Proportionality in EU banking regulation : the case for a step-change to accompany the introduction of "Basel 4"

An updated position paper from the cooperative and mutual banking associations of Germany, Austria, Italy, Spain, Poland, Luxembourg and the UK.

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Introduction and context

The tide of opinion among industry practitioners, academics and many regulators is turning ever more strongly in favour of greater proportionality. In this paper, we draw on insights from landmark studies in the European space, such as the EBA Banking Stakeholder Group's 2016 report, and the European Banking Institute's 2018 working paper. From the industry side, we also welcome the short position paper issued earlier this month jointly by nine national banking associations in Europe. We agree, in general, with their analysis and conclusions. The Basel Committee itself is now waking up to the problem, with its recent publication of the results of a proportionality survey among national supervisors, and several papers from the Financial Stability Institute. And with the start of EU implementation of the "Basel 4" package now imminent, the time for action in the EU has arrived.

Executive Summary

This paper proposes a **better, more radical** solution to the persistent and worsening problem of the **regulatory compliance burden** experienced by smaller European banks. To accompany the introduction of the latest "Basel 4" measures, we respectfully call on the European authorities to embrace more completely the principle of proportionality by introducing a **systematically** differentiated **SEGMENTED REGIME ("SR").** The SR would be suitable for banks ranging from global systemically important banks (G-SIBs) to **small and non-complex banks ("SNCB")**, in place of the current patchwork of derogations under CRR and CRD, **without compromising on resilience or customer-facing standards and quality**. In the paper, we outline the nature of the problem, and its wider significance for European citizens and businesses. Based on Article 5 of the Treaty of European Union, small banks have a **legitimate expectation of proportionate prudential regulation**, as of fundamental right, not as a favour, concession or afterthought. Also Recital 46 of CRR explicitly states that the provisions of the CRR shall 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.

We welcome the individual moves, and progress so far, towards proportionality deriving from the **Commission's Call for Evidence** and now embodied in the nearly-complete CRR 2 package, from which our members look forward to benefitting shortly. But it is regrettably not enough, against the scale of the problem identified. It is however a good beginning. So, current ideas for a more systematically proportionate regime, which we will call a **segmented regime** ("SR"), should be refined and adopted. We seek to take forward more effective ways of delivering, in practice, the fundamental rights enjoyed by banks subject to EU banking regulation, while not spoiling its goals and meaning, namely individual safety and collective stability. We also argue that giving due consideration to these ideas is essential in order to fully respect the Commission's own commitment to the REFIT methodology. And we analyse the reasonable risks and concerns to which the SR regime model might give rise and explain how they can be satisfactorily addressed.

Looking outside the EU, we take note of recent findings, and the latest experience, on the application of proportionality in other countries, which suggest that the EU is increasingly out of step with major comparable jurisdictions, and we draw on key examples of good practice elsewhere[1].

In conclusion, we invite the European authorities to enter into a dialogue with ourselves and other affected banking associations, on the basis of this paper, its conclusions and associated ideas. We stand ready to cooperate and to contribute further.

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[1] See *Basel Committee on Banking Supervision*, Proportionality in bank regulation and supervision – a survey on current practices (2019).

The problem : regulatory compliance burden for smaller banks

Smaller co-operative and other banks across Europe struggle to cope with the burden of regulatory compliance and complexity, especially where it has a "fixed cost" element and where the regulatory frameworks were designed for much larger banks. Published evidence on this matter is available from various official and academic studies, cited in Appendix 1. On this point we are entirely in agreement with the points made in the position paper from the nine banking associations[2].

As one very concrete example of the problem, we draw attention to recent work[3] by the BVR on reporting burdens at smaller co-operative banks in Germany, where the implementation costs in the regulatory reporting system at each bank average to approx. 100 person-days per annum, and aggregate costs for FINREP /COREP/Asset Encumbrance and AnaCredit were as high as €34 million initial one off and €9 million recurring per annum. BVR experts suggested many simplifications and omissions for smaller banks. Previous and more extensive academic work (Frankfurt Goethe University, Professors Hackethal and Inderst 2015[4] and Institut für Genossenschaftswesen der Universität Münster, Schenkel 2017[5]) on the subject, whose findings remain relevant, also drew from the German cooperative banking experience. Polish cooperative banks' findings also confirm the same phenomenon and scale.

Another concrete example comes from a 2016 study[6] of Italian banks by Alessandrini et al, cited in an important new publication[7] edited by Marco Migliorelli at the Sorbonne. The study found that the proportion of bank staff needed in internal audit, regulatory compliance, risk management, and internal and external reporting ranged from 4.5% (more than 180 individuals) at a typical large bank to nearly three times as much : 14% (7 individuals) at the typical smallest bank.

The most comprehensive published evidence on the scale of this burden in the overall EU context probably comes from the summary feedback report on the fitness check consultation[8] carried out by the Commission itself in early 2018 in the field of supervisory reporting. The following extract[9] exemplifies the concerns:

Many industry respondents claimed that the costs arising from the reporting frameworks are not proportionate to the new informational insights gained from the reported data. In this

[2] *Joint views of the banking associations of Austria, Croatia, Denmark, Germany, Italy, Luxembourg, Poland, Slovakia and Slovenia*, "Proportionality in banking regulation – discussions have to continue: after the CRR/ CRD review is before the CRR/CRD review" (2019).
[3] More details available from the BVR on request
[4] https://www.bvr.de/p.nsf/0/EA57402CCD1BAC9FC1257ECF00349466/$file/GUTACHTEN-BVR2015.pdf
[5] http://www.ifg-muenster.de/forschen/veroeffentlichungen/2017/material/v_20170127.pdf
[6] *The Asymmetric Burden of Regulation : Will Local Banks Survive ?* Alessandrini et al, Money and Finance Research group, Ancona, Working Paper no. 125, June 2016
[7] New Cooperative Banking in Europe Ed. Migliorelli , Sorbonne https://www.palgrave.com/gb/book/9783319935775
[8] https://ec.europa.eu/info/sites/info/files/2017-supervisory-reporting-requirements-summary-report_en.pdf
[9] Ibid. Section 1 (page 4).

respect, smaller banks generally contested the added value of being covered by European reporting frameworks under the Capital Requirements Regulation (CRR) (either partially or fully) given the allegedly low financial stability risks that emanate from them. Furthermore, some industry respondents commented that some of the reporting frameworks generate a lot of data that is not or cannot be used effectively to monitor financial stability risks.

Later[10] in the same report, the cost issue is addressed at greater length :

General assessment of compliance costs

Overall, almost all respondents (93%), in particular those from industry, believe that supervisory reporting in its current form is unnecessarily costly for its intended purposes. Only a very few respondents (2%), most of which are public authorities, consider the level of costs as appropriate. In line with these concerns, a large majority of respondents (85%) noted that none of the EU level reporting requirements have brought cost saving benefits while only a few respondents (11%), mostly public authorities, considered that there have indeed been cost saving benefits. Supervisory reporting requirements imposed by EU regulations and/or directives were flagged as a very significant source of compliance costs

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Respondents highlighted that small and non-complex financial institutions face excessive costs due to the absence of proportionality with regard to supervisory requirements. Moreover, it was suggested that the increased quantity and complexity of these requirements are key factors generating additional costs in terms of human resources, training, legal expertise as well as changes to IT systems.

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According to industry respondents who provided such information, the average number of full-time equivalent staff (FTEs) dealing with supervisory reporting increased from an (unweighted) average of 12.4 at the end of 2009) to 18.7 at the end of 2016. Furthermore, at the end of 2009, FTEs dealing with supervisory reporting represented on average 18.9% of the compliance workforce. Respondents' also reported that by the end of 2016, these figures increased to 26.1%. Although illustrative only, these numbers show an overall increase of the compliance workforce dealing with supervisory reporting requirements both in absolute and in percentage terms.

This seriously negative phenomenon, highlighted by so many practitioners and observers, acts as a drain on the resources of small and non-complex institutions, and leads to the question of what should come first: enabling all banks to progress, or taking measures that to a large extent cause little but frustration? So, at the extreme, an otherwise adequately sound and viable local co-operative bank may be compelled to merge because it cannot afford to employ yet more compliance staff to cope with the burden, or will at best "lose steam" – i.e. the energy so necessary for contemporary competition circumstances – and stagnate. Away from that extreme, many more banks find that regulatory compliance demands too high a

[10] Ibid. Section 2 (pages10,11,12)

proportion of their collective management time and resource, which should instead be available for directing and developing their business[11]. **As a consequence, plurality, diversity, proximity and even competition itself are at some risk**.

