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Stability, Flexibility and Proportionality: Towards a two-tiered European Banking Law?

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STABILITY, FLEXIBILITY AND PROPORTIONALITY:

TOWARDS A TWO-TIERED EUROPEAN BANKING LAW?

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Abstract:

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. This papers purports to provide ideas that will relax the system and, based on an ad hoc, bespoke assessment, will provide for flexibility and proportionality for a key part of the banking sector, while maintaining stability. The paper contains a proposal for criteria to make a proper distinction between "small" (tier 2) and "large" (tier 1) banks in this context. It also provides the contours of the manner in which the rules applying to the tier 2 banks should be determined.

Tags:

Banking supervision; Single Rule Book; Capital Requirements; Liquidity Requirements; Basel Committee Standards; Proportionality; Financial Stability; Capital Requirements Regulation.

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1 INTRODUCTION

In this paper, we propose to introduce a Two-Tiered Banking Law for Europe along the lines of the organisation of rules and supervision existing in jurisdictions such as the United States, Japan or Singapore, where the rules are devised mainly considering the national market. The first "tier" of banking law would consist of the current legislative body established in the Single Rule Book[1] as well as of the current centralised organisation of the system of supervision. Typically, this first tier would be applied and applicable for the largest, cross border operating credit institutions[2] with an heterogeneous product offering and complex business models. The second tier would be preserved for smaller, non-complex, predominantly domestically operating banks whose activities do not externalize a risk to the market and endanger the stability of the financial system. Such smaller, non-complex and domestic banks are to be made subject to a simplified regulatory regime, from the perspective of rules as well as from the perspective of supervision. By challenging the suitability of applying the Single Rule Book to the entire banking industry without making distinctions factoring in size, complexity and nature of the business or the level of cross border activities, we do not purport to undermine the great benefits brought about by the establishment of the EU´s s new legislative framework in this area. We are not suggesting a less risk sensitive, less robust or less comprehensive framework for the prudential supervision of those banks that would be classified in the second tier of banking law in accordance with our criteria. Our working hypothesis has been to explore whether there is a proper rationale and support to develop a Two-Tiered Banking Law that would, in its nature, address the principle of proportionality beyond the currently proposed alleviation of the burden of rules for reporting, disclosure and remuneration. We are therefore not arguing that the pendulum of financial regulation should –even if for some- swing to a more liberal, mitigated and deregulated regime.[3] This paper discusses the need for a bespoke regime of banking law for European banks for which the methodologies and rationale of many of the Basel Committee Standards on capital and liquidity may not necessarily result in productive, efficient and proportionate laws and supervision. As we shall see in the following paragraphs, both the industry and relevant parts of the European institutional framework have been taking interest in this matter. We submit that they have not always hit the right key.

In the recent years, the debate on proportionality of banking law and supervision in Europe has become more relevant and exhaustive. One of the 15 predefined topics of the European Commission's Call for Evidence of September 2015 was inviting comments on "proportionality/preserving diversity in the EU financial sector". This topic has been widely commented by the more than 250 stakeholders participating in this consultation. A substantial number of replies on this topic concerned the setup of the European prudential supervision laws, CRR and CRD IV. The Commission summarised the responses as follows:

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1 The "Single Rule Book" is being established for the banking industry upon adoption of the Capital Requirements Regulation ("CRR") being Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012, and Capital Requirements Directive IV ("CRD IV") being Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC. Nowadays, the Single Rule Book is also purported to comprise the Bank Recovery and Resolution Directive (BRRD) being Directive 2014/59/EU establishing a framework for the recovery and resolution of credit institutions and investment firms and the rules on Deposit Guarantee Schemes as set out in Directive 2009/14/EU amending Directive 94/19/EC on deposit-guarantee schemes as regards the coverage level and the payout delay. The foundation of the Single Rule Book has been resolved in the session of the Council of the European Union of 18/19 June 2009, where the core objectives and rationale of the establishment of this framework have been motivated as follows: "The European Council also recommends that a European System of Financial Supervisors, comprising three new European Supervisory Authorities, be established aimed at upgrading the quality and consistency of national supervision, strengthening oversight of cross-border groups through the setting up of supervisory colleges and establishing a European single rule book applicable to all financial institutions in the Single Market.", Presidency Conclusions, 11225/2/09.

2 We refer to the definition of "credit institution" as this is contained in Article 4(1)(1) CRR and we will often refer to this type of institution as "bank".

3 See for a (politically convenient) series of comments that plead for a more liberal approach in the United States: Edward D. Herlihy and Richard K. Kim, *It's Time for the Pendulum to Swing Back*, Harvard Law School Forum on Corporate Governance and Financial Regulation, February 2017, https://corpgov.law.harvard.edu/2017/02/17/its-time-for-the-pendulum-to-swing-back, last consulted 28 December 2017.

"*As regards banking, some respondents suggested that capital requirements in banking legislation, including those arising from macro-prudential instruments, should better differentiate according to firm size and business model, in particular considering smaller and less complex banks.*"[4]

Reporting requirements, disclosure rules for banks and remuneration rules are at the midpoint of the feedback provided by the industry. Apart from the responses to the proportionality topic, these issues had been flagged under the heading "excessive compliance costs and complexity" as well, emphasising the concern of many respondents that the prudential requirements in CRR and CRD IV may impose a disproportionate burden on smaller and less complex institutions.

In an earlier position paper, the EBA Banking Stakeholders' Group ("BSG") contributed to the discussion with elaborate recommendations, noting that the principle of proportionality has not always been followed to the fullest extent in European banking regulation.[5] Similar to the responses to the Call for Evidence consultation, the BSG refers to the impact of reporting requirements as one of the main and important examples of how banking regulation in Europe developed to create disproportionate effects. Where in the Call for Evidence responses emphasis has been laid upon the "size and complexity" of banking businesses as a measure to make distinctions in the application of proportional banking law, the BSG rather points at the concept of systemic importance as the essential feature.

The stakeholders' comments and positions brought to the table have been heard by the Commission. The revisions to the banking law to address proportionality as they are contained Risk Reduction proposals of the European Commission of 23 November 2016[6], however, restrict the scope to exactly the topics raised in the earlier debate. The Commission argues in the Impact Assessment accompanying the Risk Reduction proposal[7] that the modular approach of the current legislative framework and the currently available exemptions and preferential treatments already reflect the relative complexity and riskiness of banking businesses. The diversity of the banking sector is therefore, according to the Commission, not unnecessarily hampered by the design of European banking law. Furthermore, the Commission expresses reluctance in the development of a "lighter regime" across the board for smaller and less complex institutions, as such a regime would be very complicated and would not be suitable to apply to a broad group of institutions.[8]

Little attention has been given thus far to the question as to whether or not Europe should reconsider its fundamental choice made at the time the Basel I Capital Accord of 1988 was transposed to European banking law. Since 1989 the Basel standards apply to every European bank, no matter the size of the bank, the systemic relevance, the complexity of the banking business or the importance of its international and cross border footprint. This choice was motivated, in the early nineties of the previous century, by the desire to avoid distortions in the competition within the European banking market[9].

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4 European Commission, *Summary of contributions to the 'Call for Evidence'*, pp. 11/12 (November 2016).

5 *Proportionality in Bank Regulation*, A Report by the EBA Banking Stakeholder Group, London (December 2015), pp. 30 and further.

6 European Commission, *EU Banking Reform: Strong banks to support growth and restore confidence*, Press Release, 23 November 2016, IP/16/3731 and European Commission, Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) No 575/2013 as regards the leverage ratio, the net stable funding ratio, requirements for own funds and eligible liabilities, counterparty credit risk, market risk, exposures to central counterparties, exposures to collective investment undertakings, large exposures, reporting and disclosure requirements and amending Regulation (EU) No 648/2012 ("CRR2"), COM(2016) 850 final; Proposal for a Regulation of the European Parliament and of the Council amending Directive 2013/36/EU as regards exempted entities, financial holding companies, mixed financial holding companies, remuneration, supervisory measures and powers and capital conservation measures ("CRD5"), COM(2016) 854 final.

7 Impact Assessment CRR2, CRD5, SRMR2 and BRRD2, Commission Staff Working Document, 23 November 2016 (SWD(2016) 377 final/2).

8 Impact Assessment, o.c., p. 28.

9 Council Directive of 18 December 1989 on a solvency ratio for credit institutions that introduced the Basel Committee Standards of 1988 (*International Convergence of Capital Measurement and Capital Standards*) contains the following recital to emphasise this uniform application to all banks: "Whereas, in a common banking market, institutions are required to enter into direct competition with one another and whereas the adoption of common solvency standards in the form of a minimum ratio will prevent distortions of competition and strengthen the Community banking system". This objective has been reiterated by the European Commission at the occasion of the introduction of CRR and CRD IV in 2013. See: Memo 13/272 of 21 March 2013 at point 5: "While the Basel capital adequacy agreements apply to 'internationally active banks', in the EU it has always applied to all banks (more than 8,300) as well as investment firms. This wide scope is necessary in the

Clear examples of banking laws in other jurisdictions, such as the United States, demonstrate that such a choice is not an inescapable consequence following from the rationale and concepts of the Basel Committee Standards. The latter are primarily developed and established for large internationally operating banks. In many jurisdictions, a multi-tiered (two- or three-tiered) banking law system applies, where most of the Basel Committee Standards are exclusively imposed on the largest, most complex and internationally active banks. For smaller, less complex and domestically operating banks another regime applies, often based on simplified and bespoke frameworks that address the specific needs of this segment of the banking industry. As is further discussed in section 4.3, in direct opposition to the approach adopted by the European authorities, it can be argued that a one-size fits all approach effectively alters competition, undermining the chances of success of smaller institutions. This view, in part, underpins the different outlook existing outside the Eurozone.

In 2017, Europe was the home of 6,596 banks with 2.8 million employees. The Eurozone alone comprised 5,063 banks with 1.95 million employees.[10] Within the Eurozone some 120 banks hold approximately 82% of the bank assets, the remaining 18% is held by a large group of approximately 4,900 banks.[11] Within the Single Supervisory Mechanism[12], the first group of banks represent the significant institutions ("SI") and the latter group the less-significant institutions ("LSI"). Most of the LSI's are established in Germany (nearly 1,600 LSI's), Austria (nearly 500 LSI's) and Italy (some 420 LSI's). The average balance sheet of LSI's in these countries ranges from 1.20 billion euro for Germany to approximately 200 million euro for Austria and 400 million euro for Italy. In other Member States of the Eurozone, the average balance sheet of LSI's is significantly higher, with the Netherlands being the Member State with LSI's having the highest average balance sheet of some 1.65 billion euro in a jurisdiction which has a highly-concentrated banking sector and a very small group of approximately 30 LSI's. Other Member States where the number of LSI's is modest but average balance sheet totals are high are France (some 100 LSI's and average balance sheet total of 1.25 billion euro) and Ireland (some 40 LSI's and average balance sheet of 1.2 billion euro).[13]

The large numbers of LSI's in Germany, Austria and Italy reflect the presence of large decentralised systems of savings and/or cooperative banks, often – like in Germany and Austria – covered under a joint institutional protection scheme ("IPS"). In Italy, a consolidation of the cooperative banking sector into three major groups is currently being considered.[14]

It is within this divers landscape of the banking industry in Europe that the Single Rule Book consisting of the CRR, CRD IV and the approximately 70 Binding Technical Standards and Guidelines of the European

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EU where banks authorised in one Member State can provide their services across the EU's single market and as such are more than likely to engage in cross-border business. Also, applying the internationally agreed rules only to a subset of European banks would create competitive distortions and potential for regulatory arbitrage. The EU has had to take these particular circumstances into account when transposing Basel III into EU law."

10 European Banking Federation, Facts and Figures 2017, www.ebf.eu.

11 The definitions of the EBF and European Central Bank ("ECB") differ, which explains the somewhat different numbers of LSI's accounted for.

12 The Single Supervisory Mechanism as this came into force on 4 November 2017, is one of the three pillars of the Banking Union, placing significant institutions under direct supervision of the ECB and supervision on less significant institutions under the indirect supervision by the ECB, as executed by national competent authorities. The main provisions shaping the Single Supervisory Mechanism are set out in Council Regulation (EU) No. 1024/2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions.

13 Source of data: European Central Bank, *LSI supervision within the SSM – Description of the LSI sector and recent developments*, November 2017. Spain is a particularly interesting case. Currently, LSI's represent a very moderate portion of the Spanish market: 6% of the Spanish banking system´s assets, in the balance sheet of only 78 institutions (including bot domestic financial institutions and foreign branches), with 31,5% of those assets belonging to small domestic banks, 59,5% to very small rural credit cooperatives, and 1,18% to savings banks. This landscape is the result of the 2008 crisis. Before the global financial crisis froze interbank credit and the real estate bubble burst, Spain had dozens of savings banks, which represented a dominating force. Many had grown from small locally-based institutions into institutions holding more assets –and accumulating more risk- than many banks. A flawed corporate governance system, arguably poor supervision and ineffective crisis management decisions brought about the almost complete elimination of a part of Spain´s financial sector with more than 100 years of tradition. Currently the savings banks (*cajas de ahorro*) represent less than 2% of the total amount of assets of LSI's and less than 0,12% of the total size of the financial market.

