EUROPEAN CENTRAL BANK

BANKING SUPERVISION

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EUROPEAN CENTRAL BANK

Proportionality in banking regulation and supervision

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Proportionality in banking regulation and supervision

- Proportionality is one of the founding principles of the European Union, engraved in the EU Treaties and a guiding principle of the European banking regulation and supervision
  - ✓ Article 5(4) of the Treaty of the European Union: "*under the principle of proportionality, the content and for of Union action shall not exceed what is necessary to achieve the objectives of the Treaties. The institutions of the Union shall apply the principle of proportionality as laid down in the Protocol.*"
  - ✓ Proportionality is carried down in the Single Rule Book (encompassing CRR, CRD IV and BRRD) and in the Basel Core principles for Effective Banking Supervision
- Proportionality is at the very core of daily supervision work at the ECB

1 **Need for proportionality in banking regulation**

2 **Regulatory debate on proportionality – the European case**

3 **Application of proportionality in supervision**

1 Proportionality is a fundamental and widely recognised principle of banking regulation

Objectives of proportionality

- Proportionality allows to ensure a safe and sound banking system by supporting a competitive banking sector, a fair distribution of the supervisory burden and a fair allocation of supervisory resources
- With regard to smaller banks, these face greater difficulties in complying with regulation, leading to potential disadvantages, such as:
  - Hampering a fair competition among market participants
  - Reducing diversity in the banking sector

Limits in the application of proportionality

- Whilst simplified frameworks are designed for less complex institutions, there are limits in the application of proportionality

➢ Smaller banks also need to remain resilient during economic downturn

➢ Hence, the need for simplified regulatory requirements for smaller banks, proportionate to size, risk and business model should not imply less stringent requirements

➢ Particular areas of attention for small banks include corporate governance, internal controls and outsourcing

➢ With respect to outsourcing arrangements, these include in many cases key processes, such as IT or credit evaluation

➢ Regular and frequent reporting is a necessary condition for effective supervision, i.e. for early warning systems

➢ The reduction in the frequency of reporting may not imply a sizeable administrative or operational relief for banks

2 The on-going debate on proportionality gives rise to challenges particular to the European banking sector

State of play

- ❑ Following the crisis, a wide range of regulatory reforms have been introduced in several areas, with the goal of increasing the resilience of the banking and the overall financial system
- ❑ Significantly higher volume and complexity of regulatory requirements for European banks
- ❑ Discussions suggests that regulatory compliance costs may have become potential asymmetrical for small banks

Proposals for smaller banks on proportionality

- ❑ Focus on changes in several areas which will enable banks to apply simpler rules and reduce compliance costs for smaller banks

Changes to reduce administrative burden

- ➢ Reduced number of data points to be reported by small banks, i.e. simplified templates and less granular data
- ➢ Less frequent reporting (less convincing proposal) – banks will not save significantly and supervisors will work with outdated information
- ➢ Reduced disclosure obligations
- ➢ Exempt smaller banks from remuneration rules

Changes which allow for simplified approaches

- ➢ Banks with small trading books could be allowed to use simpler credit risk framework for capital requirement calculation, and banks with medium-sized trading books could use a simple market risk standardized approach
- ➢ Banks with small derivative portfolios might use a simpler standardized approach to calculate capital requirements

The challenge that arises is where to draw the line between small and large banks; defining thresholds may create significant cliff effects and regulatory arbitrage

3 The distinction of banks into SIs and LSIs does not imply differences in the supervisory approach

More information on next two slides

European context

- ❑ The SSM – the system of European banking supervision comprising the ECB and the National banking supervisory authorities of the Member States – is a key pillar of the Banking Union
- ❑ The principle of proportionality was enshrined in the organisational structure, based on the significance of the supervised entities; credit institutions are therefore classified as SIs and LSIs

Concept of proportionality in supervision

- ❑ A proportionate way to ensure efficient supervision relies on a division of labour between ECB and national authorities