If a sound local bank must merge into a distant large bank, something by way of local understanding and responsiveness, and being in touch with the core business, is lost, even if the physical premises remain. This proximity is one of the enduring values of co-operative banks, but is found in other traditions too (savings banks, etc). And the consolidation and resulting concentration of banking reduces competition, and increases the dangers of large-bank group-think. Moreover, recent research by the consultancy Beikelach[12] cautions against such mergers, as the small broad-based cooperative banks are found to have the most viable business model .

So, a far better outcome would be for regulation to ensure that SNCBs can thrive at their optimum size. It would indeed be a tragedy, and a supreme irony, if local co-operative banks, which did not contribute to the global financial crisis but rather helped the cohesion of local communities by inter alia sustaining lending to citizens and enterprises, while many global banks had to be rescued, now fall victim to over- zealous and "one size fits all" regulatory repair.

The origin of the problem

This was well expressed in the **Abstract of the EBI Working Paper**[13]:

"The banking regulatory framework adopted by the European Union is both stern and unidimensional. Proportionality in banking regulation and supervision is mainly a theoretical reference, with little or no practical implementation. On the face of it, the fundamental choice to apply the Basel standards to every European bank, no matter the size, systemic relevance or complexity, would seem to provide certainty and hence stability for the benefit of the whole banking sector. However, the "one size fits all" approach hinders the development of smaller banks by creating competitive distortion."

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[11] The BVR work estimated this at 60-70% of the time of back office staff, and 30% of the time of board members.

[12] Reported in Boersen-Zeitung, December 2018 – *"Ein Hoch auf kleine Genossenschaftsbanken : Institute geringer Größe erweisen sich in Analyse als besonders widerstandsfähig und effizient - Fusionen funktionieren nicht"*

[13] *European Banking Institute*, Stability, Flexibility and Proportionality: Towards a Two-Tiered European Banking Law? (2018).

And, in a book[14] published only last month, Prof. Rainer Masera, of Università Telematica Guglielmo Marconi, further challenged the notion that "one size fits all" was necessary to ensure a level playing field as a **"false dogma"**.

The EU's banking single rule book has been based on successive frameworks agreed by the Basel Committee. While the BCBS' remit runs to large international banks[15], the EU has chosen to apply practically all of each Basel framework to its full range of credit institutions. This may not have mattered with Basel I, which was essentially just a simple system of risk weights. The step up in complexity came with Basel II, including the introduction of Pillar 2 and Pillar 3 requirements, and elaboration of metrics for market risk and operational risk. Nevertheless, at the same time, the BCBS introduced differentiation mechanisms to relieve the compliance burden on smaller / non-complex banks. The "standardised" approach for credit risk, and the disapplication of the full market risk regime for banks with "small" trading books, both recognised, at that early stage, the very principle that we advocate in this paper.

Subsequent iterations generally added further complexity in the interests of perfecting risk-sensitivity – reasonable enough for global banks and from a "global" point of view. But other jurisdictions made different choices on scope– recognising that full Basel application for all banks was not necessarily the optimum approach. Important studies from the Financial Stability Institute at Basel have examined approaches to proportionality in a wide range of jurisdictions. FSI Insights No.1[16] looked at Japan, Brazil and Switzerland as comparators to the EU and USA : all three apply a differentiated regime, rather than full Basel, to their smaller banks. The experiences of **Switzerland**[17] and **Brazil** look especially relevant, and are detailed in the Annex to the FSI paper. FSI Insights No.11[18] has looked thematically across 100 jurisdictions, finding that :

In their implementation of Basel standards, nearly all jurisdictions apply proportionality, simplifying standards in some cases and applying more stringent requirements in others. As countries shift to the Basel III risk-based capital regime, more extensive proportionality strategies are applied.

Taking into account the simultaneous burden (within the EU/EEA) stemming from the BRR Directive, the whole picture in the EU shows a systemic scarcity of proportionality via-a-vis small non-complex banks, that creates a grievous challenge for the majority of them.

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[14] See fuller citation in Appendix 1, page 23

[15] And the BCBS now claims that there was no expectation that the framework would be applied to other banks – see footnotes 19 and 31

[16] Proportionality in banking regulation: a cross country comparison. Financial Stability Institute August 2017

[17] Switzerland has moreover - since July 2018 -completed an even more radical experiment, having piloted a highly simplified regime for small banks, which is now to be finalised and made permanent – see https://www.finma.ch/en/news/2018/07/20180713-mm-kleinbanken-pruefwesen/ and https://www.finma.ch/en/news/2019/04/20190405-mm-kleinbanken/

[18] The Basel framework in 100 jurisdictions: implementation status and proportionality practices. Financial Stability Institute November 2018

We have collated in **Appendix 2** further information and observations on the key international comparisons, including – most recently – the BCBS' own survey on proportionality[19] in which several important observations are in agreement with points we make in this paper. Note in particular that the **US** applied Basel only to two dozen or so of its largest banks. Note further that subsequent to the FSI work, **Switzerland's** Financial Market Supervisory Authority (FINMA) has undertaken its own further step-change by recently[20] confirming (after a pilot that ran during H2 2018) that from 2020 it will operate its own **voluntary and highly simplified leverage –based segmented** regime for its smallest banks – described in more detail below.

For the EU, a good starting point would be to consider the five segments into which banks are already in effect divided for regulatory or supervisory purposes: G-SIBS, O-SIBS, SI, LSI and SNCB. In different parts of the EU regulations the co-legislators have found enough reasons to set up some specific rules for institutions falling into one or other of those categories. It seems obvious that the different risks, activities and complexity of different sizes and business models deserve a systematic, differentiated and segmented treatment.

Among the leading authorities that have identified the overall proportionality problem we would pick out first the **EBA's Banking Stakeholder Group**, whose excellent 2016 report[21] **Proportionality in Bank Regulation** already made important recommendations. We also mention in passing an extremely valuable recent report[22] by **De Nederlandsche Bank**, and a very useful overview paper[23] by the **Oesterreichische Nationalbank**. Among the more recent contributions, already cited above, we should again mention the 2018 publication[24] edited by Marco Migliorelli, who advances an argument complementary to the issue of proportionality, expressed in terms of "reasonableness". Finally, we welcome the excellent analysis and academic discussion in **European Banking Institute** Working Paper[25] no. 20 (2018), already cited.

What do we mean by proportionality, and why is it expected ?

There is an extensive corpus of academic literature and expert commentary on proportionality in the context of financial regulation. For the EU, moreover, **proportionality is a fundamental constitutional principle**, and obligation on EU institutions, under **Article 5 of the Treaty on**

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[19] https://www.bis.org/bcbs/publ/d460.pdf
[20] https://www.finma.ch/en/news/2019/04/20190405-mm-kleinbanken/
[21] http://www.eba.europa.eu/documents/10180/807776/European+Banking+Authority+Banking+Stakeholder+Group-+Position+paper+on+proportionality.pdf
[22] Proportional and effective supervision, De Nederlandsche Bank 2018

[23] Proportionality in banking regulation, Oesterreichische Nationalbank, Q2 2018
[24] New Cooperative Banking in Europe Ed. Migliorelli , Sorbonne https://www.palgrave.com/gb/book/9783319935775
[25] https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3128304

European Union, and this should be the starting point - so proportionality is a right, and legitimate expectation, for small / non-complex EU banks, not an optional extra, concession or favour from the authorities.

The best intellectual articulation of the dimensions of proportionality in bank regulation we find in the EBA Banking Stakeholder Group Report, from which we will quote extensively in this paper. First, there is settled case-law[26] requiring that Community / Union measures:

(1) do not exceed the limits of what is appropriate and necessary in order to attain the objectives legitimately pursued by the legislation in question;

(2) when there is a choice between several appropriate measures, recourse must be had to the least onerous; and

(3) the disadvantages caused must not be disproportionate to the aims pursued.

The report goes on[27] to analyse the ***economic*** concept of proportionality, using the three Es test – ***effectiveness, efficiency and economy*** – and also addresses the ***endogeneity*** problem and the potential for ***disproportionality***, as well as establishing the **Five Pillars of Proportionality**. This excellent material is reproduced in **Appendix 1**.

Why greater proportionality is the right answer

Nothing in this paper argues in any way that the full panoply of current and emerging banking regulation, derived from the Basel Committee's framework, is not suitable for the large international banks for which it was designed. Nor does it question the programme of post-crisis regulatory repair necessary to prevent or mitigate such crises in future. **Proportionality in prudential banking regulation does not involve lower resilience on key measures, or weaker standards of customer-facing conduct** – as we explain below. On the contrary, proportionality indirectly allows scope for unfettered development while maintaining the prudential reins intact. Correctly formulated, it can deliver financial stability without sacrificing diversity, proximity, or competition (or leading to disappearance of some SNCBs in worst scenarios) as well as maintaining fidelity to Treaty obligations.