14 This consolidation is caused by the Banche di Credito Cooperativo (BCC) Reform Act which results in the establishment of three banking groups which will include all but one cooperative bank. This will end the existence of 355 cooperative banks which account for 77% of the Italian LSI's and a total of 42% of the LSI assets. Source: ECB, o.c., p. 4.

Banking Authority ("EBA") for banks representing thousands of pages of legislation and binding rules and guidance must be applied. This Single Rule Book has been introduced to enhance the uniform application of banking laws in the entire European Union. An important driver for the European legislator to create such Single Rule Book has been the considerable impact of the financial crisis that spun off in 2008 in the European financial industry and the strong desire to reverse divergence in supervisory practices in Europe and the patchwork of banking laws, derogations, exceptions and vague provisions in Europe.[15]

2 THE CURRENT 'ONE SIZE FITS ALL'-APPROACH OF EU BANKING LAW

2.1 Scope of Applicability

The CRR and the CRD IV are applicable to all banks holding a permit granted by a competent authority in the European Union. The result is that all banks are in principle subject to the same rules of substantive banking law and organisation of the supervisory review by the competent authorities concerned. The latter is based on the three-pillar approach as introduced by the Basel II Accord in 2004[16] and its transposition into European law in 2006 via the first Capital Requirements Directive[17].

The scope of application of prudential requirements for banks is determined by the core provision of Article 1 CRR. This provision sets out that the following items apply to all "institutions"[18] supervised according to the CRD IV:

(a) Own fund requirements relating to entirely quantifiable, uniform and standardised elements of credit risk, market risk, operational risk and settlement risk;

(b) Requirements limiting large exposures;

(c) Liquidity requirements relating to entirely quantifiable, uniform and standardised elements of liquidity risk;

(d) Reporting requirements related to (a), (b) and (c) and to leverage; and

(e) Public disclosure requirements.

An important limitation of the Directive's scope is drawn by Article 2(5) CRD IV, which excludes a country-by-country based list of institutions from the application of the CRD IV and consequently also from that of the CRR. This list comprises for the most part institutions and agencies controlled and operated by the governments of the Member States, for instance developing finance companies or agencies involved in the operation of domestic financing infrastructure. Agencies and institutions included in this list are freed from the authorisation requirements for banks set out in Article 8 CRD IV. Consequently, by operation of Article 1 CRR, the provisions of CRR on capital requirements, large exposures, liquidity, reporting, leverage and disclosure do not apply to such agencies and institutions.

Neither the CRD IV nor the CRR contain, however, provisions that limit the scope of applicability to banks based on criteria of size or importance, complexity or cross-border operation. Therefore, the scope of application of the EU banking rules is not limited to what is necessary to achieve the objective of EU law in this area. Technically, it would be quite easy to bring the rules in conformity with the principle of

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15 See particularly one of the first comments of the High-Level Group on Financial Supervision chaired by Jacques de Larosière in the February 2009 report, points 99 and 100: "While the above areas for regulatory repair are relevant for all major jurisdictions in the world, and should be addressed internationally, Europe suffers from an additional problem in comparison to all single jurisdictions: the lack of a consistent set of rules. An efficient Single Market should have a harmonised set of core rules."

16 BCBS, Basel II: International Convergence of Capital Measurement and Capital Standards: A Revised Framework - Comprehensive Version, June 2006.

17 The expression "Capital Requirements Directive" is often used to refer to two directives: Directive 2006/48/EC of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast) and Directive 2006/49/EC of 14 June 2006 on the capital adequacy of investment firms and credit institutions (recast).

18 "Institutions" are defined in Article 4(1)(3) CRR as being either "credit institutions" or "investment firms". These businesses are separately defined in Article 4(1)(1) and 4(1)(2) CRR and these definitions refer to the legacy definitions pre-existing in earlier legislative frameworks in Europe.

proportionality.[19] A clear example is the framework for insurers and re-insurers as set out in Solvency II[20]. The relevant provisions of this directive only apply to insurers with a certain level of premium income and with a certain size of technical provisions[21]. This system complies with the principle of proportionality. For insurers that drop below the "size-criteria" of Solvency II, national legislators are free to design and introduce domestic laws (which may or may not be inspired on the Solvency II framework). On the other hand, the provisions of Solvency II by default apply to any re-insurer, independent of its size. But this wide scope is justified by the nature and complexity of the business of re-insurers, which makes the application of strict rules necessary.

2.2 Modular Approach - Pillar I

The core of banking substantive law is formed by Pillar I requirements as summarised by Article 1 (a), (b) and (c) CRR. In principle, these rules govern each bank unless it can be demonstrated that, in view of its organisation and the nature of its business, there is no need to apply the relevant quantification of position risk. For instance, banks that can demonstrate that they do not conduct a dealing on own account business and do not hold a trading portfolio of financial instruments, are excluded from the market risk provisions of Part Three, Title IV CRR, which contain the own funds requirements for market risk. This is what the European Commission refers to as the "modular approach" of CRR and CRD IV, which allows banks to avoid the application of certain substantive banking rules.[22]

It is however questionable whether such "modular approach" is consistently followed in supervisory practice. For instance, the available reporting templates developed by the supervisory authorities require each bank to consider the entire reporting framework, including modules that may not be relevant for such banks.[23] The onus to obtain an exclusion is on the bank. It must complete the report with "zero-values" for all risk positions for which no risk can be quantified. It depends on the acceptance of the authorities concerned whether the bank's assessment will be upheld. Therefore, obtaining an exclusion is subject to the authorities' thorough understanding of the individual bank's business model and the acceptance of the approaches followed by the bank.

Aside from these practical complexities, it may be argued that, from a methodological viewpoint, applying a "one-size fits all" approach to each and every credit institution creates unnecessary complexity. The current legislative framework[24] does not permit an easy identification of the applicable rules to the individual bank. Its management is required to work through the entire complex system of rules to find out which rules apply to its own business model and the products and services it offers. This exercise is a source of considerable difficulties and often leads to protracted discussions between banks and the supervisory authorities.

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19 With this, we refer to principle 8 of the Basel Committee´s Core Principles on Banking Supervision which state that "(…) An effective system of banking supervision requires the supervisor to develop and maintain a forward-looking assessment of the risk profile of individual banks and banking groups, *proportionate* to their systemic importance.(…)". The proportionality has many sides and interpretations, and must be applied in a number of parts of the regulatory framework. In this paper, the principle is most often referred to in its sense of "materiality", ie., the understanding that each regulation should only be directed and applied to those institutions which are relevant to the issue being addressed by a proposed regulation, and, therefore, there should be no reason to apply a rule aimed at staving off the risk of systemic risk on a bank that does not generate such risk. In detail, see the EBA´s report "Proportionality in Banking Regulation", available at https://www.eba.europa.eu/documents/10180/807776/European+Banking+Authority+Banking+Stakeholder+Group-+Position+paper+on+proportionality.pdf.

20 Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II).

21 See Article 4 (Exclusion from scope due to size) Solvency II.

22 European Commission, Impact Assessment CRR2, CRD5, SRMR2 and BRRD2, o.c., p. 27: "It can be argued that the CRR and the CRD IV are already "proportionate" to a large extent, insofar as they take into account the size, complexity and business model of institutions for various purposes. The framework as a whole is formulated in a modular manner, such that institutions must only apply those requirements which are relevant to the risks they incur. Furthermore, the framework provides for specific exemptions and preferential treatments for various purposes (e.g. own funds, liquidity, covered bonds), thus reflecting the relative complexity and riskiness of institutions and the activities they undertake."

23 Commission Implementing Regulation (EU) No 680/2014 laying down implementing technical standards with regard to supervisory reporting of institutions according to Regulation (EU) No 575/2013.

24 The most recent amendments are laid out in Commission Implementing Regulation (EU) 2017/2114 of 9 November 2017 amending Implementing Regulation (EU) No 680/2014 as regards templates and instructions.

Based on the strong feedback in the Call for Evidence exercise and the earlier comments of the BSG, the Risk Reduction proposals tabled by the Commission in November 2016 contain provisions to alleviate the reporting obligations for "small institutions".[25] Their objective is to reduce the frequency of the reporting on own funds requirements and financial information to an annual frequency, while other institutions are subject to a semi-annual or more frequent obligation.[26] While this proposal may offer some a welcome relief, it contains new complexities because of a new definition of small institutions that does not coincide with that in other European acts.[27] This in and of itself creates a new administrative burden, which stands in contradiction with the proposal's goal to reduce complexity.

2.3 Internal Models - Pillar I

With the introduction of the Basel II rules[28], a variety of calculation and quantification methods has been introduced by permitting the use of internal models, in whole or in part, for most of the risk categories. If the bank chooses to use internal models, it may avoid the application of the standardised approaches. In practice, only a handful of larger banks use internal models. The exact proportion of European banks utilising internal models for one or more of the risk factors that are required to be quantified is not known. However, a fair estimation is that the number of European banks using such internal models is not more than 5% of the entire European banking industry.

The development of internal models, the validation process to be organised in order to have the internal models accepted by the supervisory authorities and the maintenance of internal models all require massive investment in resources and, consequently, the use of internal models generates an extreme cost factor for the banks that purport to use this alternative . Only the largest banks have the means to cover it. Therefore, the vast majority of European banks apply standardised approaches for the quantification of credit and operational risk. Market risk internal models are also not relevant for this segment of the financial industry.

The December 2017 Standards of the Basel Committee aim at constraining the use of internal model approaches by placing limits on certain inputs used to calculate capital requirements under the internal ratings-based approach for credit risk and removing the use of internal models for credit valuation adjustment and operational risk. Undoubtedly these changes will result in a significant number of banks returning to standardised approaches that previously used internal models to account for regulatory capital requirements.[29] This will further reduce the need to uphold the complex banking law framework which needs to deal with standardised approaches and internal model based approaches in one single law.

2.4 Qualitative Capital Requirements - Pillar I

Similar comments may be made as regards the existing framework for qualitative capital requirements. Basel III introduced complex rules to place a greater focus on loss-absorbing capital in the form of Common Equity Tier 1 ("CET1") capital instruments. Simultaneously, these rules have been supplemented with a framework for the use of Additional Tier 1 instruments, in particular contingent convertible bonds ("coco's"). The use of Tier 3 capital has been abolished and the absolute limits to use Tier 2 instruments have been lowered. In the CRR, these rules are set forth in the provisions of Part Two on "Own Funds". They

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25 As they are defined in Article 430a CRR2.

26 See: Article 99 CRR2.

27 Reference is made for example to (i) the SSM Framework Regulation, Regulation (EU) no 468/2014 of the European Central Bank of 16 April 2014 establishing the framework for cooperation within the Single Supervisory Mechanism between the European Central Bank and national competent authorities and with national designated authorities, providing in Article 2(7) a definition of the *less significant supervised entity*, and (ii) the categorisation of banks in four categories, including (other) small banks, under the EBA Guidelines on the methodology and uniform practices for the SREP, as discussed in section 2.5. See also the examples in section 8.2.

28 It should be noted that the permissible use of internal models had been introduced at the occasion of Basel II for credit risk and operational risk, whereas for market risk the utilisation of internal models was already permitted since the introduction of the Basel 1.5 Standards. In Europe, these rules (albeit that Europe has upheld own standards that slightly deviate from the Basel 1.5 Standards) have resulted in adoption of revisions to the first Capital Adequacy Directive of 1993 (Directive 93/6/EEC). See: Richard Herring and Til Schuermann, *Capital Regulation for Position Risk in Banks, Securities Firms and Insurance Companies,* in: Capital Adequacy beyond Basel: Banking, Securities, and Insurance, edited by Hal. S. Scott, Oxford, (2005).

29 Basel Committee, Basel III Reforms, December 2017, to be consulted at www.bis.org/bcbs/publ/d424.

comprise more than 65 legal provisions and cover more than 50 pages of the Official Journal, regulating every aspect in the greatest possible detail.

Albeit the rules feature a significant level of optionality by allowing banks to fill the entire regulatory capital with CET1 instruments, they again forcefully demonstrate that many of the provisions of European substantive law are tailored to a very exclusive and restricted group of the larger banks. The vast majority of small banks will not be able to apply the optional features of the qualitative capital framework. They neither possess the resources nor the bargaining power to enter the capital markets with the issuance of complex structured bonds that are eligible to be comprised in their regulatory capital. Smaller and medium sized banks will often fall back to issue CET1 capital instruments only; in some cases a simplified Tier 2 capital instrument may fulfil their needs as well.

From this perspective, one can observe that significant parts of the Single Rule Book have little or no relevance for most of the banks in Europe. A considerable reduction of complexity could be achieved by addressing the organisational and structural requirements in the core text of the substantive banking law provisions and by removing the optionality and parts of the modular approach, which are to a large extent redundant for many banks in Europe. We will elaborate these thoughts in sections 4 and 8 of this paper.