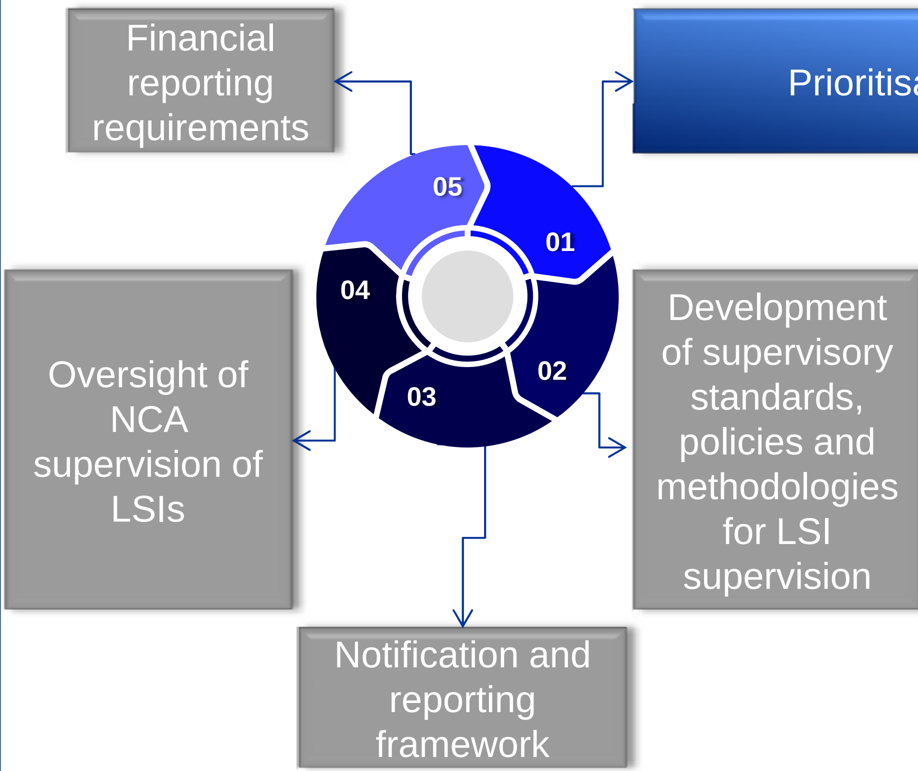
Supervision of SIs

- ➢ Classification performed according to a set of criteria (i.e. size, riskiness and type of business model)
- ➢ The intensity of the supervisory engagement is based on individual banks' profile and the cluster it belongs to
- ➢ Supervisory resources are channelled towards largest and riskiest institutions
- ➢ JST size is linked to size and complexity of supervised entity

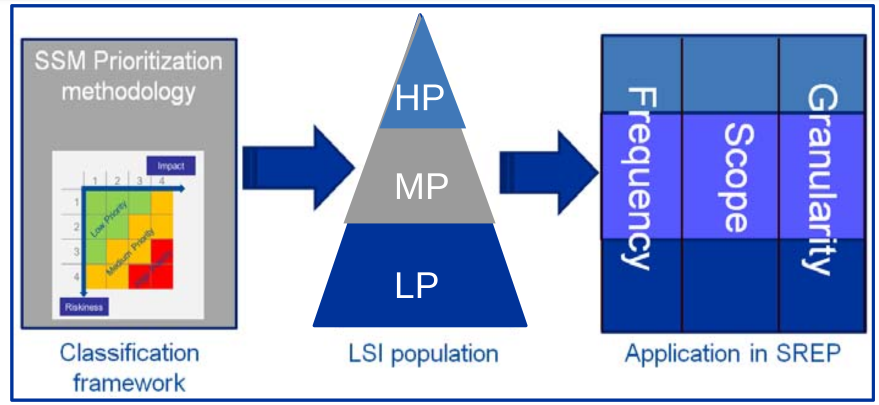
Oversight of LSI supervision

- ➢ Prioritisation into High-, Medium-, Low Priority
- ➢ The priority level is then used to determine the intensity of the cooperation and information exchange between the ECB and the national supervisors
- ➢ The prioritisation classification is the starting point for NCAs to decide on intensity of the SREP assessment (frequency, scope, granularity), supervisory expectations, information needs, etc.

