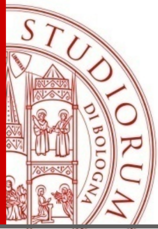
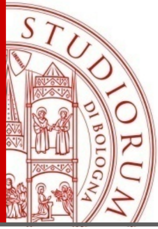


Proportionality of the Single Rulebook and the Debate on Regulatory Simplification and Diversification

Athens, 13 February 2017 - Bank of Greece

Prof. Marco Lamandini

University of Bologna – ESFS Board of Appeal and SRB Appeal Panel



Setting the Context: (I) Proportionality in European Banking Regulation and the Court's view

A flexible test of increasing judicial importance as witnessed by the CJEU case-law in *Gauweiler*, *Tadej Kotnik* and *Ledra* and in the US, in *MetLife*.

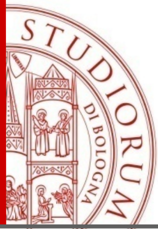
Proportionate means:

a. ***Suitable***: the measure is not manifestly inappropriate to attain its legitimate objective;

b. ***Necessary***: there are not manifestly less intrusive alternatives available

c. ***Well balanced***: the measure does not manifestly fail to balance costs and benefits

In principle, the Court is not willing to second-guess and replace its own efficiency assessment (and preferences), except in exceptional cases, if the measure concerned is manifestly wrong or manifestly excessive. But the proportionality test is also reflexive of the applicable standard of (judicial) review adopted by the Court: more deference for monetary or economic policy Gauweiler, para 68; AG Villalon, para 187); less for supervisory or resolution measures.

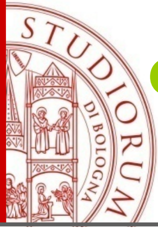


Setting the context: (II) Proportionality as a principle informing supervisory actions: … but a long way still to go

The novelty comes because in European banking regulation the principle of proportionality *is not just a limit*, ***but a principle informing regulatory and supervisory actions*** (it may require a **"positive action"**, to remove impediments to a proportionate outcome).

This requires a calibration in the exercise of supervisory competences: recital (55) SSMR calls on the ECB for the use of its supervisory powers "in the most effective and proportionate way".

It has been rightly noted, though, that the commitment to proportionality "has not been fully applied in all identified dimensions"; the call for a bolder implementation of this principle is the most recurring **and the most urgent** in the current round of discussions for the implementation of Basle III and beyond.



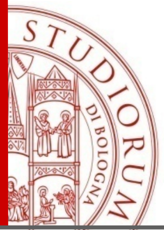
Can a Single Rule Book coexist with a reasonable differentiation of prudential requirements? The "one size fits all" fallacy

One of the core issues of the current debate on the implementation of Basel III and on Basel IV revolves around the simple idea that EU implementation of previous Basel standards, by making these rules in principle applicable to *all* European banks (but for minor adjustments), was fundamentally biased, hides **under the false pretense of a competitive level playing based upon a just illusionistic uniformity of rules, factual discriminations, deviations from proportionality, repeal of diversity and equal treatment.** This might in particular self-inflict a knock-on effect on small banks. No surpise if both the US and Japan adopted a very different approach that is faring better.

Based on the above I would like to discuss the potential for a **better calibration** of EU banking regulation and supervision to take into account the special needs of

✓small and "simple" commercial banks (also to preserve their competitive role in domestic markets) and

✓"selective" macroeconomic (even country-specific) conditions.



A) The case of small and "simple" banks: capital requirements as a clear example

a. The Japanese rules on capital differentiate between internationally active and purely domestic banks and, as noted by Ignacio Tirado (2016), "*the capital requirements of the latter are half of those of the former*". See also sec. 165 Dodd Frank (and Daniel Tarullo, 2016)

b. In the U.K. challenger banks complain 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 more low 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 U.K.] control 80% of the mortgage market*". In this way big banks skim the cream of the market, monopolise low LTV lending but at the same time increase their profits.