2.5 Supervisory Review and Evaluation Process - Pillar II

Following the three-pillar approach introduced in Basel II, Europe moved to incorporate the Supervisory Review and Evaluation Process ("SREP") in the provisions of Title VII, Chapter 2, Section III, CRD IV that apply to all banks authorised in the EU. The relevant provisions address the principle of proportionality, for instance by requiring that the organisation and governance of risk management is aligned to be comprehensive and proportionate to the nature, scale and complexity of the risks inherent in the business model and the bank's activities, see Article 74(2) CRD IV. The institution's arrangements, processes and mechanisms form the basis for the annual exercise to be conducted to evaluate the adequacy of capital and liquidity.[30]

Pillar II processes added a new and complex dimension to bank supervisory practices in Europe. Until the transposition of Basel II via the Capital Requirements Directive 2006, the organisation of supervisory review was very much left to the discretion of the competent authorities in Europe. Many differences existed between the approaches and the methodologies followed by the national competent authorities. They have converged since 2006. The harmonisation of supervisory practices received an additional boost with the adoption of CRR and CRD IV. Based on specific mandates set forth in CRD IV[31], EBA produced comprehensive guidelines aiming at the creation of a common methodology and uniform practices throughout Europe. The first of these guidelines have been published in December 2014[32]; they are currently subject to further review.[33]

The EBA Guidelines on the methodology and uniform practices for the SREP (the "EBA Guidelines 2014") recognise the principle of proportionality by introducing four distinct categories of banks graduated in terms of systemic importance and the extent of cross-border activities. Furthermore, the Guidelines formulate a supervisory engagement model, in which frequency, depth and intensity of the assessments vary depending on the category of the institution.[34] The four categories are based on the bank's size, structure, internal organisation and scope, and on the nature and complexity of their activities. In

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30 This Internal Capital Adequacy Assessment Process ("ICAAP") and Internal Liquidity Adequacy Assessment Process ("ILAAP") are based on the provisions of Title IV, Section IV, Chapter 2 CRD IV and result in an annual report to the supervisory authorities that evaluate these reports as part of the SREP. The organisation and technical criteria of SREP are embedded in the provisions of Article 97 *et seq.* CRD IV.

31 Article 107(3) CRD IV.

32 Guidelines on common procedures and methodologies for the supervisory review and evaluation process (SREP), EBA/GL/2014/13 of 19 December 2014.

33 Draft Guidelines on the revised common procedures and methodologies for the supervisory review and evaluation process (SREP) and supervisory stress testing, EBA/CP/2017/18 of 31 October 2017.

34 EBA Guidelines 2014, o.c., p. 8.

accordance with the EBA viewpoints, such categorisation should also reflect the level of systemic risk posed by the bank concerned.[35] The four categories defined by EBA are:

(a) Category 1: Banks meeting the criteria of global systemically important institutions and other systemically important institutions (in accordance with the assessment methodology of Article 131 CRD IV). Other institutions may be fitted in this category as well, depending upon the exercise of discretion by the competent authorities;

(b) Category 2: medium to large banks other than those included in Category 1 operating in their domestic market only or with sizable cross-border activities, operating in several business lines (including non-banking activities) and offering credit and other financial products to both retail and corporate customers. Included in this category are also non-systemically important banks with a specialised business line with significant market shares in these lines of business or payment systems, or financial exchanges;

(c) Category 3: small to medium banks not qualifying for Category 1 or 2, operating domestically or with non-significant cross border activities, with a limited number of business lines, offering predominantly credit products to retail and corporate customers with a limited offering of other financial products. Also, specialised businesses with limited market shares in their offering, or with limited roles in payment systems, or financial exchanges may fit in this Category 3;

(d) Category 4: all other small non-complex domestic institutions that do not fall in Categories 1 to 3 with limited scope of activities and non-significant market shares.

In accordance with the EBA Guidelines 2014, this categorisation should reflect the level of systemic risk posed by the banks concerned and should endorse the application of the principle of proportionality. The categories do not suggest a judgment about the quality of the bank's organisation. The categorisation should be made on the basis of the data received in the context of supervisory reporting and the analysis of the business model. The categorisation should be reviewed periodically.

The categorisation determines the definition of the level of supervisory engagement with the institutions concerned, applying the principle of proportionality. For example, a category 1 bank should be made subject to monitoring of key indicators on a quarterly basis and the documented SREP assessment is to be made at least annually by the authority. Individual SREP elements (key indicators, business model analysis, assessment of internal governance and institution-wide controls, assessment of risks to capital and assessment of risks to liquidity) should be reviewed at least each two-year period. For a category 4 bank such frequency would be the same, except for the individual SREP elements that may be reviewed at least each three-year period.[36]

The categorisation approach of the 2014 EBA Guidelines should be welcomed. The criteria developed by EBA may serve to draw clear lines as regards the proportional application of the relevant rules. As we will outline in section 8, where we discuss the distinctive criteria to separate banks in groups that should be subject to the different tiers of banking law, the EBA categorisation contains useful elements for such further grouping.

A closer look at the outline of supervisory engagement as defined by EBA reveals, however, that the four categories have only little relevance for application of the SREP. The level, frequency and intensity of the scrutiny exercised towards a category 1 bank will only slightly differ from that of a category 4 bank. Reporting frequencies for the institutions and feedback statements from the authorities are more or less similar throughout all four categories. The only difference in treatment concerns the updates of the SREP elements (for instance the review of the business model) and the communication between the management of the bank and the supervisory authorities. As a result, smaller, non-complex and domestically operating banks will hardly receive a lighter treatment than the largest banks in their jurisdiction.

2.6 Disclosure Requirements - Pillar III

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35 EBA Guidelines 2014, o.c., p. 11.

36 See for further details Paragraph 2.4 (Proportionality and supervisory engagement), Guidelines, o.c. pp. 27 and further.

Disclosure requirements in Pillar III of the Basel III framework have been transposed in Part Eight of the CRR. As is the case with most substantive banking law provisions, they are currently imposed on all banks without distinction. It is true the disclosure requirements permit banks to address materiality as it concerns the information made public in the disclosure statements. Such materiality tests may be applied by any bank, however, and do not differ between large and complex banks and banks that are smaller and less complex.[37]

The disclosure frequency is the same for all banks, notwithstanding their size or complexity, and should occur on an annual basis in conjunction with the date of publication of their financial statements. Banks are required, however, to assess whether more frequent disclosures must be made, depending on the relevant characteristics of their business, such as the scale of the operations, range of activities, presence in different countries, involvement in different financial sectors, and participation in international financial markets, payments, settlement and clearing systems. The assessment should consider potential changes to the regulatory capital base, the risk profile of the bank and other items prone to rapid change.[38] In this sense, the disclosure frequency may differ between large and complex banks on the one hand and small and less complex banks on the other. Yet the determination of the appropriate frequency is itself fraught with difficulties, which creates a burden for banks with less staff and expertise.

For large internationally operating banks that are listed on one or more stock exchanges, the market discipline intended by the Pillar III disclosure rules is a logical consequence of the manner of their operation and funding. However, the same rationale does not hold for smaller banks, which are often privately held. Acknowledging the need for a proportionate application of the disclosure requirements, the European Commission proposed in November 2016 to reduce the legal burden on disclosure for smaller banks. It suggested to apply the disclosure requirements to three categories of banks on a sliding scale basis, with a differentiation in the substance and frequency of disclosures. These categories are: (i) large institutions, (ii) small institutions and (iii) other. Furthermore, a distinction is made between listed and non-listed institutions.[39]

"Large institutions" are defined in this proposal as comprising (a) all systemically important institutions (as determined by Article 131 CRD IV), (b) institutions that qualify as "significant" under Article 6(4) SSM Regulation.[40] "Small institutions" are defined as banks with an average asset value equal to or less than 1.5 billion euro over the four-year period immediately preceding the current annual disclosure period.[41]

With this proposal, the Commission introduces yet another distinction between "large" and "smalle" institutions, deviating from the methodology developed by EBA in the EBA Guidelines 2014. The interesting analysis that underpins the Commission's proposal is that there should be a distinction between systemically important institutions and significant institutions, where a significant institution may not necessarily be a systemically important institution. The other way around is hard to construct: a systemically important institution according to the assessment methodology of Article 131 CRD IV will in most (if not all) cases be a "significant" institution in terms of Article 6(4) SSM Regulation. We will pay more attention to this topic in section 8 of this paper.

3 FLEXIBILITY AND PROPORTIONALITY IN NON-EU REGULATORY SYSTEMS

The previous sections have portrayed a scenario of the European banking framework where regulation and supervision are strict and stern and where proportionality finds scarce implementation. This is the result, no doubt, of the multinational character and scope of the system: a highly integrated intra-European financial market which generates contagion risk beyond the borders of the Member States. It could be labelled as a

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37 See for the materiality provisions: Article 432 *et seq* CRR.

38 See Article 433 CRR.

39 See Article 433a and 433b CRR as contained in CRR2. The explanatory notes of the Commission to this proposal provide for the following comment: "At the upper end of the sliding scale, large institutions with listed securities will be required to provide annual disclosures of all the information required under Part Eight, plus disclosures of selected information on a semi-annual and quarterly basis, including in the latter case a key prudential metrics table (Article 447). On the lower end, small non-listed institutions will only be required to make selected disclosures of governance, remuneration and risk management information and the key metrics table on an annual basis." See CRR2, p. 19.

40 Council Regulation (EU) No 1024/2013.

41 See Article 430a CRR as contained in CRR2.

unified, strict and rigid system, with perhaps “excessive” regulatory requirements and supervision powers. This, however, –so the argument would go- is to be preferred to a more lenient system, which might generate uncertainty even at a sovereign level. The multinational nature of the legal and institutional framework is thus the key differential note of the European system, when compared with jurisdictions of similar or superior level of development. To stave off the risk of sharing the damage of a potential financial crisis between countries of disparate characteristics and evolution would seem the most likely explanation for the EU´s approach. In this approach, the EU seems to be wrong and surely a lonely camper.

As we will see briefly in the following paragraphs, the systems of the USA and Japan adopt a different approach to the subject matter (similarly to Hong Kong and Singapore). Although a comparison amongst these countries shows differences in a number of relevant issues, they all share one common trend: a much higher level of *flexibility* than the EU, both from a regulatory standpoint and concerning the system´s implementation. Their laws either demand different regulatory requirements depending on the case and situation or allow for exceptions to be established. Often supervisors are empowered with sufficient discretion to design bespoke supervisory strategies and adopt regulatory measures based on a case by case analysis. The European “one size fits all” is not the rule anywhere. It must be noted, though, that rather than a two-tier approach, these systems have a *three-tier approach*: a general regulatory system for most banks; a specially enhanced set of requirements for highly systemic banks (and, in the cases of the US and Japan, globally systemic banks, following the FSB´s Key Attributes for G-SIBs); and a reduced, more nuanced approach to smaller banks.

The flexibility starts with the very design of the system. In line with arguments sustained elsewhere in this paper, the analysed comparative models –with exceptions- do not link exclusively the different regulatory treatment strictly with the size of the bank. Often other elements, such as the limited geographical area of activity or the simplicity of the business model, are key to the application of simplified regulatory rules. The limitation of the geographical scope of activity is highly relevant, for example, in Japan, where local and regional banks often receive a different treatment in many aspects. Conspicuously, the range of remedies available to the insurance deposit agency and the resolution authority in case of financial distress of the bank may vary significantly depending on the geographical factor. In respect of more encapsulated activities, more “moderate” measures have been designed.[42] Naturally, the reason for that is directly linked with the lower systemic risk inherent to banks having an essentially local business activity. Exactly the same reason underpins the size criterion (which is, everywhere, the most common criterion).[43]

The USA has a tradition of flexibility in its approach to regulation and supervision, a line of action which has been maintained even after the crisis and under the framework of the Dodd-Frank Act.[44] The system is one of general regulation with exceptions. In principle, most rules apply across the board, but, when certain circumstances accrue, smaller banks are exempted by statute/regulation or the relevant regulatory agency may dispense with certain requirements (by way of exemption). The system also allows regulators to “tailor” compliance for some entities. By such, it is meant that the regulator reduces the burden of compliance with specially streamlined or uncostly procedures to meet the requirements of the rule. This system allows for an ad hoc, granular approach to the “two-tier” model. The concern on the concept of *excessive regulatory burden* (ie, when the costs of regulation outweigh their benefits for the relevant banks) is very much present in the general regulatory framework. As an example, the US issued a *Regulatory Flexibility Act* as early as in 1980, a federal law that requires regulators –financial or not- to make a previous

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42 For a detailed analysis of this gradual approach in the Japanese banking system, see I. Tirado, *Banking Crisis and the Japanese Legal Framework,* Institute of Monetary and Economic Studies Discussion Paper nbr. 2017-E-2, Bank of Japan, available at http://www.imes.boj.or.jp/research/abstracts/english/17-E-02.html.

43 Reducing the regulatory burden with the simplicity of the business model can also be explained as related to a limited risk of contagion: those smaller banks that mainly take deposits and lend (often to micro, small and medium enterprises), with reduced additional leveraging, few or no complex financing operations and limited use of financial derivatives, are not only less likely to fail with external consequences, but they are also easier to supervise. And yet, the link with the risk of contagion is perhaps not the most important reason why these institutions deserve a different regulatory treatment: their activity also entails a reduced need to protect bank customers and, generally, the public. This element is thus also a criterion that feeds into the flexibility of regulators.