This is a useful stage to refer to the thought-leading contributions from Germany, from both the **Bundesbank** and the **Federal Financial Supervisory Authority (BaFin).** In particular we draw attention to two incisive and constructive speeches by Dr Andreas Dombret (former director of the Bundesbank) from early 2017 : *Equal supervisory rights for all? Do we need more proportionality in banking supervision?*[28] (Stuttgart, 22.02.17) and *One size fits all?*

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[26] EBA/BSG paper, page 16.

[27] Ibid. page 18.

[28] https://www.bundesbank.de/en/press/speeches/equal-supervisory-rights-for-all--do-we-need-more-proportionality-in-banking-supervision--711488

Applying Basel III to small banks and savings banks in Germany[29] (Berlin 02.02.17) ; and a short interview[30] with BaFin executive director Raimund Roeseler *"Proportionality is an urgent issue"* (02.05.2017).

Turning to the Austrian experience, a country report of rating agency Standard and Poor's (S&P) cited by the National Bank[31] ranks the heterogeneous and diverse Austrian banking system (including more than 400 independent small cooperative banks) as one of the twelve strongest worldwide, and indicates this robustness is more than a temporary effect. In the case of an economic downturn the Austrian banking system will remain resilient, according to the S&P experts. These studies underline the positive effect of a heterogeneous banking sector for financial stability.

We should also stress at this stage in the argument that, as already recognised in the text of the CRR2 dossier, there is overlap between the concepts of "small" and "non-complex" as categories deserving of more systematic proportionality. Institutions that are small but very complex, and those that may be non-complex but are large to the point of near-systemic, probably should not qualify for any alternative regime. But within the envelope of "small and non-complex" either smallness or absence of complexity may be the main driver. This should apply even in cases where, for example, small and non-complex local cooperative banks are obliged by law to be affiliated to a cooperative banking group.

Why a step-change in proportionality ?

We do not argue that there is an absence of proportionality in current rules– indeed, EU institutions have made important strides in that direction. This is a suitable point to refer to the **major and most welcome initiatives on proportionality undertaken by the Commission** as part of the CRR2/ CRD 5 package, following the call for evidence on financial regulation under the REFIT initiative. **Indeed, the Commission's REFIT work in this field is greatly appreciated.** We strongly supported the elements of proportionality, especially on reporting and disclosure, introduced in the Commission's proposal. And **we appreciate the splendid work by various MEPs** moving amendments to extend and strengthen elements of proportionality. All these are very good in themselves, but together they remain - we suggest -insufficient and incomplete- they still constitute a "patchwork of derogations". This invites the question – **do we not need to complete this agenda by a more holistic approach – "joining up the dots"**?

The FSI Insight No. 1 identifies the positives and negatives of the two main approaches to proportionality : by **category** of bank (CAP) ; or by **specific standard** (SSAP). Unsurprisingly,

[29] https://www.bundesbank.de/en/press/speeches/one-size-fits-all--applying-basel-iii-to-small-banks-and-savings-banks-in-germany-711474

[30] https://www.bafin.de/SharedDocs/Veroeffentlichungen/EN/Fachartikel/2017/fa_bj_1704_Interview_Roeseler_Proportionalitaet_en.html

[31] https://www.oenb.at/dam/jcr:c05ead6e-06b7-4bae-be5d-e13fbfbce161/Fakten-zu-Oesterreich_e_October_2018.pdf page 25

FSI concludes that the category approach is followed by Brazil, Japan and Switzerland, while the EU follows the SSAP.

The Commission's own ReFIT commitments also argue for a step change in proportionality, leading to simpler and less burdensome requirements for SNCBs, in conjunction with Basel 4 implementation. The Commission's Staff Working Document[32] of 26 November 2018 stated the following (emphasis added) :

Despite continuous efforts to ensure EU legislation is as efficient as possible, the lessons of implementation and the experiences of citizens, businesses and Member States indicate that this is not always the case. The costs imposed by legislation may not be fully necessary to achieve the objectives or the legislation in place may no longer be up to date.

The Regulatory Fitness and Performance Programme (REFIT)1 provides a response to these issues and it has been fully mainstreamed in decision-making over the last year: ***whenever evaluating or revising existing law, the Commission now systematically seeks to identify any opportunity for burden reduction while safeguarding policy objectives****. Each legislative revision presents an objective for burden reduction, when relevant, for the European Parliament and the Council to take account of in the legislative process and for Member States to refer to when implementing legislation.*

And we argue, in line with the Bundesbank, and the BaFin, that there is indeed a better way – a more systematic and proportionate especially for smaller and non-complex banks - a "segmented regime". This could draw on the German concept of the "small banking box". Such ideas were considered in the summer of 2017, during the progress of the CRR2 / CRD5 dossier, but could not be agreed, we understand, not because of fundamental opposition, rather due to an absence of consensus on the right solution, and particularly the shortage of time plus other priorities. **So we see this proposition represents unfinished business, not a radical new departure** – with the general issue now attracting attention in the Basel context (as witness the two FSI Insight papers and the BCBS proportionality survey already cited).

Indeed, there is an existing model embedded in current Basel rules which illustrates systematic proportionality : the (revised) standardised approach to credit risk, alongside the IRB approach. The latter is only suitable for larger banks with large data pools and modelling capability. The former works perfectly well for the vast majority of smaller and non-complex banks. Nor is there any reduction in resilience – if anything the opposite : IRB-using large banks benefit from a substantial reduction in their own funds requirement. So standardised users in this respect are held to a higher level of resilience. And the playing field remains level – each institution is free to choose which approach is most suitable for it to use, making its own judgment of the trade-off between risk sensitivity and capital benefit on the one hand, and complexity and compliance burden on the other.

[32] 2018 Annual Burden Survey http://data.consilium.europa.eu/doc/document/ST-14788-2018-INIT/en/pdf

What are the risks and downsides ?

First, to avoid any **risks to institutional safety and financial stability**, there should be **no compromise** on basic **standards of resilience**, essentially on own funds and liquidity – that is a given, according to the current legislation. There are moreover two important reasons why co-operative banks insist that there should be no watering down of resilience. Local co-operative banks must be seen as just as safe as big banks – smaller banks are not weak or second class banks, nor are they to be limited to a few pockets of business. Second, many national co-operative networks benefit from either mutual cross-guarantees, or an institutional protection scheme, or both. That being the case, it is clearly against the self-interest of the network members as a whole if any one local bank were able to run with lower standards of resilience. The Basel Committee puts it in a nutshell as follows: “The aim of proportionality is therefore not to reduce the resilience of banks or the banking system, but rather to reflect the relative differences in risk across banks[33].”

This does not mean that Europe should necessarily go to the other extreme, as envisaged in the United States, where even fairly large banks (by EU standards) can discard much of the prudential corpus, including all risk-based capital requirements, on condition of meeting a high 10% minimum leverage ratio. The EU needs a more nuanced, segmented approach, catering both for medium/ small and very small banks (all, of course, non-complex). We are studying closely all latest moves in this regard – for example the Swiss “Kleinbankenregime”. This may have much to offer the smallest EU banks for whom the burden of regulatory complexity is most acute. But this approach may not be suited to those banks towards the higher end of the SNCB size range as now defined in revised CRR. So, we welcome all relevant input from respected Basel-compliant jurisdictions outside the EU whose banking market moreover has many similarities with parts of the EU. From a considered reflection on all such initiatives, an optimum model for the EU can be developed.

Second, there should be no reduction in **client protection**, so conduct of business safeguards should not be affected. Nor should there be less effective controls on **financial crime** and **money laundering**.

A segmented prudential regime levels the **competitive playing field** with large banks, but does not create a protected space or regulatory advantage for small banks, as FSI also warns. On the contrary, the Basel 4 reform reflects that, at least in some cases, larger institutions have hitherto benefited from lower requirements than merited by the risk they faced. Smaller institutions will continue to pay a large “simplicity premium” since the use of standardised methods already represents an extra credit risk requirement of up to nearly 40%, even after Basel 4 output floors.

[33] *Basel Committee on Banking Supervision*, Proportionality in a bank regulation and supervision – a survey on current practices (2019), page 2.

It also seems fair to wonder if certain authorities' resistance to a fully proportionate and segmented regime has an ulterior motive – that the excess and unnecessary burden of regulation may force a consolidation or restructuring that they believe to be desirable – indeed, FSI hints at this motivation. To act on such thinking, however, is both inimical to competition, and at EU level contrary to Treaty obligations, as well as essentially dishonest.

Why attempt this alongside "Basel 4" implementation ?

