Remarkably, countries like Luxembourg, Bulgaria and Romania are among the countries with a low concentration level. Chart 1 and chart 2, which show the number of banks and the degree of concentration within the banking system, signal that proportionality considerations may be an issue for countries with a large number of small banks (especially Germany, Austria, Italy and Poland). However, there are also countries with relatively few large banks, which have an oligopolistic banking market (e.g. Denmark and the Netherlands). In such countries, proportionality could boost competition and innovation because of lower market entry barriers – which means that the case for proportionality is not limited to small or decentralized banking markets.

In the euro area and consequently in countries participating in the Single Supervisory Mechanism (SSM), banks are classified as significant institutions (SIs) or less significant institutions (LSIs)[20]; banks with total assets of more than EUR 30

[19] *The Herfindahl index (HI) is a statistical measure of concentration. In highly simplified terms, the HI for the banking sector is to be understood as follows: in a monopoly banking system with just one single bank, the total assets of this bank will equal those of the banking system (HI=100%). At the other end of the spectrum, a huge number of small or equally sized banks would yield an HI of close to 0%.*

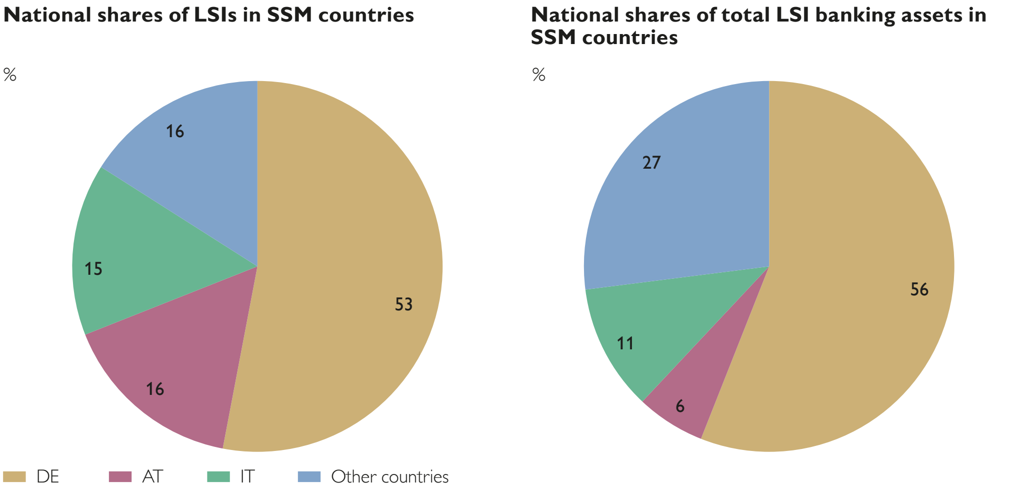
[20] *Unlike SIs, which are supervised directly by the ECB, LSIs are supervised by the national competent authorities.*

billion are in any case classified as SIs. Only LSIs are usually perceived to qualify for proportionality considerations.

According to an ECB report on LSI supervision in the SSM[21], there were 3,267 LSIs at solo level at end-2016; these institutions represent 15% of total SSM banking assets. The bulk of the LSI sector is concentrated in Germany, Austria and Italy; in Italy, the ongoing consolidation of the banking sector will markedly reduce the number of LSIs in the next few years. At end-2016, over 84% of all LSIs were located in Germany, Austria and Italy, and these three countries also accounted for more than 70% of total LSI assets in the SSM.

Chart 3

National shares



Source: Annual reports of national supervisors for 2016, ECB (2017b), p. 4.

Average total assets of an LSI in the SSM amounted to EUR 1.5 billion at end-2016 compared to just roughly EUR 200 million in Austria. By contrast, average total LSI assets were much higher in SSM Member States with larger banking sectors and fewer LSIs, such as the Netherlands, France, Ireland or Belgium.[22]

Banks with total assets of less than EUR 1.5 billion account for at most 15% of total assets within each SSM Member State, and in most countries, the share lies (substantially) below 10%. In relation to the number of LSIs the share is much higher and – with the exception of a handful of countries that have only few LSIs –, the share of LSIs with total assets below EUR 1.5 billion in total LSIs is over 90%. In Austria, such small LSIs account only for around 10% of total assets, while in terms of number, well over 95% of all LSIs fall into this category. The pattern is similar, though not as pronounced, in Germany.