44 Out of 14 major regulatory norms included by Dodd-Frank, 13 include some tailoring to the needs and requirements of small banks.

assessment of the rules on small entities before enacting them.[45] But defining the precise ambits where the flexibility in financial regulation is applied is complex, due to the complicated regulatory system of the US. There is Federal and state regulation, and up to four different regulatory agencies [46], each with their own scope, rules and practice.[47]

Exceptions and tailoring of the rules for small banks in the use are relatively widespread. The following are only a few examples. Risk-based capital guidelines introduced by the Dodd-Frank Act do not apply to banks with aggregated trading assets and liabilities of less than 1 billion USD. The liquidity risk measurement standards concerning the liquidity coverage ratio do not apply to banks with less than 50 billion USD. Some of the regulatory capital rules introduced according to Basel III –capital adequacy, standardised approach for risk weighted assets, etc.- are not applicable for banks with 15 billion USD or less in assets. Banks with less than 250 billion USD in assets or 10 billion USD in foreign exposure are allowed an additional year to implement the rule and no supplemental leverage ratio or countercyclical capital buffers are required. Reserve requirements are also designed in a way that benefits small banks, since the requirements of assets against deposits are defined based on the amount of deposits. Banks with assets of value lower than 500 million USD may be exempted from certain corporate governance rules concerning financial reporting and internal controls. But the special treatment of small and community banks does not only regard regulatory requirements: also supervision is softened in given contexts. For example, on-site examinations on banks take place at least once a year, unless the bank has less than 500 million USD in assets and meets certain additional requirements. In such case examinations are only conducted every 18 months. Similarly, reporting duties of banks are determined depending on the size and the type of business conducted by the supervised financial institution. In case a problem is identified, informal enforcement mechanisms are more likely to be applied to smaller entities, at the discretion of the relevant supervisor.

The Japanese banking model resembles the American system in many elements. Institutionally, the bulk of the work rests in the Financial Services Authority (FSA), which acts both as main supervisor and the lead resolution authority. The FSA stands alongside the Deposit Insurance Corporation of Japan (DOCJ), which acts a deposit insurance agency in its strict meaning, but which also has certain supervisory powers and plays a leading role in the execution of the recovery and resolution actions in case of a bank´s distress.

The Japanese banking system is a model of flexibility, both in terms of regulation and supervision, as well as in resolution. The flexibility of the Japanese system may be explained, to a great extent, by the structure of the banks´ debt and its relation with the sovereign´s financing needs. Japan has a relatively large number of small and regional banks alongside three globally systemic financial institutions. The balance sheet of the banking sector has a rarely high percentage of public debt.[48] Japan is the largest public debt market in the world, and the main creditors are its domestic banks. Although a highly advanced economy, it has famously

45 See 5 USC paras. 601-612.

46 Which regulatory agency supervises a bank depends on the latter´s charter (ie, if it is Federal or state based). The four regulatory agencies, in order of relevance, are: the Federal Reserve (Fed), in charge of supervising bank holding companies, state banks that are members of the Federal Reserve System and state savings associations; the Federal Deposit Insurance Corporation (FDIC), with powers over state banks that are not members of the Federal Reserve System, savings and loan holding companies); the Office of the Comptroller of the Currency (OCC), tasked with the regulation of national banking associations and federal savings associations; and the National Credit Union Administration (NCUA), in charge of federal credit unions. The four regulators are coordinated through the Federal Financial Institutions Examination Council. For detail on the functioning of these institutions, see E. Murphy, *Who Regulates Whom and How? An Overview of US Financial Regulatory Policy for Banking and Securities Markets,* Congressional Research Series Report nbr. 43087, *passim.*

47 For an overview of the regulatory burden on "small banks" in the US, see S. Hoskins and M. Labonte, *An Analyisis of the Regulatory Burden on Small Banks,* Congressional Research Service Report nbr. 43999.

48 As of March 2016 (data: BOJ, Flow of Funds), the structure of Japan´s public bond debt was as follows: The total outstanding bond debt of Japan´s Government adds to 1040 trillion yen, of which 966.7 trillion yen (93%) is bond debt of the Central Government and 73.2 trillion yen (6.4%) of the Local Governments (Subnational bond debt). An analysis of the debt by holders shows that 82.2% of total public bond debt (82.5% of Central Government bond and 78% of Subnational bond) is held by financial institutions, of which the percentages of the holdings of total public bond debt by the different types of Financial Institutions are as follows: (i) Depositary Institutions, 23.7%; (ii) Insurance Companies and Pension Funds 26.6%; (iii) other 34.8%. Of the total public debt, 5.4% is held by Social Security Funds (Public Pension Funds), 9.6% by foreign investors (essentially Central Government debt –10.2% of its total–, since the amount of foreign investors with Japanese Subnational debt is marginal –0.5%); and the remaining 2.8% of the total public bond debt goes to "others." In other words, Japan has the largest sovereign debt in the world, and over 80% of it is in the balance sheet of its own banks. more encapsulated the activity.

failed to grow for many years, with very low or even negative inflation almost every year of the past twenty. A decrease in the trust existing in the Japanese economy that spread to its public debt could have devastating consequences for its financial system, which, in turn, would spread on to the non-financial economy. Because of this "dangerous" relationship between banks and sovereign debt, the Japanese banking regulatory framework is one where supervision is intense and where the relevant authorities have strong powers to act, from a very early instance.

In Japan, the main legal regulatory instruments are the Banking Act, the Law regulating the DICJ, and, even more importantly, the "Inspection Manual for Deposit-Taking Institutions". The content of inspections and supervision is made public and clearly spelt out in this highly relevant and extremely detailed treatise of bank inspection, as well as in the "Comprehensive Guidelines for Supervision of Major Banks, etc."[49] Supervision includes a coordination division, with specific offices depending on the types and characteristics of the markets. In line with the needs of the Japanese banking sector, highly fragmented, the Supervisory bureau has separate divisions for the monitoring of the major banks and the regional and tier 2 regional banks. There is continuous collection of relevant information from financial institutions, both concerning their main figures and their operations, which are constantly under detailed scrutiny. Both the said regulatory context and practice separate clearly between the types of banks. The degree of supervision may vary not only according to the size and the geographical distribution, but also based on the business model developed for each particular institution. The amount, type and frequency of information requested is fixed by the FSA´s relevant department, based on the type of risk inherent to the bank. The degree of flexibility in this case-by-case approach is very high.

Nevertheless, the degree of supervision of Japanese domestic banks is intense. The reason is, apart from the factual banking sector-sovereign relationship, the existence of relatively lenient regulatory requirements in terms of capital (with the exception of the G-SIBs). The jurisdiction has a preventive corrective action system in place, similar to the PCA of the US model [50]. The preventive action mechanisms differentiate between internationally active and purely domestic banks: the capital requirements of the latter are *half those of the former*. The triggers are determined with regard to Common Equity Tier 1 capital, Tier 1 capital and Total Capital ratio, and the types of capital are defined as in Basel III. Domestic banks have lower capital levels to trigger early action by the FSA. This comparatively "risky" approach (riskier than the American, and much riskier than the preventive action system of the BRRD) brings about a reinforcement of the supervision: there is a trade-off between regulatory and supervisory requirements, so that the less stringent the capital requirements, the more closely supervised must the banks be [51]. This is, on the face of it, a transfer of rents from the public sector (FSA) to the banking sector, since the former must increase their investment in staff and controlling mechanisms, while the latter may enjoy a larger percentage of funds than its American or European counterparts.

4 DRIVERS, PROS AND CONS OF A TWO-TIERED BANKING LAW IN EUROPE

4.1 Two Levels of Proportionality

The principle of proportionality in banking encompasses both regulatory and supervisory aspects. Regulatory proportionality refers to formal criteria that incorporate the different degrees of complexity and riskiness of banks[52]. Supervisory proportionality instead refers to the way law is enforced in respect of different clusters of banks. This may have implications as to the frequency and intensity of audits and, in general, the engagement of the supervisory authorities with supervised banks. Between these two

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49 The Inspection Manual is available in English (http://www.fsa.go.jp/en/laws_regulations/. It is noteworthy that the most relevant legal text of the system of supervision is a regulation not addressed at banks, but at the supervisor itself. The supervision, though, is facilitated by an imposed policy of self-responsibility and disclosure, expected from all banks in Japan, which behave as if the rules binding on the FSA inspectors were, in fact, their own legal requirements.

50 The legal basis for the PCA are to be found –although only generally– in Article 26 of the Banking Act. Paragraph 2 of the said article refers to an Ordinance (subordinate legislation) 31 that contains the bulk of the regulation.

51 The Japanese supervisory authority enjoys an open –generally unrestricted– power to order measures needed for the adequate supervision of entities from the general declaration included in Article 21 of the Banking Act, entitled "Disclosure of Explanatory Documents on the Status of Business and Property for Public Inspection, etc."

52 For an insightful example, A.P. Castro Carvalho, S. Hohl. R. Raskopf, S. Ruhnau, *Proportionality in banking regulation: a cross-country comparison*, BIS, FSI Insights No. 1, August 2017.

dimensions of proportionality the relationship is often a linear one, but exceptions are also possible. A bank of small size and with a simple business model (non-complex retail domestic banks)[53] calls in principle for the application of a simplified set of rules (regulatory proportionality means less). Systemically relevant banks call for both an adequate rule book and effective supervision (regulatory and supervisory proportionality means fit for purpose, *i.e.* enough to preserve financial stability). Frequency and intensity of supervision for small banks may be less when roughly the same rule book applies across the industry, irrespective of the size and nature of the business model (and proportionality converts into a less intrusive exercise of supervision) or may be more, when a well-crafted regulatory proportionality applies and a more intense supervision may counterbalance simplified legal requirements. Intensity or frequency of supervision for small banks are also differently calibrated in respect of varying aspects of supervision and should be in any event reflexive of differences in business models but also in respect of the quality of internal compliance, risk management and audit processes of the banks involved. We will consider here below the interplay of these two levels of proportionality when considering the pros and cons of the Two-Tiered Banking Law system discussed in this paper.

4.2 The European Quest for Proportionality

As noted in the introduction, the quest for proportionality in EU banking regulation has been a recognised policy for a long time. However, whilst the general principle as such is acknowledged as a cornerstone of the EU legal system, the question lies with its implementation, and in particular with the quality and the quantity of rules and supervisory practices which are in fact necessary to ensure that the supervisory assessment of the risk profile of individual banks (and groups) is proportionately calibrated to the bank's risk and its systemic relevance. As we noted already in previous sections of this paper, the principle of proportionality is enshrined in the Single Rulebook in several respects.

Calibration in the exercise of supervisory competences is also provided for in recital (55) of the SSM Regulation, that calls on the ECB to use its supervisory powers "in the most effective and proportionate way". Moreover, proportionality is not limited to the modular approach of the Single Rule Book and the supervisory review, but must also be applied to issues regarding bank recovery, resolution and winding-up. CRD IV includes a reference to such instances in Article 74.

In line with this, the BRRD establishes in its Article 1(1) that resolution and competent authorities have to take into account in applying the directive and using the available resolution tools factors like the nature of business, the legal form, the risk profile, the size, the level of interconnectedness to other institutions or the broader financial system, the business scope and complexity, the membership to an IPS or to mutual solidarity systems and the provision of investment services or activities. Article 4 BRRD instead provides for simplified obligations on the drafting of recovery and resolution plans by institutions.

This requires recognising that the failure of a bank can have a different impact based on several different factors, including the ones listed in Article 1(1). Generally, it can be assumed that the failure of a small bank poses a smaller risk to the financial system than the failure of a big bank. However, it must be also considered that when many small banks having the same business model enter into mutual liability arrangements through IPS, cross shareholdings, integrated cooperative structures or horizontal groups, they might become systemically relevant, at least at national level.[54] As a consequence, in the event of a failure, all these small banks taken together could pose a risk to the financial system, generating what is known as the "too many to fail" problem.[55]

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53 On bank business models and their clustering compare R. Ayadi, W.P. De Groen, I. Sassi, W. Mathlouthi, H. Rey, O. Aubry, *Banking Bank Business Models Monitor*, IRCCF, 2015, p. 12 and further; R. Roengptya, N. Tarashev, K. Tsatsaronis, *Bank Business Models*, BIS Quarterly Review, December 2014, p. 58 and further.; E. De Meo, A. De Nicola, G. Lusignani, F. Orsini, L. Zecchino, *European Banks in the XXI century: are their Business Models sustainable?*, presentation at the Fifth EBA Research Workshop, *Competition in banking: implications for financial regulation and supervision*, London, 28-29 November 2016, available online on the EBA website, p. 4.

54 See: *Size Alone is Not Sufficient to Identify Systemically Important Banks*, Office of Financial Research Paper, 17-04, October 26, 2017.