The long period of post-crisis regulatory repair is coming to an end. The implementation of "Basel 4" may be the last major overhaul of CRR / CRD for many years, as firms, regulators and co-legislators experience change fatigue. A period of rule stability and consolidation thereafter is both likely and in principle desirable.

At the same time, the implementation even of Basel 3 has accentuated the need and demand for a more systematic and proportionate regime for smaller banks, as the FSI Insight studies have shown. We note that Brazil, which formerly – like the EU – imposed Basel standards on all its banks, found that Basel 3 necessitated a complete change of approach. And FSI Insights No. 11 [34](November 2018) concluded that *"as countries shift to the more complex Basel III RBC regime, greater differentiation and more extensive proportionality strategies are applied."*

Even the proposed changes in the Standardised Approach for credit risk could overstretch small institutions. The adjustments of the Standardised Approach in Basel 2 were moderate. Therefore they could have been used even by small and medium sized institutions at acceptable cost and burden. The proposed changes in Basel 4 will lead to very high granularity and complexity, and will increase the costs for IT and compliance, especially for those institutions for which the implementation of internal models is too complex. Against this background we plead for a proper implementation for those institutions which do not have to apply the output floor due to the non-use of internal models. The additional burden for these institutions should be as low as possible. It might even, for instance, make sense for such smaller institutions to be permitted to remain on the current version of the standardised approach (for credit risk only). Furthermore , **granularity** should not become a binding criterion as it would hit especially smaller banks with small balance sheets.

Moreover, the provisions of "Basel 4" will lead to a sharp increase of risk weights from 100% to 250% of local and regional cooperative banks' shares in their central institution within an institutional protection scheme (IPS). These shares in the central institution that are inherent to the inverse shareholder pyramid of cooperative banks would become more expensive overnight. This would be a massive discrimination against all decentralised banking sectors (especially cooperative banking sectors) in Europe. Considering the early warning, risk control and solidarity features of such an IPS, the proposed increase of the risk weights is not reasonable and comprehensible at all. Against this background the risk weight of 100% for

[34] https://www.bis.org/fsi/publ/insights11.htm

equity exposures in a central institution within an IPS for institutions that are members of the IPS should still apply.

Also, the current rules of the CRR concerning the regulatory treatment of speculative immovable property financing penalise banks using the standardised approach (SA) for credit risk in comparison to institutions using IRB approaches as the latter are allowed to take collateral into account in their calculations of the risk weight. This results in a massive discrimination against institutions which use the standardised approach as they have to assign a risk weight of 150% for this exposure class. In addition - according to the final Basel 4 text - banks using the standardised approach will be obliged to assign a risk weight of 150% to exposures secured by commercial real estate.

So, the implementation of Basel 4 already faces the challenge of how to avoid creating significant disadvantages for SA banks compared to IRB banks in the area of real estate financing, so that genuine equal treatment is legally ensured.

In preparing for Basel 4 implementation, there is – if we all seize the moment in 2019 – sufficient time for a systematic segmented regime to be developed and included, after due consideration, analysis and consultation, in the Commission's legislative proposal (and in line with Refit principles). That would be preferable to trying to introduce something subsequently, during co-decision.

Moreover, the consideration and analysis that will precede any proposed measures would naturally fit with the work that the EBA is already tasked to do under the Commission's Call for Advice of 4 May 2018, and the burden reduction work[35] being mandated in the current CRR 2 dossier – though the subject is wide and important enough that other stakeholders, including the co-legislators, should also give it early attention.

Towards a better structure for regulation

It is beyond the scope of this paper to outline a full description of a small and non-complex banks' regime – we seek initially to establish the principle that such an approach should be taken on board by the European authorities in the design stages of implementing Basel 4. But we can indicate what we consider to be the most fruitful directions of travel, based on the studies and experience cited in this paper.

First, it is common ground (as evidenced in both FSI Insights Nos 1 and 11) that proportionality does not, and should not, lead to lower standards of resilience. Nor should standards of conduct vis a vis individual customers / clients be affected.

Second, we doubt whether dispensing completely with risk based capital requirements in favour of a high risk-insensitive leverage ratio (as in the USA) is necessarily suitable for all,

[35] Recital 67 and new Article 430 (8)

especially the largest, banks within the SNCB size range. Also other segmented regimes do have considerable merits for the smallest banks, as a voluntary option.

Third, any SNCB SR should build on the existing achievements of the Commission, the Parliament and the Council in agreeing some specific proportionality measures in the CRR 2 dossier. These measures, though limited, were bold – as indeed is the whole REFIT approach.

Fourth, any SR should not involve any obligatory retreat from business lines already conducted as long as the banks running those activities were considered, hitherto, as "non-complex banks".

What we call for is the natural and systematic completion, in a SR, of what has already been begun – drawing also on important contributions and insights such as those from Germany and non-EU experience such as that in Switzerland. We outline below some of the broad areas that should be included :

Concrete legislative measures for a more proportionate approach

Simplified **Pillar 1 resilience** requirements : while the revised standardised approach adequately covers credit risk, as regards funding / liquidity risk the introduction of a simplified NSFR as part of the CRR 2 package is to be welcomed, as also the avoidance of the complex ALMM measures.

As regards **Pillar 2**, in Switzerland, even before the latest pilot, the smallest two categories – 4 and 5 – were required only to conduct a simplified ICAAP, while in Brazil full Basel ICAAP requirements are only applied to the systemic category. We find that the EU's current application of ICAAP methodology involves a worse and worse cost / benefit relationship (the cost being the administrative burden rather than the Pillar 2 add-on) the smaller the bank, to the point where it could even be net negative. As a minimum, we argue that SNCBs should be required to do no more than a simplified ICAAP.

Further reduction in **supervisory reporting and Pillar 3** : We argue that SNCBs could be fully exempt from current **Pillar 3 requirements**. SNCBs could continue to make basic disclosures of a few key regulatory metrics in addition to their normal financial statements, but there would be no additional disclosure required by SNCBs as evidence suggests nobody uses it. The simplification of **supervisory reporting** could also be taken further and be made more systematic. According to the mandate of EBA to present measures to reduce the compliance and reporting costs of smaller and less complex institutions a simplified core reporting process for these institutions could be implemented.

Simplified **risk management requirements** : again, we argue that the existing gradations in CRD in relation to risk committees and chief risk officers could be elaborated and extended, so that the risk management can be truly proportionate and appropriate for SNCBs.

Governance requirements, and fit & proper criteria, should also be designed in a more appropriate and proportionate manner in the course of a review of the relevant provisions in the CRD. For example, this especially requires (as they contradict the principle of proportionality) the repeal of the following supervisory measures with regard to the formal independence of a member of the supervisory board.

- A member of the supervisory board shall be considered not independent if she/he was granted a non-preferential performing loan from the supervised entity or the parent undertaking or its subsidiaries if the threshold of € 200,000 is exceeded . It is evident that in cooperatives the members are also customers of the bank. Most of them have granted loans by their cooperative bank. This criterion is especially burdensome for cooperatives, as it is hard to find members of a cooperative who do not fulfil this criterion.

- A member of the supervisory board shall be considered not independent if she/he served as member of the management body within the entity for 12 consecutive years or longer. In decentralised sectors it is extremely important to have experienced persons in supervisory boards.

- A member of the supervisory board shall be considered not independent if she/he is or has been, within the last year, a material supplier or material customer of the CRD-institution or another entity within the scope of prudential consolidation or had another material business relationship, or is an senior officer of or is otherwise associated directly or indirectly with a material supplier, customer or commercial entity that has a material business relationship . This criterion does not sufficiently take into consideration that especially in cooperative sectors the affiliated institutions do always have a material relationship to their central institutions. That means persons who have a function in an affiliated institutions will always count as dependent. This seems to be a consequence that was not intended.

Generally we think that the quite complex provisions regarding fit and proper have to be modified for small cooperative banks. The new requirements make it hard for small cooperative banks to recruit candidates for their supervisory boards from their members (being a member is a precondition to serve anywhere in the boards of a financial cooperative). However it is the core idea of cooperatives that members control the management as the members are also the owners of a cooperative bank. The same goes for the central institution in a cooperative banking group: here too these new provisions impede the control of the management by the owners.

Under **BRRD,** smaller banks should no longer be obliged to draw up a resolution plan. As these small and non-complex institutions will be wound up under normal insolvency proceedings the provisions of the BRRD will be never applied to them. So the current obligation to draw up resolution plans does not make any sense.

Conclusion

Our associations -representing tens of millions of members and many more millions of customers in the EU, are convinced by the arguments and proposals included in this paper. **We respectfully commend them to the Commission** and other European authorities, and expect serious consideration to be given to them. We kindly invite these distinguished authorities to develop a prompt dialogue on this important matter, having in mind evidence of seriousness of the situation elaborated above. All the contributors (listed on page 3) and their respective organisations stand ready to engage in such dialogue at the authorities' convenience.