LSIs use a wide variety of business models, but retail banking predominates. Also, LSIs' activities are – geographically more concentrated than those of SIs.[23]

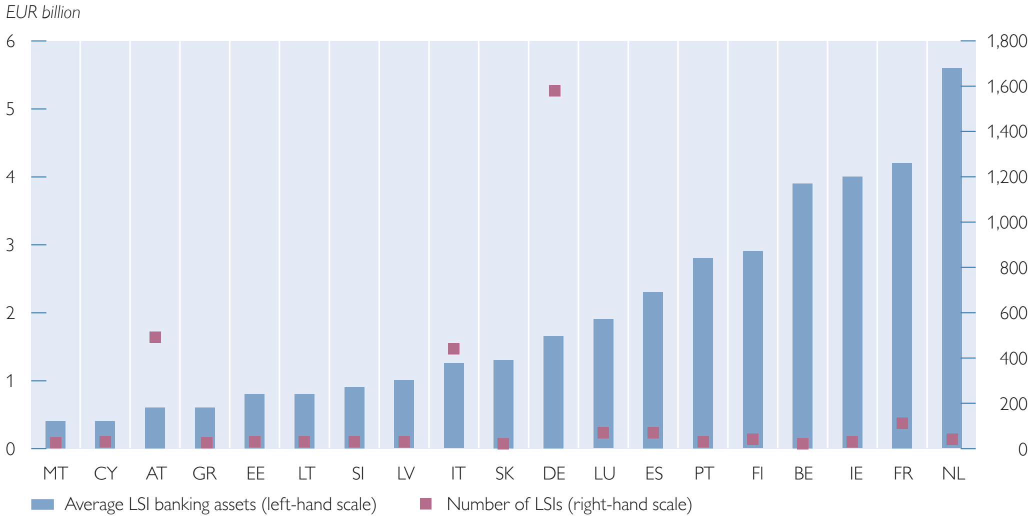
[21] *As published in ECB (2017b), p. 4.*

[22] *See ECB (2017b), p. 5.*

[23] *See ECB (2017b), p. 6.*

Chart 4

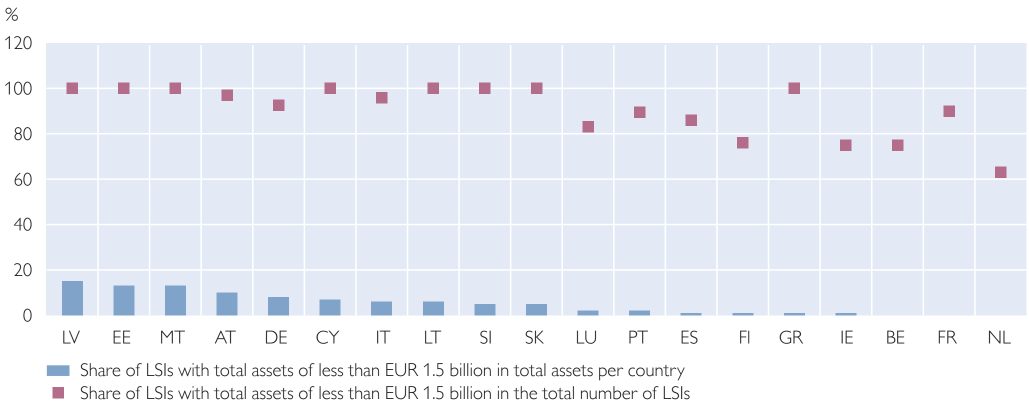
Average total assets and number of LSIs in SSM countries



Source: ECB (2017b), p. 5.

Chart 5

LSIs with total assets of less than EUR 1.5 billion



Source: Authors' calculations based on data from S&P Global Market Intelligence (formerly SNL Financial) and national reports.

The overall conclusion thus is that the bulk of small SSM banks are located in Germany, Austria and (at least still up to 2016) Italy. This reflects the presence of large, decentralized savings and cooperative bank systems, which in Germany and Austria are often organized within joint institutional protection schemes (IPS). However, one must not jump to the conclusion that proportionality is relevant only in these countries. As stated in section 1, the size and complexity of existing regulatory frameworks may represent a market entry barrier for new players, especially as the digital transformation of financial services progresses.

3 Overview of existing proportionality approaches

3.1 Globally, existing proportionality approaches are very heterogeneous

As indicated before, the principle of proportionality is firmly established in the Basel regulatory and supervisory framework.

The Financial Stability Institute (FSI) at the Bank for International Settlements (BIS) distinguishes between the following basic approaches in implementing proportionality in selected regional jurisdictions:[24]

- *Categorization approach for proportionality (CAP):* banks are categorized by various qualitative and/or quantitative characteristics – with size being the decisive characteristic as a rule – and a specific regulatory regime is applied to each of the categories.
- *Specific standard approach for proportionality (SSAP):* tailored criteria are established for the application of specific requirements for a subset of prudential standards, such as disclosure requirements, liquidity indicators, large exposure limits and market risk.