55 V. Acharya, T. Yorulmazer, *Too many to fail – An analysis of time-inconsistency in bank closure policies*, 2007, Journal of Financial Intermediation, 16, 1, pp. 11-31.

4.3 Avoidance of Competitive Distortion

But despite this formal acknowledgement, the commitment to proportionality in delivering the Single Rule Book for banking "has not been fully applied in all identified dimensions".[56] The devil is always in the detail. Although the direction of travel is or should be clear, tensions arise on how to get to the desired result. A unitary approach in transposing Basel III capital requirements in 2013 was expressly motivated by the European Commission[57] for path dependency and competitive reasons, so as to prevent distortions and potential for regulatory arbitrage. This was a reiteration of the rationale brought forward by the European legislator underpinning the decision to transpose the first Basel Committee Standards of 1988 to apply to all banks in Europe.[58]

Similar concerns are echoed in the Basel context, where fears are often voiced that "a differentiated approach for smaller banks will change the competitive game for banks participating in the same market" and "a proportionality regime may have the potential to discourage corporate activities both at the domestic and cross-border levels that might otherwise be useful in improving the structure of the banking industry".[59]

Are these concerns really justified? It seems doubtful, at least in these terms. Banks business models are many (ranging from non-complex retail domestic banks, mostly located in Italy and Portugal to complex retail domestic banks, mostly located in Germany and Italy, to diversified banks and investment banks) and different business strategies impact also on competitive performance. Profitability and risk exposure are to some extent specific to each different business model. Moreover, commercial retail banking is, still today, quite parochial[60] in its territorial outreach due to persistent home biases, despite the Banking Union[61]. Unlike wholesale global banking (a segment highly concentrated on its own right)[62], cross-border retail banking is offered only by a handful of major banking groups, out of the almost 5,000 banking groups active in the Eurozone. LSI's, which do not fall under direct ECB supervision, compete domestically and have a comparatively small balance sheet total[63]: roughly 18% of the balance sheet total of the Eurozone banking system.

Moreover, this 18% is not evenly spread across all countries, but is essentially concentrated in three of them, namely Germany, Austria and Italy (the Italian industry being however in transition towards a new market structure).[64] These countries alone host around four-fifths of all the LSI's, whose balance sheet total amounts to 80% of annual economic output in Austria and Germany respectively. Additionally, in Germany and Italy those institutions are the ones that provide most of the funding to small and medium-sized enterprises and finance the greatest part of the regional economy.[65] It is hardly credible that focussed, non-

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56 BSG, Proportionality in Bank Regulation, o.c. p. 7.

57 Memo 13/272 of 21 March 2013 at point 5 quoted in footnote 9.

58 See: for a further reference footnote 9.

59 A.P. Castro Carvalho, S. Hohl. R. Raskopf, S. Ruhnau, *Proportionality in banking regulation: a cross-country comparison*, o.c. p. 4 and 13.

60 *Compare Capital markets and EMU*, Report of a CEPS Working Party, T. Padoa Schioppa, K. Lannoo and D. Gros (Brussels: CEPS, 1998), p. 1 and 3 noting the special, and dual, nature of banking and its being both parochial (the vast majority of European banks doing most of their business with and earning most of their profits from domestic customers) and global; T. Padoa Schioppa, *Un sistema bancario unico in eurolandia?*, in Banca, impresa, società, 2001, p. 16 (drawing parallels with the progressive evolution of interstate banking in the US).

61 Compare ECB, *Banking Structures Report*, October 2014, p- 9-10 noting also that over the period 2009-2013, the size of domestic banking assets, as opposed to banking assets under foreign control, increased. Also, the European Commission found, already in its 2007 Report on the retail banking sector inquiry (SEC (2007) 106, Brussels, 31 January 2007, p. 19 that European retail banking markets are extremely fragmented along national borders.

62 C. Borio, *The banking industry: struggling to move on*, Keynote speech, at the Fifth EBA Research Workshop, *Competition in banking: implications for financial regulation and supervision*, London, 28-29 November 2016, available online on the EBA website, p. 16.

63 *Caught in the middle? Small and medium-sized banks and European banking supervision*, Speech by Sabine Lautenschläger, Member of the Executive Board of the ECB and Vice-Chair of the ECB's Supervisory Board, at the Banking Evening of the Deutsche Bundesbank Regional Office in Baden-Württemberg, Stuttgart, 22 February 2016, available at: https://www.bankingsupervision.europa.eu/press/speeches/date/2016/html/se160222.en.html.

64 For more data, see footnote .

65 ECB: Survey on the access to finance of small and medium-sized enterprises in the euro area April 2013 to September 2013, November 2013.

complex retail commercial banks, although they still represent the largest peer group, can distort competition in banking, even at the national level, to the detriment of major financial groups and the banks with other business models.

Rather, the opposite may be true.[66] A one-size-fits-all implementation of some requirements may have ramifications on the competitive pressures present in banking markets, which different institutions are differently equipped to face. An uneven playing field arises, for example, because large banks have more market power[67] and access to cheaper funding than smaller ones or can take advantage from significant economies of diversification or risk dissemination. Cheaper funding usually might be the result of an implicit guarantee to "too-big-to-fail" banks' creditors that they will be bailed out in case of a crisis. A comparative assessment of the Monte dei Paschi recapitalisation, on one hand, and of the restructurings of several other small to medium-sized banks occurred in Italy from 2015 to 2017, on the other hand,[68] seems to confirm that this force may still be in place. Exit in banking is much harder than in other sectors (and, as it has been noted, 'this can bias the industry towards a permanent state of excess capacity')[69], but the picture is not the same across the whole industry.

Furthermore, there is concern that excessive compliance costs threatens the competitiveness of local and regional banks.[70] A survey conducted by Ernst & Young for Luxembourg in 2016 found that, on average, regulation accounts for 35% of the investment expenditure of the banks. The proportion reaches as much a 51% of expenditure for smaller institutions, which leaves little room for investment in business expansion or service improvements. The smallest entities are also those which incur the most costs locally of the various regulatory measures.[71] These findings are consistent with those discussed in the recent past in the US[72]: there are economies of scale in regulatory compliance and on this small banks are thus at a clear disadvantage.[73] The regulatory burden seems to drive small and medium sized banks out of the market and to cause significant changes in the market structure. The number of small- and medium sized banks is visibly declining both in the US and in Europe, but changes in the market structure to the detriment of small banks are much stronger in Europe. There are now some 5,000 LSI's in Europe and 5,538 banks with simplified prudential standards in the US.[74] This may be a matter of concern if "the superiority of retail banking model was a common lesson drawn from the crisis experience and yet, this is precisely the model most threatened by the persistence of ultra-low interest rates".[75] This may also have additional unintended adverse

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66 Compare also S. Dickinson, D. Humphry, P. Siciliani, M. Straughan, *The Prudential Regulation Authority's secondary competition objective*, in Bank of England, Quarterly Bulletin, 4, 2015; R. Masera, *Regole e supervisione delle banche in Europa*, in R. Masera, Sfide e opportunità della regolamentazione bancaria: diversità, proporzionalità e stabilità (ECRA: Roma, 2016), p. 27.

67 In Europe, if before the crisis retail banking markets were already concentrated at national level, with Belgium, The Netherlands, Finland, Sweden at one end of the spectrum as the most concentrated markets and Italy, Spain and Germany on the other end of the spectrum (European Commission 2007 Report on the retail banking sector inquiry, pp. 18-19), market concentration as measured by the Herfindahl-Hirschman index (HHI) has increased both in the Eurozone and EU level since 2010 (ECB; *Banking Structures Report*, p. 14) .

68 M. Lamandini, D. Ramos Muñoz, G. Lusignani, Banks Restructuring and Resolution in Italy (2015 2016): Lessons from Recent Italian Regulatory Experiences, RLB, 2016/3, p. 166; Id., Does Europe Have What It Takes to Finish the Banking Union? Non-Performing Loans (NPLs) and Their Hard Choices, Non-Choices and Evolving Choices, EBI working paper 2017, forthcoming in Columbia Journal of European Law, Vol. 24, Issue 2, 2017; C. Hadjiemmanuil, Monte dei Paschi: a Test for the European Policy Against Bank Bailouts, OBLB, 2 May 2017; Id., Limits on State-funded Bailouts in the EU Bank Resolution Regime, in European Economy, Banks Regulation and the Real Sector, 2016, 2.

69 C. Borio, The banking industry: struggling to move on, o.c. p. 15.

70 Among many, see: A. Schenkel, *Proportionality of Banking Regulation – Evidence from Germany*, 2017, available at: http://www.ifg-muenster.de/forschen/veroeffentlichungen/2017/material/v_20170127.pdf

71 Survey on the cost of regulation and its impact on the Luxembourg financial marketplace, 2017, available at https://www.abbl.lu

72 Compare S.M. Hoskins, M. Babonte, Congressional Research Service, Washington D.C., 22 April 2015 (also published in R. Masera, *Sfide e opportunità della regolamentazione bancaria: diversità, proporzionalità e stabilità*, p. 163)

73 G. Ferri, P. Kalmi, *Only Up: Regulatory Burden and Its Effects on Credit Unions*, Filene Research Institute Report, 2014; G. Ferri, *Regole bancarie ragionevoli a tutela di diversità, stabilità e cre*scita, in R. Masera, 'Sfide e opportunità della regolamentazione bancaria: diversità, proporzionalità e stabilità', p. 157

74 R. Masera, Regole e supervisione delle banche in Europa, o.c. p. 32.

75 C. Borio, The banking industry: struggling to move on, o.c. p. 8.

macroeconomic effects especially in extraordinary times or in particular areas characterized by deep economic distress[76] when, exceptionally, this can lead to credit restrictions.[77]

Finally, the problem of adaptation and calibration of the general framework to the specific needs of small banks is made only more acute by legal concerns. Where existing rules are not designed to *expressly* leave an appropriate room for further proportionality calibration at the implementation and enforcement stage (in other terms where "primary text of regulations and directives [do not] expressly and specifically allow for flexibility")[78], the European Commission and EBA feel disarmed to apply the proportionality test, also on a case-by-case basis. In this way, the principle of proportionality (and its recurring mention within the frame of the Single Rule Book) runs the risk of being confined into a purely declaratory role.

4.4 Should Capital Requirements Be Revisited?

Not surprisingly the call for a bolder implementation of the proportionality principle was probably the most recurring and the one felt with the greatest sense of urgency in the Basel revision and in the current round of discussions concerning the Risk Reduction proposals of November 2016. In its resolution of 23 November 2016, the European Parliament called on the European Commission:

> "*to prioritise work on a small banking box for the least risky banking models and to extend this work to an assessment of the feasibility of a future regulatory framework consisting of less complex and more appropriate and proportionate prudential rules specifically adapted to different types of banking model*".[79]

The implied assumption underpinning the partial reconsideration of the role of proportionality in a better calibration of prudential requirements for non-complex retail domestic banks is that under certain conditions a one-size-fits-all approach to bank regulation and supervision, albeit formally respecting the level playing field, is running against it. Due to differences in size and business model, a disproportionate regulation for non-complex retail domestic banks may undermine their ability "to compete with more established players"[80], for new entrants to access the market and in extreme situations might give rise to a "knock on effect on certain financial institutions"[81].

For instance, in the United Kingdom, it has been calculated that – due to the differences in the risk weights under the IRB and standardised models –

> "*for every £ 1 of capital set aside to cover credit risk, a large bank can do 10 times lower LTV mortgage lending than a small bank or a building society. Put another way, for taking exactly the same credit risk, the smaller lenders have to set aside ten times more capital that the 6 biggest firms that [in the United Kingdom] control 80% of the mortgage market*".[82]

Since capital is a bank's most scarce and most expensive resource, this is not only a competitive disadvantage. The "one size fits all" approach hides – in the clothes and under the false pretence of equal treatment – a fatal discrimination against non-complex retail domestic banks because it requires them to set aside much more capital to take the same risk that significant banks are weighing in a different and more favourable way through IRB models. Moreover, as it has been noted[83], this generates additional

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76 J.S. Masur, E.A. Posner, *Should Regulation Be Counter Cyclical?*, Coase-Sandor Institute for L&E Working Paper No 782, November 2016.

77 Rainer Masera, *Banking Union and its political economy implications*, presentation delivered at the EBI-EALE workshop in Bologna, 17 September 2016 (available on the European Banking Institute website www.ebi-europa.eu), p. 6; R. Masera, *CRR/CRDIV: the trees and the forest*, PSL Quarterly Review 67 (2014), p. 381-422; R. Masera, *Regole e supervisione delle banche in Europa*, o.c. p. 27.

78 BVR, *Taking proportionality seriously – protecting the diversity of the banking sector*, 12 recommendations from the National Association of German Cooperative Banks, p. 2. This constituency is notably very vocal in advocating a better calibration of rules for small banks: see also the Expert opinion of A. Hackethal and R. Inderst, *Auswirkungen der Regulatorik auf kleinere und mittlere Banken am Beispiel der deutschen Genossenschaftsbanke*n, 30 September 2015.