- Since capital is a bank's most expensive resource, the "one size fits all" approach to capital coupled with the competitive alternative IRB vs. standardised model hides – in the clothes and under the false pretence of equal treatment – a fatal discrimination against small banks in two concomitant ways:

i. **it denies the potential for a *reasonable* calibration of capital requirements** for small banks, adjusted to take into account the relative simplicity of their business model, and

ii. **it requires small banks to set aside much more capital to take exactly the same risk** that big banks are weighing more favourably through IRB models.

Either way, but positive action is needed to re-proportionate

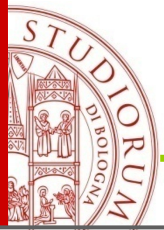
The result is bluntly discriminatory and contradicts the level playing field, without adding (but rather subtracting) to competition in the Single Market (international banks would still successfully compete in domestic markets even if small banks were given back their structural strengths through a recalibration of requirements departing from the fallacy of "one size fits all"): **But what alternatives?**

a.apply the Japanese capital requirements to European small "domestic" banks with a simple business model that apply the standardised model (with few refinements): this would perhaps sufficiently counter balance the big banks' advantage of risk weights under the IRB model; **or**

b.confirm the one size fits all capital requirements but **amend quite substantially the risk weights under the standardised model** adopting : e.g. the challenger banks' proposal in the United Kingdom (risk weights as the median of the 10 big banks' IRB models).

Note that the big bank advantage is not countered enough by the leverage ratio and by additional systemic risk capital buffers: **also these buffers are indeed based on overall risk weighted assets.**

A similar contradiction could potentially hide in the distinction between **case-by-case** and probably more stringent **MREL** requirements **vs standardised TLAC** requirements (applicable only to big banks).



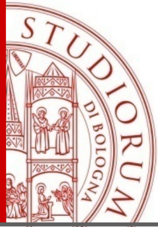
Current simplification proposals with the Bank Reform Package: a first step but not enough

The European Commission took action with its 2016 EU Banking Reform Package, **mostly proposing simplifications for small institutions on the frequency of reporting, on disclosure requirements, on remuneration and on banks exposures to SMEs**. Efforts (also in Basel) of the European Commission to further adjust capital requirements under the "SME supporting factor" are welcome, but this is not enough to level the playing field between big and small banks.

The adaptation and calibration of the general framework to the specific needs of small banks is, still, plainly insufficient. To straighten this, two regulatory approaches are equally possible **in terms of drafting** to achieve a reasonable and calibrated small bank framework

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

b. identifing "from scratch" a proportionate small banks' regulatory package as opposed to the unitary Single Rule Book as we know it now.

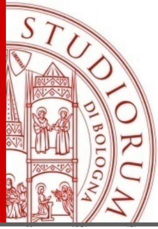


The way ahead towards a "small banking box"

The European Parliament, in its resolution of 23 November 2016 called on the European Commission "*to prioritise work on* ***a small banking box for the least risky banking models*** *and to extend this work to an assessment of the feasibility of a future regulatory framework consisting of less complex and more appropriate and proportionate prudential rules specifically adapted to different types of banking model*".

A few convincing examples were offered by the EBA Stakeholders Group in its 2015 Report on proportionality: some were introduced in the EC Bank Reform Package proposal 2016 whilst others – e.g. on IRB-model and on a differently calibrated corporate and risk governance – were not.

In delivering this positive action, the Single Rule Book should undergo a robust test of suitability, necessity and balance for each of its rules and the result should specify what rules are explicitly applicable to small banks**.** This would finally counter inertial expansion of the unitary ("one size fits all") approach: a risk witnessed even in the US. It is not proportionate to apply a provision conceived for large international banks to all banks on the sole basis that it was not expressly excluded.