In principle, the CAP establishes consistent prudential rules for banks sharing similar characteristics in a particular jurisdiction. Brazil, Japan and Switzerland, where banks are classified by size and/or the degree of cross-border activity, with different rules applying in different segments, may serve as examples of the CAP.[25] Brazil has divided its financial system into five segments, taking into account size, cross-border activity and banks' risk profile. The complete Basel framework is applied only to the six largest, internationally active banks in segment 1. The remaining banks in segments 2 through 5 are subject to less comprehensive prudential requirements, depending on their risk profiles and business models.[26] Switzerland groups banks (and securities dealers) into five categories based on measurable criteria related to total assets, assets under management, privileged deposits[27] and required capital. The Basel standards apply fully to institutions classified under categories 1 through 3, whereas banks in categories 4 and 5 are subject to a less comprehensive regulatory regime.[28] Japan roughly divides its banking system into two categories: internationally active institutions (with branches or subsidiaries abroad) that apply full Basel standards and banks that are subject to domestic regulation.

Unlike the CAP jurisdictions, the SSAP jurisdictions, i.e. the European Union, Hong Kong SAR and the United States, grant exemptions or permit the application of simplified regulation on specific areas to banks that fulfill particular criteria. These criteria are explained separately for the EU below. These exemptions are targeted at reducing the operational burden for banks without unduly weakening overall prudential standards. Traditionally, the U.S. approach to financial supervision and regulation has been characterized by flexibility[29] with a view to avoiding an

[24] *See Castro Carvalho et al. (2017), p. 5 f.*

[25] *See Castro Carvalho et al. (2017), p. 6 ff as well as annex p. 13 ff.*

[26] *See Central Bank of Brazil (2017).*

[27] *Privileged deposits benefit from protection up to a maximum of CHF 100,000 by analogy to the "covered deposits" of EUR 100,000 under Article 2 (5) in conjunction with Article 6 (1) Deposit Guarantee Scheme Directive (DGSD 2014) in the EU.*

[28] *See https://www.finma.ch/en/supervision/banks-and-securities-dealers/categorisation/.*

[29] *The current U.S. administration is seeking to relax banking regulation (in particular the Dodd-Frank Act). The U.S. Congress has already passed legislation easing bank rules. Recently the U.S. Federal Reserve issued a proposal to ease the Volcker Rule; see http://www.handelsblatt.com/finanzen/geldpolitik/us-notenbank-fed-legt-vorschlag-fuer-erleichterungen-beim-banken-eigenhandel-vor/22627478.html?ticket=ST-4543869-i0WSMLoAo75ruLFZLGka-ap3.*

excessive regulatory burden. While the existing standards principally apply to all institutions equally, under certain conditions, specific exemptions with respect to different regulated areas may be granted in addition to the selection of banks into different regulatory categories.[30] Such regulatory relief is provided for especially in the context of stress tests and capital planning and with regard to counterparty risk, market risk and liquidity risk.[31] Hong Kong SAR provides for proportionate application of the standards above all with regard to liquidity risk and credit risk (including large exposures and counterparty risk as well as disclosure).[32]

The key feature of every proportionality regime is the set of criteria used to identify the banks to which a proportionate framework is applied. These criteria vary widely across the reviewed jurisdictions and differ considerably between the CAP and SSAP approaches. Size plays an important role in each of these concepts, where the respective thresholds[33] for applying the full Basel framework are set in either absolute or relative terms to total exposures, GDP or capital. These thresholds vary considerably. It must be noted that the different thresholds also result from the size and structural characteristics of the banking sectors in the individual countries:[34]

- In Switzerland, the absolute threshold of total assets is EUR 13 billion and hence comparatively low.
- The threshold is about twice as high in Hong Kong SAR, with total assets coming to over EUR 26 billion.
- Japan does not apply a threshold for size; the criteria for considering a bank internationally active, however, create an implicit size threshold similar to that applied by Hong Kong SAR.
- Brazil uses a relative threshold (total exposure to GDP exceeds 10%), which corresponds to about EUR 170 billion.
- The United States has set the highest threshold among the jurisdictions for full application of the Basel framework – total assets of around EUR 203 billion.

Additionally, the SSAP jurisdictions apply size-related thresholds for individual regulatory areas, particularly for the treatment of market and counterparty risk as well as disclosure requirements. As a case in point, the United States exempts all banks with insignificant trading activities (trading assets below EUR 810 million or 10% of total assets) from full application of market risk requirements.