79 European Parliament resolution of 23 November 2016 on the finalisation of Basel III (2016/2959(RSP)).

80 BSG, *Proportionality in the Bank Regulation*, p. 15; European Commission, Economic Review of the Financial Regulation Agenda, SWD (2014) 158 final, p. 260.

81 BSG, Proportionality in Bank Regulation, p. 28.

82 Letter from challenger banks to United Kingdom Treasury Department, 30 June 2016, Annex 1.

83 Letter from challenger banks to United Kingdom Treasury Department, 30 June 2016, Annex 1.

disturbing markets effects, because small banks are pushed to write proportionally higher LTV mortgages (since they have to charge more than large banks for low LTV mortgage lending), whereas the biggest bank write proportionately lower LTV mortgages and their profitability is materially higher than that of the small banks. This is clearly paradoxical, because "the banks taking the lowest risks and setting aside the least capital to support these risks [appear to] generate the highest levels of profitability".[84]

This is just one of the reasons why, in the United Kingdom, challenger banks have faced difficulties in entering the banking market. Others revolve around funding, capital requirements, payment infrastructure access and regulatory disadvantages compared to the existing banks. This example shows that the distinction between standardised and advanced IRB approaches adopted so far in Europe (differently from the US, where the Collins Amendments provide that capital requirements calculated under the standardised model are the minimum also for banks adopting IRB approaches) has brought about a situation in which capital requirements are less demanding for systemically relevant banks that apply IRB models, while being more capital intensive for non-systemically relevant banks. The future will tell if the new Basel III reform recently endorsed and the revision of both the standardised and IRB approaches, which were precisely adopted in the words of the BCBS "to restore credibility in the calculation of risk-weighted assets and improve the comparability of banks' capital ratios"[85], will re-establish in due course the desired level playing field.

4.5 Proportionality in Governance and Reporting

A second example of lack of proportionality is offered by corporate governance and reporting requirements. Also in this context, a quick look at the US post Dodd-Frank multilayer regulatory framework – as discussed in section 3 of this article - can help draw some parallels. One salient innovation[86] in Dodd-Frank was the creation of different classes of banks – largely but not exclusively based on total assets – for the purpose of calibrating proportionate requirements to them. This greater stringency is based on a variety of factors related to the banks' systemic importance. The standards must cover capital, liquidity, risk management, resolution planning and concentration limits, but the Federal Reserve may add other standards that it finds appropriate.

The European Commission's Risk Reduction proposals of 2016 take first important steps towards the same direction, mostly on reporting, disclosure and remuneration. The Japanese example may in turn suggest that additional regulatory simplifications on corporate governance and internal controls could perhaps be granted if risk management and regulatory compliance were in turn better supervised on an ongoing basis by local oversight teams. Weaker internal functions at the level of small and medium sized banks – as inevitably determined by size and business model - would be supported, in this way, by a more cooperative and proactive external supervision. This would reverse, however, the current approach to supervisory proportionality, which posits a less intrusive role, and less frequent visits, for supervisors at Category 3 and Category 4 institutions in accordance with the EBA Guidelines 2014 as discussed in section 2.5. At the same time, though, it would partly subsidize compliance costs for non-complex retail domestic banks, to redress the competitive level playing field. This approach would also fit well within the decentralised implementation of banking supervision on LSI's within the Banking Union, nicely factoring all proximity advantages and regional specificities at the level of national competent authorities.

5 TOWARDS A TWO-TIERED BANKING LAW IN EUROPE?

What to do, then? If, as recently acknowledged also by Sabine Lautenschläger, "proportionality involves applying a distinct set of rules to banks operating in the same market" [87], the question is how to frame such a Two-Tiered Banking Law. Objectives pursued, costs and benefits involved must thus all be kept into account. This implies, on the one hand, that the risks to financial stability posed by individual banks and

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84 Letter from challenger banks to United Kingdom Treasury Department, 30 June 2016, Annex 1.

85 BCBS, High-level summary of Basel III reforms, BIS, December 2017, p. 1

86 D.K. Tarullo, *Rethinking the Aims of Prudential Regulation*, Speech at the Federal Reserve Bank of Chicago, Chicago, 8 May 2014 (available online), p. 2

87 *Is small beautiful? Supervision, regulation and the size of banks*. Statement by Sabine Lautenschläger, Member of the Executive Board of the ECB and Vice-Chair of the Supervisory Board of the ECB, at an IMF seminar, Washington D.C., 14 October 2017.

groups of banks must be assessed, while also considering the implications of proportionality for bank competition at a local level. On the other hand, the costs of regulation and supervision matter as well.

As noted, non-complex retail domestic banks are likely to face greater difficulties in complying with complex regulation. This puts them at a disadvantage (and even more so in the current unfavourable economic environment of persistent ultra-low interest rates which erode their net interest margins) and, consequently, reduce the diversity of operators in the banking sector.

Therefore, proportionality is one of the necessary elements to foster such diversity, which in turn should make the banking system more stable and resilient in the future. This builds towards an interpretation of the principle of proportionality as a sort of security mechanism to protect smaller and less risky financial institutions from excessive regulatory requirements. Indeed, regulatory costs should not distort market results and arbitrary effects resulting from a one-size-fits-all application of rules should be avoided. Therefore, different rules for different institutions can apply to reduce the potential for regulatory distortions, as long as they are the same throughout the EU. One critical point to consider, to dispel any possible misunderstanding, is what the intended aim of a proportional regulation and supervision is. If proportionality means applying simpler rules for non-complex retail domestic banks, it still does not follow automatically that the rules should be less stringent overall, or that smaller banks can simply get away with holding less capital or liquidity or being less monitored. They should be as sound as other banks, but differently regulated and supervised to balance the costs and benefits involved. However, this should not be at the expense of their ability to remain competitive and at the same time resilient during an economic downturn in order not to disrupt the provision of credit to the economy.[88] This reflects what was stated by EBA in 2015:

> "*the principle of proportionality means that small and non-complex institutions can comply with the principles by implementing less complex, but still appropriate, [...] policies, while large and complex institutions have to implement more sophisticated [...] policies*".[89]

6 CRITERIA FOR DISTINCTION FIRST AND SECOND TIER BANKS

6.1 *Search for a Proper Definition of "Small" and "Large" Banks*

Throughout this paper, we refer to the two groups of banks as "large banks" and "small banks" for which the Two-Tiered Banking Law should be developed. Large banks should then be subject to the current Single Rule Book provisions, whereas small banks should be made subject to the "second tier" of banking law. How this second tier should be organised and structured will be discussed in section 8. In this section, we will first comment on the categorisation of the two groups. As appeared from the discussion in earlier section, European banking law adopted distinct approaches for the categorisation of banks for which either different banking rules apply (or where the banks may opt for the application of exemptions or options following the modular approach of the Single Rule Book) or for which distinct approaches apply as regards the supervisory engagement with the banks or the organisation of the ECB supervision in the Single Supervisory Mechanism.

In this paragraph, we comment on the different considerations and rationale of the distinct categorisation systems. We aim to weigh these considerations and rationale to develop a methodology to make a distinction between banks that should be included in the first tier and those that should be made subject to the second-tier banking law and supervisory engagement model.

6.2 Small Banks and Large Banks as Distinctive Criterion

Cleary, the size of the bank would be an important indicator from the perspective of systemic relevance for its qualification as "small" or "large". We do not believe, however, that the size of a bank alone can be a proper distinctive criterion. The situation of IceSave in 2008 demonstrates that even small banks can create extraordinary problems with considerable contagion effects on the financial markets. The Icelandic banks that operated on a cross-border basis were, measured against competitors in the European markets,

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[88] Ibid.

[89] Opinion of the European Banking Authority on the application of the principle of proportionality to the remuneration provisions in Directive 2013/36/EU, EBA/Op/2015/25.

small.[90] Nevertheless, they caused quite some turbulence and damage to clients as a consequence of their collapse. Perhaps this case may be an example of the "Butterfly Effect" occurring in the supervision of the financial markets.[91] In addition, the factor of interconnectedness by means of participation in IPS, in cooperative structures, mutual liability arrangements, cross shareholdings, may enhance the riskiness of even small institutions. Therefore, the criterion of size of the banking organisation alone would be counterproductive, if it would be applied as the single determining factor to categorise banks in the second-tier.

However, size as a criterion operates in several instances as the determining factor for the application of exemptions or the ability for banks to opt for a more favourable treatment. Reference could be made to the recent Risk Reduction proposals of the European Commission and the classification of banks in Article 430a CRR2 as being "small" in the event the average balance sheet total in the four preceding years of the year of the reporting obligation is less than 1.5 billion euro. As we have seen in section 1, this particular number of balance sheet size would accommodate a very large group of LSI's that would not hold balance sheets exceeding 1.5 billion euro. Thereby the Risk Reduction proposals offer considerable relief in respect of reporting and disclosure requirements for many smaller banks in Europe.

By providing this example of the Risk Reduction proposal, it must be noted that the criterion of "small banks" as set out in Article 430a CRR2 only operates to exempt banks from a part of the requirements of the Single Rule Book. Other requirements of the Single Rule Book for which no choices have been made by the European Commission on the basis of the principle of proportionality apply in full. This means that smaller banks (in terms of balance sheet) will nevertheless be subject to provisions of the Single Rule Book for which it may be argued that they are either redundant or not fit for purpose.

Reference can also be made to the EBA Guidelines 2014 categorising banks in four groups. The criteria as displayed in section 2.5 of this paper, also demonstrate that size does not operate as a single determining criterion, but that for a bank to rank in Categories 3 or 4 (the categories assuming a "lighter touch" SREP and less intensive engagement of the supervisory authorities with the bank), additional criteria must be met, such as the relative market share of the bank concerned and the lack of complexity of the business model (for instance homogenous credit product offering).

6.3 The Classification of SI's and LSI's

The size of an institution does matter, however, for the classification between SI's and LSI's in the context of the Single Supervisory Mechanism. Although it is perceived in certain cases as arbitrary[92], one of the criteria of Article 6(4) SSM Regulation concerns assessment of significance based on the criterion of "size". An SI is a bank that holds total value of assets exceeding 30 billion euros. However, "size" does not operate as the only criterion to determine whether a bank (or banking group) may be considered significant. Also, other criteria apply, which, amongst others, relate to the importance of the bank for the economy of the European Union or a specific member state as is related to the GDP of that member state, although banks holding less than 5 billion euro assets would not be comprised in the significance classification in respect of the GDP-criterion.

Another criterion which may be an indicator for significance in accordance with the Single Supervisory Mechanism is the significance of the cross-border activities. This criterion serves to streamline the supervision on banks operating in multiple markets in different Member States by means of a subsidiary model or by means of a branch model. For banks operating in a subsidiary model, the classification of the group as "significant" within the meaning of Article 6(4) SSM Regulation will be consequential for the

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90 At a national, Icelandic, level, the Icelandic banks Kaupting and Landsbanki (IceSave) were huge, though. Their sizes was about 9 times the country´s GDP.

91 J.G. Fichte, *Die Bestimmung des Menschen* (1799) Buch 1 (Zweifel) "In jedem Momente ihrer Dauer ist die Natur ein zusammenhängendes Ganzes; in jedem Momente muss jeder einzelne Theil derselben so seyn, wie er ist, weil alle übrigen sind, wie sie sind; *und du könntest kein Sandkörnchen von seiner Stelle verrücken, ohne dadurch, vielleicht unsichtbar für deine Augen, durch alle Theile des unermesslichen Ganzen hindurch etwas zu verändern*." The free translation to English of the last (emphasised) part of this (popular) quote is "you could not remove a single grain of sand from its place without thereby ... changing something throughout all parts of the immeasurable whole".

92 See: ECoJ, T-122/15, Landeskreditbank Baden-Württemberg - Förderbank v European Central Bank.

organisation of the supervision on consolidated basis, where the structure of group supervision by multiple competent authorities is replaced with a single centralised supervisory authority, the ECB. This perspective should be catered for in the classification to determine which banks should be categorised in one of the two tiers. It may also be useful to comprise in this assessment the further criterion as set out in Article 6(4) SSM Regulation, to consider:

> "*an institution to be of significant relevance where it has established banking subsidiaries in more than one participating Member States and its cross-border assets or liabilities represent a significant part of its total assets or liabilities subject to the conditions laid down in the methodology*."

Clearly, the organisation of the banking business operating in multiple jurisdictions where there is overhang of the international business compared to the domestic business of the banking group, justifies, in any event, a closer and more intensified relation between the supervisory authority and the bank. This means that there will be an important driver to eliminate potential coordination problems in the event multiple supervisory authorities are involved. This justifies transfer of the supervision to the centralised system of the Single Supervisory Mechanism. In such instances, ECB supervision should be the default solution for every bank having a considerable international footprint in the European Union or Eurozone. The materiality threshold to make a choice for such ECB supervision should not be too high (and even could be considerably lower than the ordinary 30-billion-euro balance sheet criterion).[93]

6.4 Systemically Important Institutions

In accordance with the methodology developed by the BCBS[94] and as endorsed by the Financial Stability Board, the Single Rule Book adheres in Article 131 CRD IV to the classification of systemically important institutions by applying the scoring method to address the five factors that may indicate that a bank is "systemic important". These five categories are for Globally Systemic Important Institutions ("G-SII") (i) size (of the group), (ii) interconnectedness (of the group) with the financial system, (iii) substitutability of the services or of the financial infrastructure provided (by the group) (iv) complexity (of the group) and (v) cross-border activity (of the group), including cross border activity between Member States and between a member state and a third country. For "Other Systemically Important Institutions" (these may be considered the European systemically important banks, "O-SII")) the criteria of (i), (ii) and (v) must be scored an, additionally, there must be a score for the importance for the economy of the European Union or of the relevant member state. The expression "of the group" in the above list has been placed between brackets, to point out that in the methodology captured in the provision of Article 131 CRD IV systematic relevance would only be assessable if it concerns groups of banks (therefore the premise is that the bank concerned has organised itself in a subsidiary model).