June 2019

This is the second, updated, edition of a paper initially produced in April 2019

Appendix 1 : Listing of relevant official and academic studies / reports on proportionality and the burden of regulation.

Appendix 2 : Comparisons with leading non-EU jurisdictions.

APPENDIX 1 – LISTING OF OFFICIAL AND ACADEMIC STUDIES ON BURDEN OF REGULATION AND PROPORTIONALITY

1. "Proportionality in Bank Regulation" – a report by the **Banking Stakeholder Group of the European Banking Authority**, December 2015

http://www.eba.europa.eu/documents/10180/807776/European+Banking+Authority+Banking+Stakeholder+Group-+Position+paper+on+proportionality.pdf

The important sections on the nature and principles of proportionality, referred to in the main paper, are reproduced here :

The three Es – see page 18

One way of conceptualising the economic perspective [on proportionality] is to apply what might be termed the Three Es test.

Effectiveness *(is the proposed regulatory measure likely to have a significant impact on addressing the problem being identified?),*

Efficiency *(have alternatives to the proposed measure – including alternative regulatory measures – been considered to determine whether the same objective could be achieved at a lower cost?), and*

Economy *(are there potential wider costs and benefits for the economy as a whole).*

Finally, the report establishes[36] the Five Pillars of Proportionality :

(1) Objectives: whether a particular regulation that is designed to apply to all regulated institutions is disproportionate in relation to the objective sought.

(2) The totality of regulation: whether the totality of regulation (as opposed to each regulation taken alone) is disproportionate for the key regulatory objectives, given the possibility of diminishing marginal returns that may emerge if regulation is taken beyond its optimal level in terms of scope and intensity. This also includes whether the cost benefit analysis is applied to the totality of regulation, takes into account all relevant costs and benefits, and considers the costs and benefits of alternative measures.

(3) Excess Complexity: whether regulation is excessively and unnecessarily complex for the objectives that are sought and whether the same regulatory objectives could be achieved, and with the same degree of effectiveness, with less complex regulatory requirements.

[36] Ibid. page 20

(4) Differentiations: whether, in the application of a regulation, sufficient differentiations are made between different types of banks without compromising the objectives of regulation. Such differentiations might relate to, for instance, size, business models, ownership structures, etc. Imposing similar requirements (the one-size-fits-all syndrome) on small and large banks in certain aspects of financial regulation may result in undesired effects, as the former would face proportionately higher costs while their systemic significance is low.

(5) Materiality: whether a particular regulation either applies to institutions to which it should not be applied (the materiality principle) and/or to institutions which are subject to a costly new regulation when they are only marginally exposed to the risks that such regulation aims to control.

For the purposes of this paper, while there is of course much overlap, the pillars of differentiation and materiality are probably the most relevant.

2. "Proportional and effective supervision" – a report by **De Nederlandsche Bank**, 30 May 2018

https://www.dnb.nl/en/binaries/Proportional%20and%20effective%20supervision_tcm47-376254.pdf?2018102212

From the accompanying press release :

"There are indications of increased homogeneity among banks. More attention should be given to promoting heterogeneity in the financial sector, as this helps to improve financial stability. This is the conclusion of a study into proportional and effective supervision, which DNB published today. A more diverse financial sector reduces the impact of an external shock on financial stability.

Over the past ten years, banking regulation and supervision have become both stricter and more comprehensive. Necessarily so, as post-crisis regulatory reforms were needed to increase the resilience of individual banks while restoring financial stability.

As a result, the risk-absorbing capital of financial institutions has increased significantly, because banks bolstered their capital in terms of both quantity and quality. While higher capital requirements make banks safer, this does not automatically imply that the banking sector as a whole has become less sensitive to risks.

………..

Regulation may be one of the factors explaining this. All banks are subject to the same statutory restrictions when optimising their balance sheets. The more numerous and detailed these restrictions are, the more banks' activities may be pushed in the same direction. However, other factors unrelated to regulation may also play a role. Indications of increasing homogeneity must therefore be studied in further detail and closely monitored.

In the Netherlands, homogeneity in the banking sector warrants attention with a view to financial stability. The sector has become substantially less diverse in recent decades. We highlighted this trend in our 2015 report "Perspective on the structure of the Dutch banking sector". Homogeneity among financial institutions is an uncertain factor for financial stability because these institutions are exposed to the same types of risks, and their response to shocks is similar.

The study therefore recommends that increased attention should be devoted to heterogeneity in regulation and supervision. More diversity at a sector level will contribute to reducing systemic risk. One way of achieving this is to promote proportionality in regulation and supervision to facilitate compliance by smaller, less complex or more specialised banks. The study published today lists recommended actions aimed at improving proportionality in regulation and supervision and reducing the regulatory burden. More generally, identification of anticipated and unanticipated responses to new rules should be an integral part of the regulatory design process."

3. Proportionality in Banking Regulation, (Boss, Lederer, Mujic, Schwaiger) Monetary Policy and the Economy Q2/18 , **Oesterreichische Nationalbank**

https://www.oenb.at/dam/jcr:d9e8bdcc-fb74-4de0-9c28-af2bf4c00391/05_mop_2_18_proportionality_in_banking_regulation.pdf

Extract from Summary and conclusions (emphasis added)

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.

……….

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).

4. Bank of England Response to European Commission Call for Evidence on EU Regulatory Framework for Financial Services February 2016

https://www.bankofengland.co.uk/paper/2016/boe-response-to-european-commission-call-for-evidence-on-eu-regulatory-framework-for-financial

extract on proportionality :

Proportionality/preserving diversity in the EU financial sector Are EU rules adequately suited to the diversity of financial institutions in the EU? Are these rules adapted to the emergence of new business models and the participation of nonfinancial actors in the market place? Is further adaptation needed and justified from a risk perspective? If so, which, and how?

Example 1: CRD IV, CRR Proportionality in banking regulation

Issue: Unlike other large jurisdictions, such as the USA, the EU applies the same rules to all its banks in seeking to achieve a level playing field. Consistent standards are key to delivering safety and soundness in the financial system and thus the Single Market. That is particularly the case for large, internationally active banks. But a "one size fits all" approach of common binding rules for all banks, no matter what their size, complexity or level of crossborder activity, can cause distortions given that the costs of regulation tend to bear more heavily on smaller banks. Policy makers need to weigh the desirability of the same rules for all firms with wider objectives, including growth, financial stability and effective competition. More proportionate, differentiated rules are more likely to enable banks of different size and business model to compete on an equal footing across the EU than the same rules applied to all banks.

The costs of regulation must be proportionate to the benefits. The benefits and costs vary across banks of different size and business model. Often the benefits of regulation are proportionately bigger for larger or more complex banks, while to the extent that regulation imposes fixed costs those will tend to bear more heavily on smaller banks. The financial stability benefits from regulation of large, internationally-active banks mean these firms should meet the global standards that are designed with such banks in mind. Broadly speaking, EU regulation already reflects the greater benefits from applying tighter requirements to such banks. For example, higher capital buffers are required for large, interconnected banks and recovery and resolution planning is also tighter. But aspects of EU regulation are not fully consistent with those global standards, partly due to the need to apply rules across all banks.

Suggestion: A differentiated approach would allow the EU to align regulation of larger banks more closely with global standards, thus supporting financial stability. But it can also recognise the lower benefits, and sometimes higher costs, from regulation of smaller banks. More proportionate rules can help to promote competition and growth. That, in turn, can enhance the resilience of the banking system: lower barriers to entry foster competition, allowing new banks to substitute for any loss in the provision of finance by less resilient firms, while growth improves loan performance, supporting profitability. While there are clearly challenges in putting a more proportionate approach into effect, including defining the boundary between groups of banks to which different rules might be applied, these have been overcome in other jurisdictions, such as the United States which applies a narrower set of regulatory rules to smaller banks, and only applies global standards to large, internationally-active banks. The gains for the EU of adopting a similar approach could be material.

A more proportionate approach could be adopted for many aspects of bank regulation. For example, there is a case for ensuring that regulatory reporting requirements do not go beyond what is necessary for effective supervision of smaller banks. Regulation could also be tailored to business models: the benefits from the prospective application of the Net Stable Funding Ratio (NSFR) should be larger for banks that rely more heavily on wholesale funding. Differentiated approaches should be carefully designed to avoid unintended distortions: there is a need to reduce the competitive imbalances that exist between firms using model-based approaches for estimating mortgage risk weights relative to firms on standardised approaches. These imbalances can have unintended effects on the safety and soundness of banks by encouraging banks on standardised approaches to compete for riskier mortgages, where the capital differentials are less marked. Finally, remuneration policy should also be proportionate to the risks the policy is meant to mitigate and the cost it imposes on a firm.