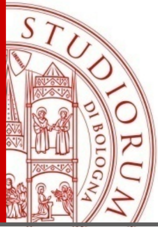
B) The case of "selective" prudential adjustments

Let us now turn to the second example of better proportionality. I make the case for "selective" adjustments of prudential requirements to counter, **in exceptional circumstances (Gauweiler, § 55; AG Villalon, § 153)**, severe economic conditions, when the application of regular (and higher) prudential requirements would disproportionately affect credit provision and in this way deepen a deflationary spiral

If it is out of question – as Andreas Dombret (2016) suggested - to reconsider capital and other prudential requirements for small banks **in general**, is it really uncalled to do so *at least in exceptional deflationary economic conditions,* ***to transitoril***y *accommodate funding needs to the economic (extremely) negative cycle*?

It is our belief that proportionality could help to calibrate the rules' phasing-in and *transitory and counter-cyclical phasing-out* under a scenario of deflation and lack of demand for banks' equity instruments.

PHASED OUT

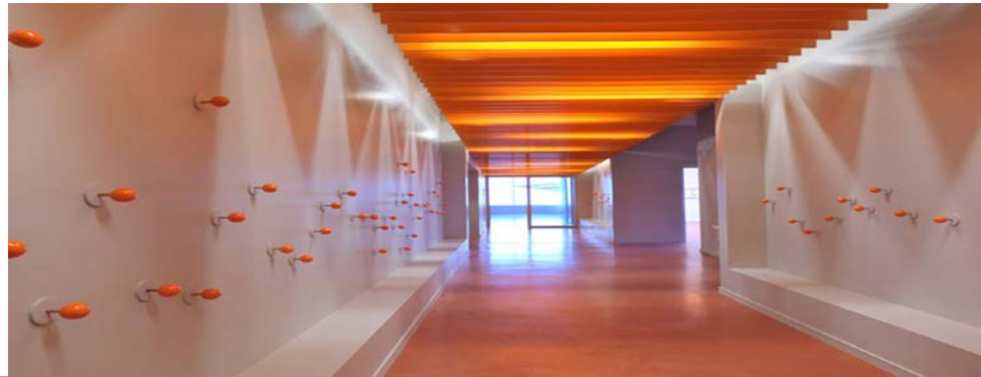


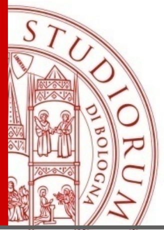
Two examples: A) The case for a counter-cyclical «corridor» for capital requirements of small banks?

If small banks in Japan have endured a long deflationary scenario with capital requirements that are half those of large and/or interconnected banks, some proportionate flexibility to adjust prudential requirements for small banks to the cycle could be achieved - **provided it is permitted by new enabling Level 1 provisions (also granting the needed regulatory flexibility to EBA)** - by using, instead of fixed capital thresholds, a 'corridor', coupled with supervisory powers to adjust the requirements in light of the bank's risk profile and the economic cycle.

In terms of prudential policy, the ammunition of additional capital is certainly right and delivers suitable counter cyclical effects, but only if applied in anticipation, in good times and as a preventative measure. It may have worrisome feedback and pro-cyclical effects if applied in very bad times, if there is no demand for bank capital.

Proportionality also means choosing the right time to impose the right requirement!



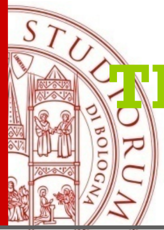


B) Country-specific counter-cyclical calibration of some prudential requirements?

Countercyclical calibration could be general for all EU less significant banks with a "simple" business model and/or individual or **even country-specific, when exceptionally justified by severe economic conditions affecting only one or some Member States**.

The CJEU neatly clarified this in *Gauweiler* when the Court found that it was applicable by design only *selectively to an handful of Member States* in troubled economic conditions. Such a selective, country-specific monetary policy measure was necessary to fulfil the ECB mandate of a single monetary policy. But **if monetary policy must be unconventionally selective to counter country-specific serious disturbances and, in this way, restore the monetary policy transmission channels in the Euro-area, also micro and macro prudential policy should act consistently**. In times of economic growth, capital requirements for small and "simple" banks could be set at the highest end of the corridor to accumulate own funds in good times. When bad times come, capital requirements could be partly relaxed within the corridor to counter any pro-cyclical contraction of bank lending.