The assessment methodology is rather complex, and the exact calculation of scores is not always transparent. However, without discussing this topic in more detail in this article, we point out that the methodology itself contains interesting and useful elements to address the subject matter of grouping of banks into the two tiers.

Firstly, the methodology for G-SIIs and O-SIIs has with intend departed from the original assessment of banks only based upon size to address the "Too-Big-To-Fail" syndrome. As the assessment methodology evolved, there was also a clear understanding that size alone does not constitute systemic relevance, but that this criterion should be assessed in combination with other factors too. The evolution in the theory about systemic importance of financial institutions, also placed considerable emphasis on the constraints of

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93 Reference can be made to the provision of Article 7(2)(b), SRM Regulation, Regulation (EU) No 806/2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund. This provision provides the authority and power to the Single Resolution Board to nominate "other cross border groups" to be comprised in the remit of the SRB powers and responsibilities, even if this concerns banking groups that do not qualify as being "significant" within the meaning of the SSM Regulation. This discretion is granted to the SRB in recognition, that even for smaller banking groups with a cross border presence, full coordination of the decision in the context of resolution (planning) may be required and productive. To date, the SRB has nominated 15 European banking groups to fall within the scope of exercise of powers and authorities by the SRB. See: SRB publication of 6 June 2016 to be consulted via: https://srb.europa.eu/sites/srbsite.

94 BCBS, Global systemically important banks: updated assessment methodology and the higher loss absorbency requirement, July 2013.

interconnectedness, where the new motto became “Too-Interconnected-To-Fail”. Contagion effects (and therefore systemic crisis) could also be provoked by smaller but extremely interconnected financial institutions. The clearest example of such a problem, is the collapse of Lehman Brothers which was in terms of size big in its domestic market, but on a global scale did not belong toto the real “mastodons”. If one considers the balance sheet of this bank, it would not score very high in the classification category size in the assessment methodology for G-SIBs, but this bank would score very high on the assessment categories “interconnectedness”, “cross border operation”, “substitutability” and “complexity” as the bank was interconnected with almost the entire financial industry on a global scale.[95]

Following that rationale, smaller banks that are heavily interconnected with other smaller or larger banks, for instance by means of an IPS, central cooperative structure or other arrangements that constitute potential cross-liabilities, should in our view not be classified in the “lighter tier” of banking law, nor should engagement with supervisory authorities be less intense.

Similarly, the criterion of substitutability should produce consideration to the categorisation in the second-tier. Examples in Europe demonstrated that even for smaller banks with significant participation in payments infrastructure and the relationship with significant numbers of (retail) customers, specific scrutiny was required in order to avoid the building up of potential contagion effects to other parts of the financial industry and jeopardy to the interests of customers. Such significant participation in payment systems, prevented an orderly transfer of the systems operated by such banks to potential investors and required, therefore, extraordinary measures to address the failures of such banks.[96]

Finally, useful benchmark criteria can be found in the categories of the size cross border operations and the relative weight of the bank’s business to the national or European economy. For the former, we do believe that it would be inappropriate to move banks (no matter the size) with a complex cross border operation to the second tier of the banking law as we are proposing in this paper. As has been noted hereabove, such cross-border footprint justifies an effective and robust governance of the supervision model to be applied to the banking group (if organised in a subsidiary model) or to the cross-border activities by the bank established in one member state (if the bank operates a cross border services or branch model). We only need to point out to the issues created by the Icelandic bank sector, to support the conclusion that light touch banking law or less intense supervision would be completely inappropriate in such cases. As regards the importance of a bank for the national or European economy, we do believe that only in rare circumstances such importance would be existent for smaller banks. Rather, importance in market shares in a member states or on the scale of the European Union would only be constituted by banks that have a relative size. By nature, such banks should belong in the first tier of banking law.

6.5 EBA SREP Guidelines Methodology

As we have discussed in section 2.5, the EBA Guidelines 2014 promote a system of categorisation in four classes for which different approaches in respect of supervisory engagement is warranted. When taking a closer look at the criteria developed for such categorisation, one could observe that the EBA Guidelines provide for a blended rationale, deriving parts of the criteria from the assessment methodology for systemically important institutions, and the other part from criteria that are included in the Single Supervisory Mechanism assessment of significance. Among other criteria, the categorisation method merges the criteria of Article 131 CRD IV for systemically important institutions with those of Article 6(4) SSM Regulation.

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95 See for an in-depth analysis of the topic of “systemic relevance”: S. Schwarcz, *Systemic Risk*, Duke Law School Legal Studies, Research paper Series, No 163, (2008). See furthermore: H.S. Scott, *Connectedness and Contagion; Protecting the Financial System from Panics*, MIT Press, (2016).

96 A clear example is the near collapse of the domestic SNS Reaal group in the Netherlands. This financial conglomerate faced difficulties as a result of investment in certain toxic (real estate) assets. The fact that the bank provided services to approximately 1.3 million retail customers holding current accounts with access to the Dutch payment system, was one of the factors that contributed to the inability to substitute the services by transferring this portfolio to another bank. The SNS Reaal group has been nationalised by decision of the Minister of Finance of 1 February 2013. SNS Reaal was, in terms of size, not a very large bank.

In addition to the said mixed criteria, some interesting qualitative criteria have been added to the list for categorisation. In short, these additional criteria assess the level of complexity of a banking organisation, even if that organisation is not systemically important[97]. For instance, the heterogeneity of the product and services offering of a bank contributes to a higher categorisation in the upper classes. A bank that would, apart from offering (consumer) credit, also offer other services (for instance it would act as broker for its clients dealing on the stock exchanges), is ranked in the higher categories and will be subject to a higher level of engagement with the supervisory authorities in the SREP.

7 PROPOSED METHODOLOGY FOR TIERING IN THE TWO-TIERED BANKING LAW

We suggest that the methodology to allocate banks in one of the tiers of banking regulation and, accordingly, to apply a disparate (and proportional) engagement with the supervisory authorities should focus on (i) complexity and (ii) the absence of systemic relevance, with the size of the bank´s balance sheet serving as the first proxy to determine classification. Banks that are considered "significant" in accordance with the balance sheet criterion of article 6(4) SSM Regulation belong in tier 1 of the Banking Law.[98] Banks that are assessed as being G-SII or O-SII obviously also fall in the first-tier bracket. Banks with a complex business model or offering specialised services (for instance they are clearing member and participant in clearing of financial instruments), should also be classified in the first tier.

By nature, banks operating a "universal business model" whereby other important business lines are developed beyond the granting of credit to retail and corporate customers are also not suitable for the treatment in the second tier of banking law. Such banks are, for instance, likely to hold a trading portfolio, dealing on own account, which justifies the full application of the market risk requirements. Also, universal banks are likely to benefit from the advanced methodologies to quantify operational risk addressing the diverse types of operational risk in the different business lines, and applying a simplified methodology for such banks would jeopardise risk sensitivity of the applicable requirements.

Banks that have a significant international and cross border footprint should also be excluded from the second tier. We therefore acknowledge the importance of robust supervisory mechanisms that encompass the entire business as operated by the bank in all international markets. Perhaps, exceptions could be made if the importance of the international business does not exceed a certain threshold as compared to the entire business of the bank. For instance, the proportion domestic and international business is 90% to 10%.

We are more hesitant to bring the criterion "size" forward as the sole criterion for the tiering in one of the two tiers.

For instance, a bank that would be undoubtedly qualifying as LSI, but that holds a certain sizeable balance sheet (let us say for the sake of reasoning, the balance sheet total is 20 billion euro), that would not operate a complex business model (for instance the product offering is restricted to consumer and corporate loans), that would only be operating in one member state serving exclusively the domestic market and where the business may be considered "substitutable", we consider such a bank eligible to be placed in the second-tier of the banking law. We consider it proportionate that such a bank would be alleviated from the complex modular approach of the Single Rulebook and would operate standardised approaches for the quantification of risk. A bank of this size is not likely to be a logical entrant to the international capital markets to issue complex structured bonds, and it is likely that funding of the bank by means of CET1 and perhaps a small portion of Tier 2 instruments would be a suitable way of organising the regulatory capital. Our reasoning is therefore, that size itself should not be the overriding criterion to classify banks in the first, most burdensome, tier of banking law, but may serve as a first classification criterion. We therefore also believe that there will be sufficient "clients" for the second tier of European banking law.

8 THE CONTOURS OF THE RULES APPLYING TO SMALLER EUROPEAN BANKS

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[97] If it is systemically important, there would automatically a significant score on the "complexity" topic which forms part of the assessment methodology for G-SIIs.

[98] We are not debating the question as to whether the size-criterion of Article 6(4) SSM Regulation should be made subject to revision. Significance of banks holding more than 30 billion euro of assets justifies, in our view, the direct supervision of the ECB on such banks. This may be considered arbitrary, but we support the spirit of pragmatism as this was upheld in the design of the Article 6(4) SSM Regulation-criteria, to formulate thresholds that would secure the direct supervision of ECB for approximately 80% of the bank assets in the Eurozone.

8.1 Which Rules Can be Dispensed?

The crucial question is which rules the regulation of smaller banks can dispense with. Answering this question presents a challenge. It is much easier to bemoan the flood of regulation than to pinpoint a particular measure that is superfluous. Each of the regulatory rules has its rationale and justification, and none of them can be discredited as not advancing at least in some way the important public interest in the stability of the financial system. Whoever proposes to exempt certain institutions of one them will easily be accused of weakening the efficiency of the supervisory and regulatory framework, and risking the outbreak of another financial crisis. At the same time, suggesting only minor deviations exposes the whole purpose of the reform to doubt. The game of the Two-Tiered Banking Law might not be worth the candle where it is restricted to only cosmetic changes in the facade of the existing rules.

Yet to ask the question which rules can be dispensed with may be the wrong approach. The point of our proposal is not to get rid of this or that provision of the CRR or the CRD IV. Rather, it is to reduce the overall regulatory burden on small and medium sized banks. There is hardly any doubt that this burden as such is too high, which creates the danger that small institutions might be crowded out by big ones. The burden is not a single rule but rather their *combined effect*. Saying which of them should be discarded is as impossible as to determine which straw broke the camel's back. Instead, it is preferable to find general methods of alleviating the regulatory burden and catering for flexibility.

8.2 Exemptions and Tailoring of Rules to Small Institutions

A first possible approach is to exempt smaller institutions from those rules that are designed with a view to big or "significant" institutions. As possible candidates, one may think of almost the entirety of the provisions that have been introduced in the wake of the financial crises. The goal of these provisions is to safeguard the stability of the financial system against risks resulting from the demise of a big financial institution. For examples of such rules, one only needs to think of the specific capital conservation, counter-cyclical and liquidity buffers, the requirement of a minimum total loss-absorbing capacity (TLAC and MREL), the crisis management and bank resolution framework, the rules on market risk, the bank governance rules and risk measures such as the bonus caps, or the structural reforms of banks.[99]

Most of these rules already provide for the possibility to exclude small institutions from their scope. For instance, Member States are allowed to exempt small and medium-sized investment firms from the requirement to hold a capital conservation and the counter-cyclical buffer, provided that this does not threaten the stability of the financial system.[100] The CRR authorises banks and investment firms to replace the own fund requirements for the trading book where they have only "small trading book business", which is defined in relation to their total assets.[101] The Commission has suggested to introduce further exemptions in the context of its Risk Reduction proposals.[102] *Inter alia*, it has tabled lighter disclosure rules for small institutions[103] as well as exemptions for certain institutions from the bonus caps[104]. It has also suggested that EBA shall tailor the reporting requirements for large exposures to the size, complexity, and the nature and level of risks of the institution's activities.[105] As we have noted, these amendments have been expressly based on the proportionality principle and the need to decrease the administrative and compliance burden for smaller institutions.[106]

Though these rules and proposals are to be welcomed, they have an important drawback: they are piecemeal solutions. As a matter of fact, they do not aim at a Two-Tiered Banking Law, but create several new categories and distinctions. To illustrate, the definition of a "small institution" suggested under a new Article 430a CRR2 does not coincide with the exemption from the bonus cap under Article 94(3) CRD5. It

99 For an overview of these measures and their costs, see Commission, Staff Working Document, Economic Review of the Financial Regulation Agenda, SWD(2014), 158 final, p. 49 et seq.
100 Article 129(2) and 130(2) CRD IV.
101 Article 94 CRR.
102 See reference in footnote 6.
103 Article 433b CRR2.
104 Article 94(3) CRD5.
105 Article 394(4) subparagraph 2, CRR2.
106 CRR2, pp. 7, 18 and text of Article 394(4) subparagraph 2; CRD5, pp. 3, 5, 7 and 9.

has no connection to the tailoring of the reporting requirements suggested under Article 394(4) subparagraph 2 CRR2, nor with the already existing definition of the term “small” in the context of the trading book business under Article 94 CRR. Moreover, in the context of the Supervisory Review and Evaluation Process, the EBA SREP Guidelines define four distinct categories of banks utilising definitions that deviate significantly from the current and future CRR provisions. As a result, the existing and suggested privileges do not contribute to a simpler and more transparent second regulation of small and medium-sized institutions. Quite to the contrary, they even increase complexity. They require constant monitoring of a plethora of different thresholds and criteria, which is an additional onus for a firm with modest financial assets and a limited number of employees. The goal of reducing the regulatory burden is thus largely failed.