Size-related thresholds cannot capture the full extent of business models and related risks. Therefore, other variables to categorize banks are used in both approaches, e.g. supervisory approval (Hong Kong SAR, Brazil), the business model (Hong Kong SAR, Brazil), the bank's role in the banking system (Hong Kong SAR), the risk profile (Brazil, the United States, Hong Kong SAR and Japan), and involvement in cross-border activities (Japan).[35] The FMA/OeNB proportionality concept presented in section 5 provides also for (absolute and relative) size thresholds, additionally taking into account criteria for business model complexity and risk,

[30] *See Joosen et al. (2018), p. 12.*

[31] *See Castro Carvalho et al. (2017), p. 6 ff as well as annex p. 13 ff.*

[32] *See Castro Carvalho et al. (2017), p. 6 ff as well as annex p. 13 ff.*

[33] *All absolute thresholds are given in euro below to make comparisons easier. Conversion is at the exchange rates of March 29, 2018.*

[34] *See Castro Carvalho et al. (2017), p. 7 f.*

[35] *See Castro Carvalho et al. (2017), p. 8.*

complemented with a revocation right for supervisory authorities regarding the proportionality status.

3.2 Proportionality in current EU banking regulation

The CRR and the Capital Requirements Directive (CRD IV)[36] contain a total of 26 provisions that are explicitly or implicitly applicable in a "proportionate" manner. As a rule, these provisions standardize the application of a given requirement in a manner that is "proportionate to the nature, scale and complexity of those institutions" or in such a way that the degree of application of a requirement should reflect differences between different types of institutions in a proportionate manner, taking into account their "size, internal organization and the nature, scope and complexity of their activities." The first wording is regularly found in requirements that must principally be observed by all institutions across the board, respecting a proportionate application (for example implementation and execution of an internal capital adequacy assessment process). In turn, the second wording concerns institutions that must observe more stringent requirements (above all, setting up committees and similar internal management obligations). Thus, proportionality requirements are not uniformly defined under the CRR or the CRD IV.

Proportionality requirements can be found primarily with regard to market risk,[37] credit risk[38] and partly also with regard to reduced disclosure requirements and a lower disclosure frequency for small unlisted institutions.[39] Moreover, the concept of proportionality is also reflected in regulations regarding authorization, waivers and respective exemptions.[40] According to recital 14 of the Bank Recovery and Resolution Directive (BRRD), the principle of proportionality also applies to recovery and resolution planning. The contents and information requirements specified in the BRRD establish a minimum standard for institutions with evident systemic relevance, but authorities are permitted to apply different requirements to other institutions. For instance, the BRRD establishes appropriate options to categorize and distinguish between institutions in the "simplified obligations" framework.[41] In the FMA's Bank Recovery Plan Regulation[42] detailing the content and level of detail of bank recovery plans, the FMA used discretionary powers to

[36] *See CRR (2013) and CRD IV (2013).*

[37] *As a case in point, Article 94 CRR (2013) envisages a derogation for institutions with small trading book business, enabling such banks to use a simplified framework to calculate capital ratios for trading book business.*

[38] *As a case in point, Article 169 CRR (2013) standardizes general principles on the appropriateness of rating systems, models and systems used to make specific estimates under the internal ratings-based (IRB) approach and the related risk management processes and controls.*

[39] *As a case in point, under Article 433 CRR (2013), all institutions must publish disclosures at least on an annual basis. Large institutions with business that exceeds a specified threshold must publish disclosures more frequently (semiannually, quarterly).*

[40] *Examples of waivers for minimum capital requirements in credit institution groups are the solvency waiver for subsidiaries on an individual basis (Article 7 (1) CRR), the solvency waiver for parent institutions on an individual basis (Article 7 (3) CRR) and the solvency waiver for individual credit institutions permanently affiliated to a central body (Article 10 (1) CRR). The application of liquidity coverage requirements under Part Six CRR (liquidity, in particular application of the liquidity coverage ratio, LCR, and the net stable funding ratio, NSFR) may be fully or partly waived under Article 8 CRR for subsidiaries where all institutions of the single liquidity subgroup are authorized in the same Member State (Article 8 (2) CRR), for credit institutions permanently affiliated to a central body (Article 10 (1) CRR), as well as for members of an institutional protection scheme (IPS, Article 8 (4) CRR).*

[41] *See BRRD (2014), Article 4.*

[42] *FMA Bankensanierungsplan-Verordnung (see FMA, 2015).*

classify credit institutions into four categories, with proportionate requirements applying e.g. to recovery plan contents and updating frequency.

4 Outlook: additional proportionality proposals under discussion in the EU

In September 2015, the European Commission launched a call for evidence on the EU regulatory framework for financial services. The purpose of this consultation was to identify key areas where efficiency can be increased and that hold potential for improvement. The responses of over 300 stakeholders can be grouped into four main demands:[43] reducing unnecessary regulatory constraints on financing the economy, enhancing the proportionality of the regulatory framework without compromising prudential objectives, reducing undue regulatory burdens, and making the regulatory framework more consistent and forward-looking.

The European Commission's report of December 2017 to the European Parliament, the European Council, the European Economic and Social Committee and the Committee of the Regions contains a preliminary conclusion about the measures already taken in response to the results of the call for evidence with respect to the problem areas identified.