5. **New cooperative banking in Europe : strategies for adapting the business model post crisis.** Edited by Marco Migliorelli, Sorbonne Business School

This edited volume showcases how the European cooperative banks have continued to evolve amid a new competitive scenario that resulted from the Global Financial Crisis started in Europe in 2008. The cooperative banking paradigm has been put under an unprecedented pressure as a consequence of factors such as the exceptionally low interest rates set by the European Central Bank, low profitability generated by traditional banking services—which are the backbone of the cooperative banking business—and the entrance of fintech companies into the banking market. **Furthermore, tightening regulation since the beginning of the crisis has produced an increased capital and liquidity burden which in some cases have forced cooperative banks to reduce lending to their members and customers, putting under question the traditional countercyclical role of cooperative banks in periods of crisis.** For these reasons, it is of the utmost value to observe and analyse how cooperative banks have been reacting in the attempt to preserve their unique business model and, at the same time, to keep providing credit to the economy. A number of scholars active in the cooperative banking sector have been involved in this edited volume as contributors.

https://www.palgrave.com/gb/book/9783319935775

6. **Stability, Flexibility and Proportionality : towards a two-tiered European Banking Law ?** (**European Banking Institute Working Paper 2018 – no. 20** : Bart Joosen/ Marco Lamandini/Matthias Lehmann/Kitty Lieverse / Ignacio Tirado.)

https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3128304

The conclusions of this detailed paper (emphasis added) are extracted below :

As it is apparent from the description included in this paper, the banking regulatory framework adopted by the European Union is both stern and unidimensional. Hard requirements are in place, with no distinction depending on the situation. **Proportionality is only a theoretical reference, with little or no practical implementation.** To be sure, the transposition of Basel has been done in a manner that will convey a message of extreme prudence, strong supervision and certainty to the market. But, as we have tried to prove, this approach comes at a cost. On the face of it, strictness would seem to provide certainty and hence foster the financial activity and attract investment to European banks. **However, the excessive costs imposed on some banks, on the smaller entities, hinder their development and undermine a market niche that has proven very relevant across the globe. Smaller banks render necessary community services, perform proximity banking, finance start-ups and reach out to customers that would otherwise suffer a financing gap.** This paper purports to provide ideas that will relax the system and, based on an ad hoc, bespoke assessment, will entail an improvement for a key part of our banking sector. It is also our idea that such an approach will not only not increase the risk of the financial system, but rather that it will normalise it, bringing it closer to the more advanced financial systems.

7. "Community Banks e banche del territorio. Si può colmare lo iato sui due lati dell'Atlantico?" ("Community Banks and local banks. Can the gap be bridged on both sides of the Atlantic? ") By **Prof. Rainer Masera, Università Telematica Guglielmo Marconi** published by **ECRA - the publishing house of the Italian Cooperative Credit network**, in March 2019.

http://www.creditocooperativo.it/news/dettaglio_news.asp?i_menuID=35328&hNewsID=145978

In this very recent publication, Prof. Masera challenges the dogma of "one size fits all."

"The official explanation given in support of the one size fits all surveillance model, adopted in the transposition of the Basel standards over the last thirty years, writes Masera, asserts that this was necessary to ensure a level playing field for all banking companies in the single market. This dogma is false. "

"It can be shown" - Masera argues – "that the opposite is true : the small banks and medium-sized local / regional were penalized under the competitive profile for four distinct but concurrent reasons: the substantially fixed costs of compliance deriving from an increasingly complex, articulated and constantly changing hypertrophic regulation; the lack of / insufficient recognition of the different systemic footprint of local banks compared to the large internationally active banks; the advantage in terms of the cost of financing systemic banks, considered too big to fail, before the introduction of the resolution scheme for European banks from 2014; and the impossibility for the local banks of "gaming the Basel rules" to artificially lower their risk weighted assets."

APPENDIX 2 – COMPARISONS WITH LEADING NON-EU JURISDICTIONS

1. "Proportionality in bank regulation and supervision – a survey on current practices" Basel Committee on Banking Supervision, March 2019.

https://www.bis.org/bcbs/publ/d460.pdf

We note the following significant and timely observations in this study published by the BCBS last month which indeed validate several of our own arguments.

First, the Introduction reaffirms that *"the Committee's original Basel I framework was focused on the capital adequacy of "international banks" only, with no expectation that the framework be applied to other banks"*.

Second, the paper gives the same example of existing proportionality within Basel standards that we used on page 12 above - the choice of standardised or internally-modelled approaches.

Third, BCBS acknowledges the increasing burden of complexity : *"Over the past decade, the Committee has pursued a comprehensive and wide-ranging set of post-crisis reforms. These reforms have helped strengthen the resilience of internationally-active banks and enhance global financial stability, but they have also resulted in a* ***more complex framework that is more resource-intensive to implement*** *and supervise. As a result, some jurisdictions have introduced a proportionate approach to their domestic regulatory framework, while others have revised existing proportionality regimes."*

2. "Proportionality in banking regulation – a cross-country comparison" Financial Stability Institute, Insights on Policy Implementation, August 2017.

https://www.bis.org/fsi/publ/insights1.pdf

(a) Extract below : the case of Switzerland (pages 19-20) – relates to the state of policy *before* FINMA's latest small banking pilot in H2 2018

In Switzerland, proportionality is a constitutional principle that is rigorously applied in all financial market regulation, in combination with an established principle-based approach. In line with its broader financial market strategy, Switzerland consistently implements the international minimum standards. It makes use of exemptions or derogations where these standards provide for them, with the aim of appropriately applying the proportionality principle. At the same time, the application of this principle is underpinned by a risk-based approach to supervision. The Swiss approach and the strategy adopted by FINMA, the Swiss financial market regulatory and supervisory authority, on the use of proportionality and equivalence with international standards can be illustrated by the examples presented in this Annex.

On the level of delegated regulation, FINMA uses a transparent and consistent categorisation of banks to differentiate between applicable requirements in specific areas. Throughout its regulatory and supervisory process, FINMA assigns prudentially supervised banks and securities dealers to five different supervisory categories, based on measurable criteria: total assets, assets under management, privileged deposits37 and required capital. The institutions in categories 1 and 2 are subject to continuous and intense supervision, because of their importance and risk profile. As of December 2015, category 1 comprised two G-SIBs and category 2 included three D-SIBs. Institutions in category 5 are subject to less intense supervision and direct on-site supervision is triggered only by the occurrence of extraordinary events.

The proportionality principle incorporated in the Swiss prudential regulation is based on the categorisation system. Institutions in categories 1, 2 and 3 are considered internationally active and/or important banks and are thus subject to the full Basel framework, while banks in categories 4 and 5 qualify for a more tailored treatment. Further, banks in categories 1 and 2 (G-SIBs and D-SIBs) must comply with stricter requirements in specific areas than do category 3 banks. FINMA has used this categorisation in different circulars to implement the proportionality principle: Circular 2016/01 regarding disclosure requirements, for instance, prescribes the full international disclosure framework for banks in categories 1, 2 and 3 but requires banks in categories 4 and 5 to disclose less information less frequently. Following the same logic, the liquidity framework provides that exemptions are applicable to all banks in supervisory categories 4 and 5. Moreover, simpler and less detailed reporting on the LCR and NSFR is required from banks in these two categories.

The large exposure limit of 25% does not apply to category 4 and 5 banks for their interbank exposures to non-SIBs. The approach chosen in Switzerland is similar to the regulation applied in the European Union. In addition, only those banks are allowed to use lower risk weights for their shortterm exposures (on demand and overnight) to highly rated non-SIBs.

Circular 2017/01 on corporate governance for banks makes heavy use of the risk categorisation. For example, only banks in supervisory categories 1 to 3 are obliged to appoint separate audit and risk committees and they must also appoint a chief risk officer (CRO). For banks in supervisory categories 1 and 2, the CRO must be a member of the executive board. In addition, mandatory implementation of compensation rules is restricted to banks with capital of CHF 10 billion or more.

Proportionality is also applied in circulars that pertain to capital buffers and capital planning, as well as to operational risks, (counterparty) credit and market risk. For example, FINMA provides a simplified SA-CCR for banks in categories 4 and 5 (as well as category 3 in the case of insignificant derivative exposures) (Circular 2017/07). In terms of credit risk, FINMA does not require category 4 and 5 (and in some cases category 3) banks to apply a complex “look-through” approach in order to determine the exact risk weight of fund positions in the banking book. Instead, they can use risk weights set by the authority which match standardised documentation. Irrespective of category, banks with an insignificant trading book (of less than

CHF 30 million and 6% of balance sheet assets) may use banking book rules to underpin the market risk of equity and debt instruments (Circular 2008/20).