3 Examples of proportionality in SSM approach to oversight the LSI Supervision (1/2)

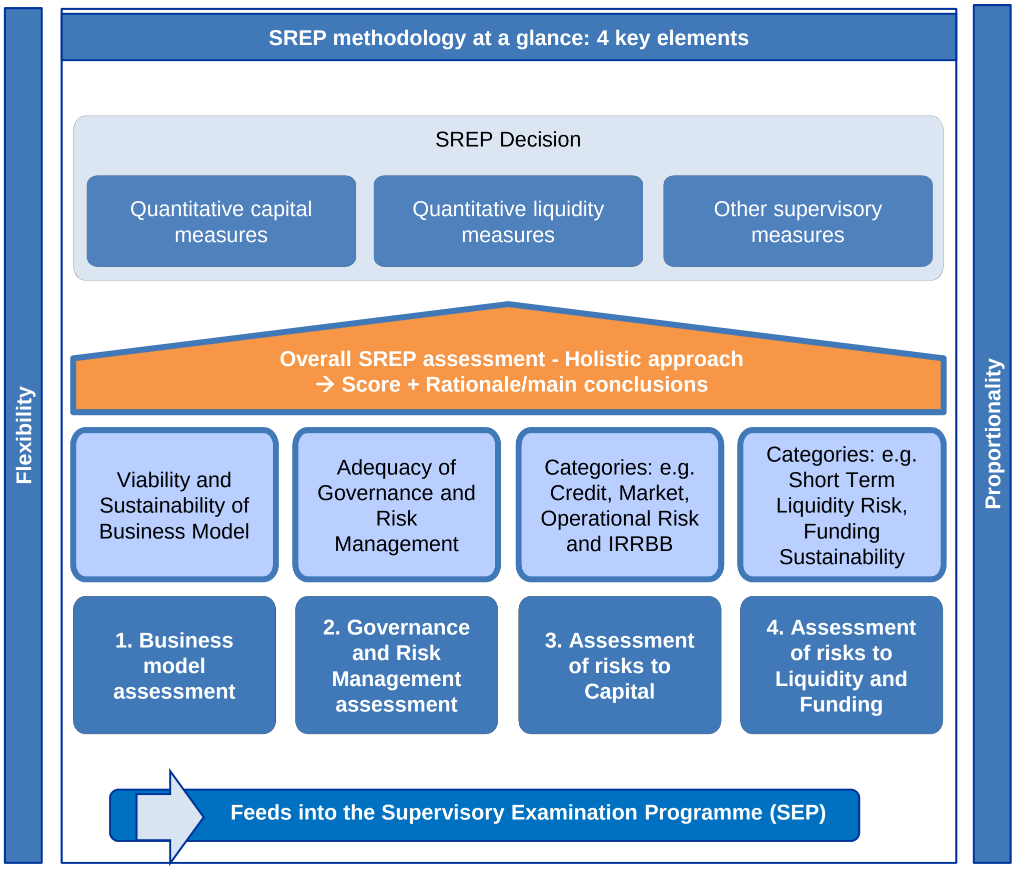


Prioritisation of LSIs - No "One-size-fits-all approach"



- SSM Prioritisation Methodology is primarily focused on riskiness and impact (includes size and complexity) of the institution's activities
- This results in the classification of the LSI population in High-, Medium-, and Low- priority institutions
- ECB uses Prioritisation in a number of oversight tasks including the development of supervisory standards and policies for LSI supervision, or in relation to notifications and reports from NCAs

3 Examples of proportionality in SSM approach to oversight the LSI Supervision (2/2)



Intensity of assessment

- Annual frequency for the full SREP assessment for HP LSIs, but lower minimum frequency for Non-HP LSIs; for all LSIs: annual update of the SREP
- LSIs' risk controls assessed through less detailed questionnaires (compared to SIs)
- For every LSI, the risk (sub)categories are assessed only if deemed material

Supervisory expectations

- For instance, depending on the nature, size and complexity of the institution and its businesses, the risk management methodologies and processes (in particular for non-HP LSIs) can be less complex

Information needs

- Methodology tailored to information reporting requirements applicable to LSIs (which, compared to SIs, are significantly reduced in terms of scope and subject to extended implementation timelines) but also any other supervisory data available at NCA

Conclusions

- Proportionality is a key topic of interest to all of us
- The need for proportionality in global banking regulation and supervision is widely recognised
- The practical implementation of this principle has limits and may be subject to continuous debate
- As guarantors of financial stability and sound European banking sector, we at the ECB are of the view that proportionality for smaller banks can imply <u>simpler but not less stringent rules</u>
- All banks should hold a level of capital and liquidity commensurate to their risks