In connection with the issue of proportionality, the European Commission pointed out the ongoing review of the CRR, the CRD IV, the BRRD and the Single Resolution Mechanism Regulation. The proposal for the legislative package to reform the cited frameworks (CRR/BRRD review) was published in November 2016.[44] It contains a number of measures to increase proportionality in the areas of disclosure, reporting, remuneration and market risk.

According to the European Commission's proposal, the frequency and scope of disclosure requirements would depend on whether the requirement applies to a large or to a small, non-listed institution. Large, listed institutions (i.e. global and other systemically important institutions as well as institutions with total assets of at least EUR 30 billion) will have to fulfill the Basel III disclosure requirements as implemented in the revised CRR, whereas small, non-listed institutions will only need to fulfill selected annual disclosure requirements. Small institutions are defined as having total assets averaging up to EUR 1.5 billion in the past four years. Non-listed institutions are institutions that have not issued securities admitted to trading on a regulated market in a Member State. Small, non-listed banks will only be required to make selected disclosures of key metrics, in particular regarding own funds, liquidity, governance, remuneration and risk management information on an annual basis. Institutions that are neither large nor small (other institutions) will be required to make full annual disclosures and to publish key metrics on a semiannual basis.[45]

With respect to remuneration, institutions that had total assets averaging up to EUR 5 billion in the past four years or employees whose annual variable remuneration does not exceed EUR 50,000 or does not represent more than 25% of their total

[43] *See European Commission (2016a).*

[44] *See European Commission (2016b and 2016c). For a critical academic appraisal of the European Commission's proposals taking into account proportionality aspects, see Stern (2017).*

[45] *See European Commission (2016b) Article 430a CRR as proposed.*

annual remuneration shall be exempted from specific remuneration rules (regarding the partial payment of variable remuneration in instruments and deferral principles). However, it will remain at the competent authorities' discretion to apply more stringent rules.[46]

With reference to market risk, among other things the thresholds for small trading books shall be increased from EUR 15 million to EUR 50 million.[47]

In the area of reporting, the European Commission's proposal envisages a lower reporting frequency for small institutions (according to the aforementioned definition). Moreover, the proposal explicitly states that data which are already available to competent authorities (though at different levels of granularity or in a different format), shall not be collected once again. This provision corresponds to the "multi use of data" concept that the OeNB has been advocating for some time and that will be described in more detail in the following section on the FMA/OeNB proportionality concept.[48] Additionally, the European Commission's proposal envisages mandating the EBA, first, to deliver a report on the cost of the existing supervisory reporting system, including recommendations to simplify reporting. Second, the EBA is to develop a compliance tool aimed at facilitating institutions' compliance with the relevant prudential provisions in relation to their size and business model to reduce the related operational burden and costs especially for small institutions.[49]

The European Commission intends to focus particularly on reporting, above and beyond the CRR/BRRD review. To this end, the European Commission launched a "fitness check of supervisory reporting requirements" in financial services legislation in the summer of 2017. This fitness check included a public consultation from December 1, 2017, to March 14, 2018, to gather quantitative evidence on the cost of compliance with existing supervisory reporting requirements and to collect negative examples of inconsistent, redundant or duplicate supervisory reporting requirements.[50]

In November 2017, based on the European Commission's legislative proposal, the European Parliament published an initial preliminary report with amendments that itself contains proposals on increasing proportionality in the framework. Accordingly, the report cites the following criteria for defining a small and non-complex institution:[51]

- quantitative criterion: total assets of less than or equal to EUR 1.5 billion (option for the competent authority to lower the threshold value from EUR 1.5 billion to 1% of GDP of the Member State provided that the threshold value exceeds 1% of the respective Member State's GDP, or increase the threshold value from EUR 1.5 billion to up to 0.1% of the Member State's GDP at the consolidated level), and

[46] *See European Commission (2016c) Article 430a CRR as proposed.*

[47] *See European Commission (2016b) Article 94 CRR as proposed.*

[48] *See European Commission (2016b) Article 99 (11) CRR as proposed.*

[49] *See European Commission (2016b) Article 519b CRR as proposed.*

[50] *See European Commission (2017a and 2017b).*

[51] *See European Parliament (2017a), Article 4 (1) 144a CRR as proposed. The authors are aware of the fact that the document published by the European Parliament is a draft report. The final outcome of the proportionality debate of the Parliament's Committee on Economic and Monetary Affairs is yet to be published.*

- qualitative criteria: the bank is not a large institution in the sense of a global systemically important institution, an "other systemically important institution" or an SI, its trading activities are low, the total value of the derivative positions is less than or equal to 2% of total on- and off-balance sheet assets, liquidation in insolvency proceedings is credible and feasible, and the institution does not use internal models.