Proportionality is also applied in Pillar 2. In particular, category 4 and 5 banks do not have to conduct an extensive ICAAP and are only subject to an alleviated stress test. To determine the capital requirements for interest rate risks, FINMA plans to exempt small banks from certain requirements, such as the provision of an independent validation function. Finally, recovery planning is not required for these banks as it is assumed that a normal insolvency procedure would pose no threat to financial stability.

(The extract above describes the high degree of proportionality already introduced by FINMA even before the further step-change of the leverage-based pilot that is now to be confirmed. The latest information (April 2019) from FINMA on this permanent small bank option based on leverage ratios is shown below for completeness and ease of reference, with links.)

The Swiss Financial Market Supervisory Authority FINMA is implementing the small banks regime within its regulatory scope. This involves it exempting small and solid banks from certain regulatory requirements and adjusting some of its circulars accordingly. The small banks regime seeks to increase efficiency in regulation and supervision for small and particularly solid institutions. The goal is to reduce the regulatory burden on such institutions without jeopardising their stability and safety. Institutions in the regime must therefore be extremely well capitalised and enjoy high liquidity. In return, they are able to benefit from a regulatory regime with significantly reduced complexity. They no longer need to calculate risk-weighted assets, for example. FINMA launched the idea of the small banks regime in 2017. Since then and in parallel with the pilot project which started in July 2018, it has conducted a constructive and intensive dialogue with numerous industry representatives, particularly regarding the possible relaxations. Compared with other financial centres, the proposed regime leads the way in terms of both its content and timing.

Small banks regime to become definite

Before the small banks regime can be implemented, the Federal Council's Capital Adequacy Ordinance must be amended on the one hand. The Federal Department of Finance has prepared a draft text in this connection. On the other hand, FINMA is adjusting its circulars on "Outsourcing – banks and insurers", "Operational risks – banks", "Corporate governance – banks", and "Disclosure – banks" based on the Capital Adequacy Ordinance. The relaxations introduced as part of the small banks regime pertaining to outsourcing and operational risks should also apply to institutions with the FinTech licence in the future. The consultation exercise on the revised FINMA circulars is being conducted in parallel with the consultation on the amendments to the Capital Adequacy Ordinance. The consultation will go on until 12 July 2019.

https://www.finma.ch/en/news/2019/04/20190405-mm-kleinbanken/

Swiss categorisation of the banking system		Table 5
Category	Criteria (CHF in billions)	Number of institutions (2016)
1	Total assets ≥ 250 Assets under management ≥ 1,000 Privileged deposits ≥ 30 Required equity capital ≥ 20	2
2	100 ≤ Total assets < 250 500 ≤ Assets under management < 1,000 20 ≤ Privileged deposits < 30 2 ≤ Required equity capital < 20	3
3	15 ≤ Total assets < 100 20 ≤ Assets under management < 500 0.5 ≤ Privileged deposits < 20 0.25 ≤ Required equity capital < 2	29
4	1 ≤ Total assets < 15 2 ≤ Assets under management < 20 0.1 ≤ Privileged deposits < 0.5 0.05 ≤ Required equity capital < 0.25	63
5	Total assets < 1 Assets under management < 2 Privileged deposits < 0.1 Required equity capital < 0.05	202

Source: FINMA, *Annual Report*, 2016, p 94.

(b) Extract below : the case of Brazil (pages 13-14)

In implementing Basel II and Basel II.5, Brazil has chosen to apply the minimum capital standards to the country's whole financial system. This comprises more than 1,400 institutions that range from large and complex banks to credit unions and securities dealers. In the early 2000s, the intention was that universal application of the standards would contribute to the stability of the financial system. At the same time, the one-size-fits-all regulatory approach has presented supervisory challenges, given the unavoidable necessity of exercising judgment on qualitative and quantitative requirements.

The Basel III reforms have prompted a change of approach. Brazil had already implemented proportional requirements in its Internal Capital Adequacy Assessment Process (ICAAP) and offered a simplified calculation of regulatory capital for banks with a low risk profile. However, the first direct decision to exempt institutions from the enforcement of a specific Basel standard corresponded to the minimum LCR ratio.

A process has been initiated to apply proportionality to the application of the more complex standards. That includes the market risk framework, the enhanced disclosure templates and the frameworks for recovery and resolution developed by the Financial Stability Board (FSB). In effect, the Central Bank of Brazil, the country's regulatory and supervisory authority, has abandoned the approach taken since Basel II and, instead, has undertaken a comprehensive and public segmentation of the Brazilian financial system, setting the scene for the introduction of regulatory requirements on a proportional basis.

The regulation that establishes the new regulatory framework15 and divides the Brazilian financial system into five segments was issued in January 2017. It takes into account the size, the international activity, and the risk profile of the subject institutions (see Table 4). The size criterion is measured as an institution's total exposure, calculated according to the leverage ratio framework, divided by the Brazilian gross domestic product for a given year. The segmentation is applicable at the consolidated level to institutions operating in and from Brazil, which means that a foreign institution would be viewed from the perspective of the operations of its Brazilian subsidiary. The size ratio uses the total exposure measure because it includes on- and off-balance sheet items and the relative ratio ensures that the thresholds retain their significance over time. The regulation also sets the operational details on how the initial segmentation is defined, on the mechanics of calculating the thresholds, on the recategorisation of banks from one segment to another and on possible supervisory actions regarding the definition of the most suitable segment for an institution. The authority can override/adjust the segmentation in certain circumstances.

The segmentation is designed to provide a comprehensive but simple categorisation of the financial system. The aim is also to define a categorisation suitable for a variety of regulatory topics, ranging from prudential supervision to recovery and resolution issues.16 Once the segmentation has been established, the next step is to establish different regulatory requirements using the five segments as drivers for deciding on the appropriate proportionality for each specific situation, following the implementation schedules of the post-crisis reform agenda without compromising prudential objectives.

Segmentation of Brazil's financial system — Table 4

Segment	Size ratio threshold (Total exposure/GDP)	Internationally active (Total consolidated assets abroad ≥ US$ 10bn)	Number of institutions (June 2016)
S1	Size ratio ≥ 10%	Yes	6 banks
S2	1% ≤ Size ratio < 10%	No	7 banks
S3	0.1% ≤ Size ratio < 1%	No	39, including 36 banks
S4	Size ratio < 0.1%	No	422, including 83 banks
S5	Size ratio < 0.1% and business model of non-banks	No	989 non-banks

Source: Central Bank of Brazil.

The intention is to require the full application of Basel III standards to segment S1 – comprising the six largest and most complex banks and the internationally active banks. This category includes all the D-SIBs and represents 70% of the system's total exposures, as of June 2016. On the other hand, for the S5 group – which includes 989 non-banking institutions representing 1% of the system's total assets (because they do not calculate total exposures) – appropriate simplified approaches are planned, taking into account the burden of the prudential requirement and the desired degree of conservativeness. For institutions in the intermediate segments S2, S3 and S4, the aim is to design a prudential requirement that fits their risk profile, leaving scope for specific supervisory action in terms of prescribing a more complex approach to managing and measuring the risks incurred by each institution.

The first regulation that makes use of the segmentation of the Brazilian financial system was issued in February 2017 and establishes minimum requirements for the risk management and the capital management framework. It provides specific differences on what institutions in different segments are required to implement. Examples of proportional treatment introduced in the regulation include the Basel ICAAP requirement for institutions in S1 and the provision for a simplified ICAAP to be performed by banks in S2; the explicit provision that only institutions in S1 are required to do reverse stress tests; and the establishment of simplified rules for institutions in S5.

3. Comparisons with the USA – latest proposals from the Federal Reserve Board

Extract from press release (31 October 2018)

https://www.federalreserve.gov/newsevents/pressreleases/bcreg20181031a.htm

The Federal Reserve Board on Wednesday invited public comment on a framework that would more closely match the regulations for large banking organizations with their risk profiles. The changes would reduce compliance requirements for firms with less risk while maintaining more stringent requirements for firms with more risk.

The framework establishes four categories of standards for large banking organizations--those with more than $100 billion in total consolidated assets. The proposals build on the Board's existing tailoring of its rules and would be consistent with changes from the Economic Growth, Regulatory Reform, and Consumer Protection Act.

"The proposals would prescribe materially less stringent requirements on firms with less risk, while maintaining the most stringent requirements for firms that pose the greatest risks to the financial system and our economy," Chairman Jerome H. Powell said.