This could smooth the pressure towards recapitalisation and consolidation of small banks and thus to a radical change in the market structure during bad times: a problem that is quite country-specific because in the banking industry there are great differences in the degree of concentration of domestic banking markets throughout Europe and a significant reliance on a great number of small banks especially to finance, through relational lending, SMEs is primarily witnessed in Germany and Italy. This will hit the industry structure disproportionately throughout Europe



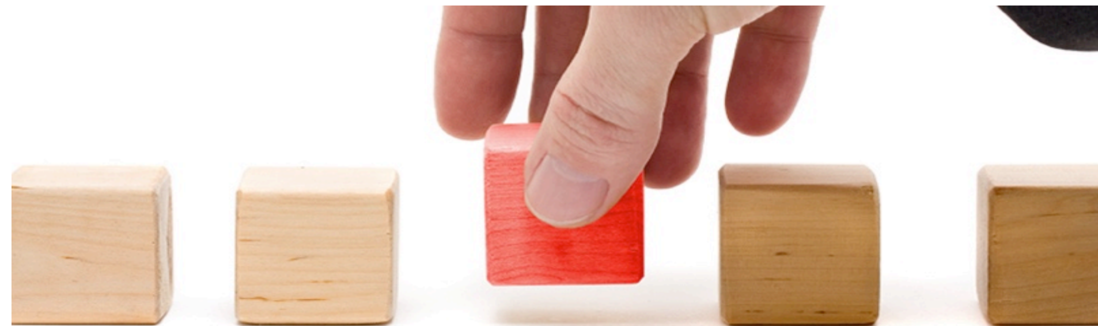
The interesting case of a centralised exercise of O&D with country-specific exceptional calibrations

Under certain conditions, proportionality could also *exceptionally* help in *selectively* calibrating prudential requirements on a country specific or individual basis beyond the small banks/large banks dichotomy.

A) Regional, individual or country-specific differences could be taken into account in determining mortgage risk weights in the standardised model, as suggested by the EBA Stakeholder Group;

B) it could also justify, in exceptional circumstances, the adoption of well calibrated and country specific transitory periods in the exercise of some of the options and discretions by the ECB, e.g. in the definition of the *phasing-in transitory periods* for new prudential requirements or deductions for DTAs. (Art. 19, ECB Regulation 2016/445)

Yet it is important not to confuse the question of **who has the power** to exercise O&Ds, which the SSMR correctly allocates to the ECB with **the way such power can be proportionately administered** by the ECB).

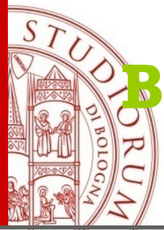


A “selective” approach could also better “proportionate” the resolution context

The same reasoning could also apply in the resolution context, for instance in respect of MREL requirements.

The flexibility offered by the principle of proportionality could guide the SRB in adjusting the phasing-in of its MREL requirements, if this is considered necessary to take into account country-specific or individual exceptional circumstances.

The requirement to banks to issue and place more subordinated, bail-inable instruments to increase the “safety cushion” that protects deposits could be calibrated in the time it takes to become fully operational, to acknowledge that, in the current macroeconomic scenario, the placement of such instruments is objectively a very different task in different areas of the Union.



But under what exceptional economic conditions can a "selective" approach be granted?

The decision over when is it appropriate to calibrate prudential requirements selectively should **not be subject to political horse-trading**. Robust econometric analysis can help to assess whether:

i.the economy in the relevant **area is deflationary and thus quite distant from the Euro area inflationary target**;

ii.higher or new prudential requirements do impact on, and **are causally related to an upcoming restriction in loan supply,** since the negative cycle does not allow to properly recapitalise the institution; and

iii.a further restriction of credit supply is causally linked with the deepening of the deflationary spiral, in a vicious circle. In this scenario where prudential requirements become pro-cyclical, **financial authorities could even run the risk of jeopardising the single monetary policy, if they do not accept a reasonable degree of flexibility in their single prudential policy.**