In addition to these criteria, the proposals envisage a revocation right for the competent supervisory authorities and an opt-out clause for institutions. Institutions meeting this definition will mainly be subject to less stringent reporting and disclosure requirements and a simplified calibration and reporting of the net stable funding ratio (NSFR).[52]

The final design of these proposals and the choice of which ones to take on board in the amended EU legislation depends on the outcome of the trilogue negotiations between the European Commission, the Council of the European Union and the European Parliament that are scheduled to begin mid-2018.

5 The FMA/OeNB proportionality concept: "Pillar 1+ approach"

In the context of the CRR/BRRD review, the FMA and the OeNB have proposed a comprehensive concept on proportionality referred to as "Pillar 1+ approach." The cornerstone of this joint concept are compelling premises to be considered when introducing proportionality in the regulatory framework with a view to addressing arguments in favor of and against proportionality in equal measure. According to the concept, rules of proportionality must not create negative incentives. Above all, they must not result in regulatory arbitrage or impair the quality of supervisory activity, thereby undermining financial stability.

Given the complexity of the current regulatory framework, a near-term introduction of a new, separate framework for small, non-complex banks was not deemed feasible, which is why, as a starting point, proportionality considerations ought to lead to simplification within the existing framework (rather than to the development of a parallel regime for small, non-complex banks). Future regulatory proposals should account for how the concept of proportionality may be applied during implementation. Such an approach does not rule out that there will eventually be a separate rulebook for small, non-complex banks. Compared with setting up an entirely new regulatory framework, introducing proportionality into the existing one has the advantage that uniform regulatory principles are ensured for all banks. With this in mind, the principle of proportionality should be taken into account at an early stage,[53] especially when adopting new Basel standards in EU supervisory legislation (e.g. when enacting the final Basel III framework into the EU legal framework). Proportionality should be limited to areas in which application to small, non-complex institutions appears expedient to enhance financial stability.

The FMA/OeNB concept for introducing proportionality in the regulatory framework provides for a "Pillar 1+ approach": small, non-complex banks will remain subject to all Pillar 1 requirements, but are to be partly exempt from Pillar 2 requirements and fully exempt from Pillar 3 requirements. This approach is designed to ensure that the basic principles of the regulatory framework remain

[52] *See European Parliament (2017a and 2017b).*

[53] *See BCBS (2017).*

uniform for all institutions. For this reason, no exemptions under Pillar 1 are envisaged (e.g. of the NSFR).

To reduce the complexity of the framework, Article 4 CRR as proposed should include a uniform definition of small, non-complex institutions[54] consisting of three criteria:[55]

- Total assets must not exceed any of the following thresholds: EUR 5 billion, 0.4% of the Member State's GDP and 0.2% of total assets of all institutions established in that Member State at the unconsolidated level.
- In light of their low risk profile, these banks must not issue any transferable securities admitted to trading on a regulated market (according to the definition of the Markets in Financial Instruments Directive – MiFID II).
- Furthermore, these institutions may have only a small trading book according to Article 94 CRR as proposed (up to 5% of total assets or EUR 50 million) and the exposure value of their derivatives must not exceed the threshold stipulated in Article 273a CRR as proposed (less than or equal to 5% of total assets or EUR 20 million).[56]

The supervisory authority is to be given a revocation right. Even if an institution meets the above-mentioned criteria, it may be refused application of the Pillar 1+ approach due to its risk profile, company structure, legal form and status, interconnectedness to other institutions and/or the financial system, or the complexity and scope of its activities. Specifically, this could mean, e.g., high holdings of complex products or cross-border activities (outside the EU). Particular thresholds for such activities could conceivably be included in the above-mentioned list of criteria.

Principally, institutions that fulfill the criteria and are thus eligible for application of the proportionate approach must notify the supervisory authority thereof. Separate authorization will not be given. To ensure transparency and legal certainty, the EBA shall publish a list of the names of all credit institutions that have been authorized to apply the proportionate regime.

Institutions meeting the criteria cited above will benefit from the following regulatory relief:

- Pillar 2: the internal capital adequacy assessment process (ICAAP) and the internal liquidity adequacy assessment process (ILAAP) provide a substantial input into the determination of the capital and liquidity requirements in the supervisory review and evaluation process (SREP). Considering the high operational burden and large amount of resources needed to implement these processes in small, non-complex institutions, their relative contribution to financial stability is limited. Hence, it is proposed to use at least highly simplified, broadly automated supervisory procedures in these areas, and to refocus on the

[54] *The European Commission is currently proposing a similarly consistent categorization of investment firms as part of the investment firm review, see https://ec.europa.eu/info/publications/171220-investment-firms-review_en.*

