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Proportionality in the Single Rule Book

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1 The Need for Proportional Regulation and Supervision

1.1 A Diversified Banking Landscape

The European banking sector is characterised by great diversity. It is difficult to find common features of banks' organisational and business models that are valid for the entire European Union (EU). Nevertheless, some similarities may be found in sub-groups of member states if compared to other member states.

Italy, Germany and Austria, for instance, feature large numbers of nationally active smaller banks with fairly small balance sheets. These member states, however, are also home to some of the largest internationally active European banks. France and the Netherlands, on the other hand, have a concentrated banking sector, characterised by a relatively small number of banks with a balance sheet that is on average more significant than in other member states. France and the Netherlands are also the headquarters of some of the largest internationally active European banks. Spain tends to develop as a jurisdiction

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with a largely concentrated banking sector and as the home of Europe's largest banks with a very significant footprint on a global scale. Concentration in this member state and the disappearance of smaller banks is a result of the attempts to improve the health of the sector after the global financial crisis.

The differences between the member states make the discussion on proportionality of European banking law complex, as there will be very different drivers across the European Union to set the scope of proportional application of banking law. Countries with a concentrated sector with internationally active larger banks will be less motivated to apply banking law in a differentiated way. Member states with large numbers of smaller banks will be more inclined to question the need to apply the full framework of European banking law to all banks established within their jurisdiction and to invoke the principle of proportionality.

Absent a common denominator regarding the rationale and objectives for applying the principle of proportionality to banking law, any framework at the European level dealing with proportionality risks being full of ambiguities. What is more, any discussion of a differentiated application of capital requirements and other regulatory requirements seems moot because of the standards developed by the Basel Committee on Banking Supervision (BCBS), also known as the Basel standards. The EU has made the fundamental decision to apply these standards to all banks established in the Union. The main rationale, besides competitive aspects of a level playing field which will be addressed below (2.2), was financial stability. This raises the more basic question of the relation of this goal and the principle of proportionality.

1.2 Proportionality and Financial Stability

Proportionality and financial stability are often presented as antithetical. One thesis is that proportionality is necessary to avoid excessive burdens on the industry. In particular, small and medium-sized banks often use "proportionality" as a catchphrase to underline that the current framework exceeds what is necessary to reach the goals of protecting depositors and the functioning of the financial markets. The thrust of the argument is that the wave of new regulations introduced after the financial crisis would respond to problems primarily created by large or "systemically significant" institutions. While these institutions would be able to weather the regulatory storm, it would fall much harder on smaller banks, which do lack the staff, the expertise and the financial means to keep abreast of every new detailed regulatory requirement. In essence, this thesis is that small institutions get punished for problems

caused by the big players. Proportionality is invoked as a plea for a quick reform of this lopsided situation.

The antithesis, which tends to coincide with the views of regulators and supervisors, is that proportionality may produce dangers for financial markets. In particular, it is highlighted that the application of diverging sets of rules to banks operating in the same market may undermine its stability (e.g. Lautenschläger 2017). It is also true that small banks are not per se less risky (cf. Boss et al. 2018). Indeed, the last crisis was by no means restricted to large and interconnected institutions, but also involved smaller institutions such as savings banks, which had distributed complex and opaque products to their clients without properly advising them about the risks entailed. Moreover, one must remember that many small institutions pursue the same business model and form mutual liability arrangements via institutional protection schemes, as a result of which they may together become systemically relevant (e.g. Lautenschläger 2017). Besides, critics point to the (negative) implications of proportionality for competition (e.g. Lautenschläger 2017). Particularly one can often hear the complaint that any exceptions for smaller institutions could damage the competitive level playing field for all institutions in the Union and the idea of a Single Rule Book (see on this point: below 2.2). In short, the antithesis is that the maintenance of the stability of the financial system, understood in a holistic sense, would not allow for any different treatment of large and small banks.

In this debate, mainly conducted between small enterprises and regulators, it is often forgotten that the thesis and the antithesis can be combined to a synthesis. Proportionality must not necessarily be considered as an antagonism to stability, but can actually contribute to the latter. To see why, one must take into account the negative effects that inadequate and overly burdensome regulation can have on a diversified banking landscape (see Lautenschläger 2017; Dombret 2017). Legal requirements that are practically or economically burdensome to fulfil threaten the business model of small- and medium-sized institutions, which is focused on simple transactions and local markets (Dombret 2017). These institutions cannot rely on large economies of scale that would provide the financial means to deal with complex regulatory or supervisory requirements. Sooner or later, such requirements will have the effect of diminishing their relative importance or driving them out of business altogether.