The changes would significantly reduce regulatory compliance requirements for firms in the lowest risk category, modestly reduce requirements for firms in the next lowest risk category, and largely keep existing requirements in place for the largest and most complex firms in the highest risk categories.

"With these proposals, banking organizations will see reduced regulatory complexity and easier compliance with no material decline in the strength of the U.S. banking system," Vice Chairman for Supervision Randal K. Quarles said.

Firms would be sorted into categories based on several factors, including asset size, cross-jurisdictional activity, reliance on short-term wholesale funding, nonbank assets, and off-balance sheet exposure. Each factor reflects greater complexity and risk to a banking organization, resulting in greater risk to the financial system and broader economy.

(The October 2018 US framework deals with relatively large banks – down to US$ 50 billion. The final piece of proportionate regulation covering smaller “community banks” – up to US$ 10 billion – was trailed in November 2018 and put in place in February 2019.)

Extract from press releases and official documents

https://www.occ.gov/news-issuances/news-releases/2018/nr-ia-2018-125.html

Three federal banking agencies today invited public comment on a proposal that would simplify regulatory capital requirements for qualifying community banking organizations, as required by the Economic Growth, Regulatory Relief, and Consumer Protection Act. The proposal would provide regulatory burden relief to qualifying community banking organizations by giving them an option to calculate a simple leverage ratio, rather than multiple measures of capital adequacy.

Under the proposal, a community banking organization would be eligible to elect the community bank leverage ratio framework if it has less than $10 billion in total consolidated assets, limited amounts of certain assets and off-balance sheet exposures, and a community bank leverage ratio greater than 9 percent. A qualifying community banking organization that has chosen the proposed framework would not be required to calculate the existing risk-based and leverage capital requirements. Such a community banking organization would be considered to have met the capital ratio requirements to be well capitalized for the agencies' prompt corrective action rules provided it has a community bank leverage ratio greater than 9 percent.

https://www.occ.gov/news-issuances/bulletins/2019/bulletin-2019-6.html

1. Summary

The Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation (collectively, the agencies) are issuing a notice of proposed rulemaking that would provide a simplified measure of capital adequacy for qualifying community banking organizations consistent with section 201 of the Economic Growth, Regulatory Relief, and Consumer Protection Act. Qualifying community banking organizations that comply with and elect to use the community bank leverage ratio (CBLR) framework and that maintain a CBLR greater than 9 percent would be considered to have met the capital requirements for the "well-capitalized" capital category under the agencies' prompt corrective action (PCA) frameworks and would no longer be subject to the generally applicable capital rule.

2. Note for Community Banks

This proposed rule would apply to qualifying community banks, which include national banks and federal savings associations that have less than $10 billion in total consolidated assets and meet other prudential criteria.

3. Highlights

The proposed CBLR framework is a simple alternative methodology to measure capital adequacy for qualifying community banks. The proposal would provide material regulatory relief while maintaining safety and soundness in the banking system. Because the CBLR framework is intended to be relatively simple to implement, it is based on a subset of data that are currently reported by banks in their regulatory filings.

To begin using the proposed CBLR framework, a bank would have to meet the following requirements:

- Have average total consolidated assets of less than $10 billion and not be an affiliate or subsidiary of a banking organization subject to the advanced approaches rule.
- Have mortgage servicing assets of 25 percent or less of CBLR tangible equity.
- Have deferred tax assets arising from temporary timing differences, net of valuation allowances, of 25 percent or less of CBLR tangible equity.
- Have off-balance-sheet exposures (excluding derivative exposures and unconditionally cancelable commitments) of 25 percent or less of total consolidated assets.
- Have total trading assets and trading liabilities of 5 percent or less of total consolidated assets.
- Have a CBLR greater than 9 percent.

Appendix

Proposed Requirements*

	Category I	Category II	Category III	Category IV	Other Firms
	U.S. GSIBs	≥ $700b Total Assets or ≥ $75b in Cross-Jurisdictional Activity	≥ $250b Total Assets or ≥ $75b in NBA, wSTWF, or Off-balance sheet exposure	Other firms with $100b to $250b Total Assets	$50b to $100b Total Assets
Capital	**TLAC/Long-term debt**				
	Stress Testing • CCAR qualitative and quantitative • Annual company-run stress testing • Annual supervisory stress testing • Annual capital plan submission	**Stress Testing** • CCAR qualitative and quantitative • Annual company-run stress testing • Annual supervisory stress testing • Annual capital plan submission	**Stress Testing** • CCAR qualitative and quantitative • Company-run stress testing every other year • Annual supervisory stress testing • Annual capital plan submission	**Stress Testing** • CCAR quantitative (two-year cycle) • Supervisory stress testing (two-year cycle) • Annual capital plan submission	
	Risk-Based Capital • GSIB surcharge • Advanced approaches • Countercyclical Buffer • No opt-out of AOCI capital impact	**Risk-Based Capital** • Advanced approaches • Countercyclical Buffer • No opt-out of AOCI capital impact	**Risk-Based Capital** • Countercyclical Buffer • Allow opt-out of AOCI capital impact	**Risk-Based Capital** • Allow opt-out of AOCI capital impact	**Risk-Based Capital** • Allow opt-out of AOCI capital impact
	Leverage capital • Enhanced supplementary leverage ratio	**Leverage capital** • Supplementary leverage Ratio	**Leverage capital** • Supplementary leverage ratio	**Leverage capital**	**Leverage capital**
Liquidity	**Standardized** • Full LCR (100%) • Full NSFR (100%)	**Standardized** • Full LCR (100%) • Full NSFR (100%)	**Standardized** • Reduced LCR (70-85%)† • Reduced NSFR (70-85%)†		
	Internal • Liquidity stress tests (monthly) • Liquidity risk management	**Internal** • Liquidity stress tests (monthly) • Liquidity risk management	**Internal** • Liquidity stress tests (monthly) • Liquidity risk management	**Internal** • Liquidity stress tests (quarterly) • Tailored liquidity risk management	

* This figure does not reflect risk committee and related risk management requirements or single-counterparty credit limits.
† For firms subject to Category III requirements with wSTWF of $75 billion or more, 100% LCR and NSFR requirements would apply. For firms subject to Category III requirements with less than $75 billion in wSTWF, the proposal would request comment on reducing the LCR and NSFR requirements to a level between 70-85%.
Glossary: NBA – nonbank assets; wSTWF – weighted short-term wholesale funding; AOCI – accumulated other comprehensive income; CCAR – Comprehensive Capital Analysis and Review; GSIB – global systemically important bank holding company; LCR – liquidity coverage ratio rule; NSFR – net stable funding ratio proposed rule; TLAC – total loss-absorbing capacity.

4. "The Basel framework in 100 jurisdictions: implementation status and proportionality practices"

Financial Stability Institute, Insights on Policy Implementation, November 2018.

https://www.bis.org/fsi/publ/insights11.pdf

The different versions of the Basel framework are designed, in principle, for internationally active banks. Indeed, one of the fundamental objectives of the BCBS, starting with Basel I, has been to minimise the competitive inequality of internationally active banks. Nevertheless, many authorities have applied Basel I and II, to non-internationally active banks operating in their jurisdictions. This may reflect the fact that Basel I and II dealt solely with risk-based capital. This, combined with the simplicity of Basel I and the standardised approaches introduced under Basel II, made it relatively easy for authorities to implement4 across a range of banks and banking systems. National authorities could thus apply a reasonably homogenous set of prudential rules within their jurisdictions and secure a certain level of international recognition for their national regulatory frameworks.5 6. The intricacies of Basel III pose implementation challenges for smaller, less complex banks. Basel III has increased the volume and complexity of new rules, encompassing not only significant changes to the numerator and denominator of the RBC regime, but also the introduction of new leverage, liquidity and large exposures rule. In many non-BCBS jurisdictions - where the banking industry remains largely focused on traditional lending activities - the added complexity is affecting the pace of implementation of the new reforms.

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Nearly all 100 jurisdictions apply some form of proportionality, at least with respect to the adoption of the Basel RBC regime (Table 7). In other words, jurisdictions have not typically applied a full version of any Basel RBC standard to all banks in their jurisdiction. This may reflect the fact that perhaps more than any other prudential standard, the RBC regime contains various subcomponents that may be subject to a proportionate approach, particularly for smaller, less complex banks.

As countries shift to the more complex Basel III RBC regime, greater differentiation and more extensive proportionality strategies are applied. Countries under Basel I and Basel II tend to apply the Basel framework uniformly to all banks, even when the rules are modified to reflect country specificities. In contrast, proportionality strategies become more multifaceted in countries under the Basel III RBC regime, due in part to a number of new features that have been introduced under the standard.