[55] *The criterion "the institution does not use internal models" listed in the draft proposal of the European Parliament (see section 4 or European Parliament (2017a), Article 4 (1) 144a CRR as proposed) might be used as an additional criterion – subject to clarification that proportionate requirements would still be an option for small, non-complex institutions within a banking group which qualify as small, non-complex institutions in line with the harmonized definition except for the fact that they use an internal model developed for the entire banking group and managed by another group entity (typically the parent bank) rather than a dedicated internal model. At the same time, it must be ensured that the simplifications do not benefit the group entity managing the internal model – comprehensive supervision at the consolidated level must not be compromised.*

[56] *See European Commission (2016b).*

principle of letting banks decide for themselves how to conduct their internal assessment processes. Another option might be to exempt small, non-complex banks from the ICAAP, ILAAP and SREP requirements completely and instead introduce an additional blanket Pillar 2 requirement for these institutions. However, the potential calibration of this blanket requirement should be based on previous supervisory experience and benchmarks. Besides, it would be necessary to ensure that waiving banks' individual Pillar 2 requirements (given the resulting lack of risk sensitivity) does neither result in a preferential nor disadvantageous treatment for these banks compared to others.

- Governance and "fit and proper" criteria: raising thresholds in this area could mean that the requirements for institutions to establish committees and apply more stringent fit and proper criteria may be scaled back and that committees could be merged to a greater extent.[57]
- Disclosure: for lack of informative value, the comprehensive disclosure requirements should be completely eliminated for small, non-complex banks or, as the European Commission proposed in its CRR review, should at least be reduced to key metrics.
- Reduction of the administrative burden: replacing the authorization requirement with a notification requirement, e.g. in the case of a marginal reduction of own funds in line with Articles 77 and 78 CRR could reduce the related administrative burden without compromising financial stability.

The proportionality concept of the FMA and the OeNB therefore combines the CAP and SSAP approaches insofar as, according to the CAP, a uniform definition for small, non-complex banks is established for which, under the SSAP, exemptions or relief measures are to apply in specific regulatory areas. In this sense, the proposal does not envisage a separate rulebook for small, non-complex institutions.

Moreover, small, non-complex institutions could be made exempt from drawing up a (formal) resolution plan and from meeting a (formal) minimum requirement for own funds and eligible liabilities (MREL) if, in the view of the resolution authority, insolvency proceedings or a private-sector solution appears credible and feasible.

To preserve the quality of supervisory activities, continued supervisory access to core information from banks, in particular from small institutions, is important. Under the FMA/OeNB proportionality concept, all existing reporting requirements would continue to apply to small, non-complex institutions, as availability of sufficient reporting data is a key component of a risk-based supervisory approach that appears all the more important given the (potential) exemption from Pillar 2 requirements. With respect to supervisory reporting it is crucial to implement the "multi use of data" concept so that all institutions involved in banking regulation are obligated to establish whether required reporting information is already available in another, e.g. a more granular, form, to rule out the collection of duplicate information except for exceptional circumstances.[58] This concept is designed to improve transparency and interinstitutional cooperation; also, it increases efficiency by automating data collection processes and thus above all reduces the burden on small banks.

[57] *In Austria, the thresholds for installing a nomination committee, a remuneration committee and a risk committee were raised from EUR 1 billion to EUR 5 billion when the Austrian Banking Act was amended in 2017 (Federal Law Gazette Part I 2017/149).*

[58] *The "multi use of data" concept has been envisaged in Article 99 (11) CRR as proposed for amending the supervisory framework.*

For institutions subject to CRR requirements, the introduction of the proportionate requirements presented above would be possible only via an amendment at the European legislative level, more specifically, within the framework of the CRR/BRRD review. Overall, the relief measures detailed above would considerably ease burdens and save costs both for credit institutions and for the supervisory authorities. Even if simplified requirements were introduced, the quality of supervisory activity and financial stability would remain ensured above all by clear criteria for defining small, non-complex institutions, the right to revoke the proportionality status in specific cases, the availability of up-to-date reporting data, hence risk data, as well as a capital add-on offsetting the optional exemption from Pillar 2.

In the course of the CRR/BRRD review, besides the FMA/OeNB concept, the "small banking box" presented by the German Finance Ministry was likewise discussed. While certainly being comparable, both concepts diverge with respect to details, which we will outline below.