A true improvement and alleviation can only be achieved where a second regime is introduced that applies across all institutions. For this purpose and as noted in section 6, a uniform definition of the category “small” is needed. Only this approach allows banks to easily identify which requirements they must comply with. The characterization of a firm as “small” must at the same time bear significance and free it from a number of different rules.

Certainly, the regulators have good reasons to defend tooth and nails the limitation of existing exclusions and exemptions to bespoke cases and criteria. For instance, they will argue that the bonus cap must cover medium-sized institutions in order to avoid moral hazard. There can be no doubt that a strict regulation is preferable when looking solely at the objective to reduce risks for the stability of the financial system. But as important and obvious as this consideration may seem from the regulator’s perspective, it must be balanced against the regulatory burden created for the firm. The principle of proportionality requires to not narrowly focus on the objective to be achieved, but to also take the costs for the private sector into account. Some compromise must be reached between absolute stability and the goal of preserving small institutions in the interest of a diversified banking landscape.

Therefore, a graduated approach to banking supervision is necessary. Institutions of limited size and complexity should be subjected to rules that are less burdensome than those for larger and more complex banks.[107] A similar proposal has been made in the US where it was suggested that to introduce banks with different “charters”.[108] One may object that a “two size fits all” approach is not ideal either, as it puts to many institutions into the same pigeonhole, and instead favour more categories.[109] Yet “Two-Tiered” is already much better than “one size fits all”. It also fares comparatively well against exempting distinct kinds of institutions under different rules, which creates complexity and bureaucracy.

8.3 An Independent Regime for Small Institutions

The gist of the first approach is to introduce a second, lighter regime for smaller and less complex institutions. The banks belonging to the second tier could benefit from a number of special exceptions and adjustments tailored to their specific needs. The advantage of this approach is that it is relatively easy to develop because it is based on the existing legislation. Yet exempting smaller institutions from some of the rules that apply to large ones may not be sufficient. It may leave many rules in place that are not necessary. It will also not change the level of complexity of the existing rules, which would continue to exist in their current form. Indeed, such an approach may end up creating additional complexities by adding even more rules to the existing ones. In sum, merely creating exceptions and exemptions for smaller institutions may not be sufficient to implement proportionality an *operational* principle of supervision.

A more ambitious approach would be to draft an entirely independent second regime.[110] The regulator would have to write specific requirements for banks in tier 2 by looking for the rules that are indispensable for ensuring the integrity, functioning and stability of small banks, which may be completely different from those for larger and more complex institutions. This “bottom-up” approach presents some distinct

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[107] Compare A. Dombret, *Banking diversity and regulation – do we need more proportionality in banking regulation?* Speech at the Banking Industry Conference of the People’s Banks and Raiffeisen Banks, Berlin, 8 June 2016, p. 6.

[108] Sean M Hoskins and M. Labonte, *An Analysis of the Regulatory Burden on Small Banks*, Congressional Research Service (2015) R43999, p. 38–39.

[109] See D.K. Tarullo, *Rethinking the Aims of Prudential Regulation,* o.c., p. 5, who suggests as minimum three distinct categories.

[110] A. Dombret, *Banking diversity and regulation – do we need more proportionality in banking regulation?* Speech at the Banking Industry Conference of the People’s Banks and Raiffeisen Banks, Berlin, 8 June 2016, p. 5.

advantages. First, it avoids the danger that rules designed for large banks are unnecessarily extended to smaller ones. Second, a regime that is specifically designed for small institution will by its very nature be less complex. Following the bottom-up method may also be necessary in light of the principle of proportionality. This principle is not taken seriously if one starts from the riskiest business models and then provides exceptions for those that are less dangerous, as it is currently the case with the modular approach of the Single Rule Book. On the contrary, the principle of proportionality requires to look at each type of institution individually and ask which requirements are justified to reach the regulatory objectives. The second approach would invite a fundamental reconsideration of the existing rules and would force a thorough assessment of its suitability, necessity and *stricto sensu* proportionality in respect of small banks. We believe that the recent efforts by the European Commission to develop a new and tailored prudential regime for investment firms provide support for feasibility of the approach to develop an independent, new, regime for the tier 2 banks.[111]

The practically most important consequence of the more ambitious method, and possibly its single most important advantage, is that it would involve a fundamental departure from the Basel Framework for smaller and less complex banks. The Basel rules have been drafted primarily with internationally active banks in mind.[112] As has been noted, Europe nevertheless has chosen to extend the Basel Standards to *all* banks established in the Union.[113] This not only creates tremendous burdens for small firms, but is also unusual when compared with other laws in the world, for instance the regulation of small and community banks in the US.[114] The Commission's implicit presumption that all banks in the EU are potentially active in cross-border trading is not supported by empirical evidence. Moreover, given the degree of harmonization in Europe it may be more appropriate to consider the whole of the EU, or at least the whole of the Eurozone, as a *single* jurisdiction for the purposes of Basel. It then becomes apparent that imposing the full breadth of the Basel Standards to all banks in Europe is uncalled for. Our recommended approach could correct the fundamental error made during the transposition of the Basel rules into EU law. It could create a second regime for small banks that is entirely separate and different from those of large and internationally active rules.

8.4 A Compromise Proposal

However, a drawback of the more ambitious method is that the new provisions would have to be written from scratch. One could not build upon earlier experience that has been made, and would have to accept substantial costs and risks. There may also be legitimate concerns that the competitive playing field is distorted where two entirely differently regulated types of banks are created. This may furthermore invite significant risks of regulatory arbitrage. Finally, the introduction of a second tier for smaller banks could prove to be politically too ambitious to achieve.

A compromise solution must therefore be envisaged. Rather than providing for exceptions, exclusions and calibrations for small banks, or reinventing the wheel, the rules should instead *explicitly* specify which provisions in the Single Rule Book are applicable to small banks. This would counter the creeping and inertial expansion of the unitary ("one size fits all") approach: a risk witnessed even in the US.[115] Though the same rules would apply at least in part for smaller and less complex institutions, there would not be any automaticity in their application to them. Rather, each rule would have to be considered and analysed individually whether it is required and appropriate for institutions in tier 2. Only when the result is positive should it become part to the second tier. This exercise, which has not been done so far, is indispensable for

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111 See: European Commission, Proposal for a Regulation of the European Parliament and of the Council on the prudential requirements of investment firms and amending Regulations (EU) No 575/2013, (EU) No 600/2014 and (EU) No 1093/2010, 20 December 2017, COM(2017) 790 final and the Proposal for a Directive of the European Parliament and of the Council on the prudential supervision of investment firms and amending Directives 2013/36/EU and 2014/65/EU, 20 December 2017, COM(2017) 791 final.

112 BCBS, *Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems (Basel III)*, D, which refers to Part 1 of Basel II.

113 European Commission, 'Capital Requirements - CRD IV/CRR – Frequently Asked Questions' 4 <http://europa.eu/rapid/press-release_MEMO-13-690_en.htm> accessed 1 November 2016.

114 M. Lehmann, Single Supervisory Mechanism Without Regulatory Harmonisation? Introducing a European Banking Act and a 'CRR Light' for Smaller Institutions, EBI Working Paper Series 2017 - no. 3, p. 21 et seq.

115 D.K. Tarullo, Rethinking the Aims of Prudential Regulation, o.c., p. 5

ensuring that the second regime is not permeated by unnecessary rules. Where the rules of the CRD IV and CRR are too stringent or technical, the legislator should consider tailoring them to small banks or, in case that this is not possible, to redraft them completely. As referred to above, the European Commission has demonstrated that it is possible to create within a relative brief period of drafting of approximately 1,5 year a bespoke regime which is, in balance, less complex than the CRR framework. This evidence can be found in the recent proposals for prudential requirements for investment firms.[116] Our view is that "smaller banks" would be benefiting considerably if they would be subject to a comparable and less complex regime of prudential requirements as was designed for European investment firms.

Because each rule will be evaluated as to its necessity, the second-tier banking law regime could be much shorter and less complex than the current EU framework. It could thereby overcome several difficulties that plague the provisions on capital requirements and make them especially burdensome for small institutions. The rules of the second tier should focus on the essentials. By cutting out unnecessary content, they should become simpler, more accessible and easier to handle. To reach this goal, entire chapters of the CRR and the CRD IV could be discarded. As an example, one might think about the Chapter on the Internal Ratings-Based Approach.[117] Eliminating them will not do much harm because in practice they are only used by large firms. One might also think about dispensing with other rules that are primarily relevant for large and complex institutions, such as the rules on market risk.

Though the second-tier of the banking law regime should be much simpler and less complex than the first tier, it must nevertheless robust. Such robustness might be achieved by suppressing some exemptions, tweaks and privileges that have been introduced in the Basel rules for big banks. A candidate for elimination are the rules on AT1 capital instruments and other hybrid instruments[118] as has been noted in section 2.4. It may be decided that these instruments do not count towards the Tier 1 capital of small firms. Small firms would then be required to only hold "plain vanilla" core capital, where a small proportion of regulatory capital could be filled in by non-complex Tier 2 subordinated loans. This is the price they would have to pay for being less stringently regulated.

This shows that the independent second tier is indeed special and not just a variant of the first tier. It also evidences that belonging to tier 2 does not necessarily result only in privileges for small firms. The application of more basic and less complex rules might have stricter and harsher effects than the first tier. To assuage concerns about the small firms' competitiveness, one may consider giving them the option of being regulated under the umbrella of the upper tier of capital requirements. In this case, they would be allowed to choose whether they want to compete with big ones on the market for own funds or whether they are satisfied with a straight-forward and simple model of financing. In this context, they would have to weigh whether the benefit of having, *e.g.*, AT 1 capital counted is worth having to comply with the other rules of "CRR full". An even more powerful step towards a Two-Tiered Banking Law would be to prohibit small banks from entering into certain risky transactions, such as credit derivatives or structured derivatives.[119] If smaller banks would be required to refrain, with the exception of transactions to hedge own currency exchange or interest rate risks, from playing roles in the OTC or exchange traded derivatives markets, this would again bring a significant reduction of the complex rules that are currently contained in the chapters on counterparty credit risk and credit valuation adjustment risks. The price that a bank would pay if it wishes to be active in the derivatives markets as broker or (even) as counterparty dealing on own account is, that in such instances the bank is to be classified in the first tier, and that there will be full application of the rules addressing risks of derivatives transactions.

9 CONCLUSIONS

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

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116 See: European Commission, Press Release 20 December 2017, Capital Markets Union: more proportionate and risk-sensitive rules for stronger investment firms and footnote 111.

117 Article 142 -191 CRR.

118 Article 51-61 CRR.

119 'Narrow banking models' find also favour in the US, see e.g. T. Marsh, *Reforming the Regulation of Community* (2015) 90 90 Indiana Law Journal 179 (2015) 232 <https://www.repository.law.indiana.edu/ilj/vol90/iss1/5>.

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 papers 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.

We are aware that this move may cause political controversy, precisely because it was probably a political reason that justified the approach adopted by the EU regulator in the first place. The Eurozone is a shared financial market, and therefore a place where risk may spread quicker within the different Member States. The limitations in the direct financing of states envisaged in the TFEU and the inability of national banks to act as lender of last resort, coupled with the relatively high level of intra-European business activity, portrays a picture where financial turmoil in one Member State may quickly spread on to the rest. Spreading the financial risk would imply a sovereign risk and, ultimately, an apportionment of losses amongst European countries (*i.e.,* its citizens). In the light of this, the designers of the banking union decided to increase controls, enhance regulatory requirements and ensure the risk of mutualising losses (both from an ex ante –investment- and ex post perspective -rescue) was reduced to the minimum. In other words, it is the lack of mutual trust that has shaped the European system. Hence the differences with other preferred regulatory approaches. We have a deficient system, excessively rigid and with requirements and remedies that are unnecessary and too costly. The moment when the banking union was devised, in the middle of a phenomenal sovereign crisis, explains the design. It is now perhaps time to do away with its underlying fear; time to relax the system; time to make it more efficient. The two-tier approach is one step of a longer path. But an important one.

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