The premise of first introducing proportionality to the existing prudential framework, or reinforcing it within the framework, represents a major difference compared with the German concept, as the small banking box approach envisages the creation of a separate supervisory regime for small, non-complex institutions.[59]

The German proportionality approach classifies banks into three groups: systemically important (significant) institutions with total assets of more than EUR 20 billion, medium-sized institutions and small, non-complex institutions. The definition of a small, non-complex institution contains quantitative criteria (total assets of up to EUR 3 billion, supplemented by a relative criterion still under discussion) and a number of qualitative criteria. Apart from the dissimilar thresholds, the definition of a small, non-complex institution under the FMA/OeNB approach, in contrast to that under the small banking box approach, does not preclude small institutions that use internal models, provided these models were developed at the group level and are simply applied by the subsidiaries.[60]

The small banking box framework does not imply any changes compared with the status quo for systemically important (significant) institutions, as they will continue to be subject fully to the regulatory framework based on the Basel rules. Whereas only selected exemptions are envisaged for medium-sized institutions, the third group of small institutions is subject to a separate, i.e. the small banking box framework. Essentially, the latter institutions are exempt from all disclosure requirements, remuneration rules and the need to draw up recovery and resolution plans. In addition, a simplified NSFR applies to these banks, and reporting is reduced to a core reporting process.[61]

The objective of the Pillar 1+ approach proposed jointly by the FMA and the OeNB is to ensure that the basic principles of the regulatory framework continue to apply uniformly to all banks. Therefore, the FMA/OeNB approach – unlike the German proportionality concept – does not provide for any exemptions from the NSFR, a Pillar 1 requirement. Moreover, the core reporting process for small, non-complex banks proposed for the small banking box must be viewed with a

[59] *See Dombret (2017a and 2017b).*

[60] *See Dombret (2017a and 2017b). Compare also footnote 55.*

[61] *See Dombret (2017a and 2017b).*

certain skepticism, as the possible reduction in reporting could in the medium term contradict the "multi use of data" concept envisaged under the FMA/OeNB proportionality approach (e.g. because data might not be reported to the Eurosystem's AnaCredit analytical credit dataset).

6 Summary and conclusions

The extension of the scope of the Basel regulatory framework to small banks that are not internationally active as a corollary to greater financial stability has noticeably increased the cost of compliance for such banks relative to other institutions in the EU.

Considerations on introducing proportionality to prudential regulation must balance different needs, especially the possible impact on competition and on financial stability. Consequently, in devising the proportionality concept, it is key to strike a balance between keeping the regulatory burden to a minimum and ensuring compliance with prudential standards, subject to the aim of risk-based supervision to guarantee effective and efficient monitoring. Proportionality should be understood as reducing the regulatory burden if less cumbersome rules are just as effective in ensuring sufficient levels of capital and liquidity in small, non-complex banks.

The Austrian supervisory authorities consider it crucial in connection with strengthening proportionality in banking regulation to introduce a uniform definition of a small, non-complex institution to the entire regulatory framework and to (also) include a relative criterion in order to keep banking regulation from becoming even more complex overall.

However, the complexity of an institution's business model cannot be judged based on quantitative criteria alone; there is also a need for qualitative evaluation. Moreover, supervisory authorities must have the power to remove proportionality exemptions granted earlier. Introducing greater proportionality to the regulatory framework must not create any undesirable incentives or regulatory arbitrage options. Therefore, no relief measures should be granted under Pillar 1 to ensure that the basic principles of a uniform regulatory framework apply to all banks. In particular in the core areas of banking regulation (i.e. with regard to minimum capital and liquidity requirements), regulatory relief should focus only on Pillar 3 and on the reduction of the operational burden under Pillar 2. Alternatively, the (optional) exemption from Pillar 2 requirements for small, non-complex banks might be offset with a blanket capital add-on, which would need to be calibrated in such a way as to safeguard a level playing field with competitors that continue to be subject to capital add-ons under the regular Pillar 2 framework. Any new supervisory rules ought to be designed already with the concept of proportionality in mind. Thus, the principle of proportionality should be taken into account at an early stage, especially when enacting new Basel standards (e.g. the fundamental review of the trading book) into EU supervisory legislation, limiting proportionality to areas in which application to small, non-complex institutions appears expedient to enhance financial stability. In this respect, we support a combination of the two approaches in the Financial Stability Institute's paper (Castro Carvalho et al., 2017), under which institutions are classified on the basis of specified criteria, by analogy to the categorization approach for proportionality (CAP), and under which, provided these conditions are fulfilled, eligible institutions are granted particular exemptions or relief measures within the existing regulatory framework, by analogy to the specific standard approach for proportionality (SSAP).

The comparison of the proportionality regimes in various countries signals that proportionality approaches differ with respect to the classification criteria for banks. Nevertheless, banks are classified by size as a rule. Additional criteria include indicators suited to reflecting the complexity and/or risk content of the business model. The actual design of the proportionality requirements varies markedly from country to country, as do the areas to which they apply. To conclude, further analyses at the international and European levels are needed to evaluate the impacts of the different proportionality approaches as well as to establish a solid analytical basis for future proportionality rules. Ideally, more resource-friendly and cost-efficient rules could be developed on the basis of such analyses to reduce the operational burden for supervisors and supervised institutions alike without undermining the effectiveness of banking regulation.

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