The reduction or elimination of small and medium-sized institutions from the market would deal a considerable blow to financial stability. A diversified banking landscape is one of the most efficient guarantors against financial crises. It impedes the concentration of risk in a few institutions that threaten

to become systemically important. It thus acts as a bulwark against the "too big to fail" problem, which has loomed large during the financial crisis and allowed big banks to take the states and the taxpayers as hostages to secure their own survival. The more a state can rely on small and medium-sized banks for the provision of capital to the economy and households, the lesser it will be subject to a quasi-form of extortion by large institutions. Furthermore, a diversified banking landscape also spurs healthy competition and avoids overpricing and exploitation of consumers as well the creation of bubbles (see: Dutch Central Bank 2018). Such bubbles often arise through the failed judgement or fraudulent practices of a handful of players that are not subject to control or competition by other institutions. The existence of small and medium-sized banks ensures that in the event of—in the long run—inevitable miscalculations and malpractices, there will be a variety of different institutions with independent decision-making processes that have the potential of not succumbing to the same vices.

In sum, it is wrong to think that one would have to make "trade-offs" between proportionality and financial stability. Quite to the contrary, proportional regulation and supervision has a healthy effect on financial stability. It provides the fertile ground without which a diversified banking landscape cannot exist. Regulators should therefore be wary of pushing the regulatory requirements to the limits by imposing them on institutions that are unable to competitively comply with them. Such a strategy is counterproductive: Rather than reducing stability risks, it is bound to increase them. Overregulation and excessively bureaucratic supervision feed the run for size and the elimination of smaller banks. One must also bear in mind that unnecessary and inadequate regulation and supervision create costs for the taxpayer and draw away staff, time and resources from the supervision of those institutions that pose the gravest risks. Though it is undeniable that risks may arise from institutional linkages between small institutions, these risks are macro- and not microeconomic in nature. They are thus best dealt with by macroprudential supervisors, such as the European Systemic Risk Board (ESRB), and not by imposing an overly stringent microprudential regulation and supervision.

By adopting "a one size fits all approach" and submitting small institutions to the same rules as the larger ones, the regulator paradoxically adds to financial instability itself by annihilating the diversified banking landscape. In its restless quest to avoid any risks resulting from individual institutions, it creates new ones that are structural in nature and hence much more difficult to combat. Proportionality counsels instead to strive for a balanced approach: Act against risks wherever they may arise, but in proportion to their likelihood and the extent of the effects that they may have. This does not mean that

small and medium-sized institutions should be absolved from legal requirements and supervision. But their regulation and control should be measured to their size, business model and the risks they pose.

1.3 Proportionality and Regulatory Competition

Regulators and supervisors do not act in a vacuum. They are surrounded by other jurisdictions, whether "offshore" or "onshore", in which financial firms can be established. Given the incorporeal nature of financial services, they can easily be rendered cross-border. The low costs of moving a financial firm give an additional incentive for firms to select the most convenient jurisdiction and engage in "regulatory arbitrage" (see Riles 2014; Ringe 2016; Zetzsche 2016). "Exit" plays a double role as "voice". Therefore, states vie for keeping existing firms and attracting new ones to their territory, whether it is with a view of generating additional tax revenues and creating high paid jobs or simply with the aim of improving their financial sector as a stable source of funding for their economy. In this way, regulatory arbitrage produces regulatory competition (Ringe 2016). While burdensome regulation is not the only parameter on which states compete with each other, it is certainly one of them.

In this competitive context, the principle of proportionality is of the essence. A state that would enforce regulatory standards without consideration of whether they are necessary and appropriate will not only forgo the opportunity to become a financial hub. It will also eradicate the domestic industry and, as a consequence, lose its clout on the regulation and supervision of financial firms. The latter will for the most part establish their seat abroad and serve the market of the state from there. Accordingly, the state will become an importer of financial services or "distribution country" (Zetzsche 2016). On the other hand, a state with standards that are too lax may at the beginning attract some firms to its territory, until the point when clients become aware of the lack of regulatory oversight and scandals break out. This state is missing proportionality in an opposite, but equally damaging way. The goal must therefore be to strike a balance between providing efficient supervision that is tailored to the needs of a highly sophisticated industry and stringently enforcing the standards of financial regulation to sort out those bad players that endanger the protection of clients and thereby damage the reputation of the state as a financial centre (Zetzsche 2016).

Finding the golden equilibrium in financial regulation and supervision is not an easy task. It is even more complicated by the fact that the environment in which financial firms operate is constantly changing. This requires a dynamic

approach to regulation and supervision: The requirements must constantly be assessed in terms of the necessity and adequacy of the cost they entail for firms with respect to the goals pursued by the regulator. In this context, at no time must a state lose sight of what the other states do. Like a private entrepreneur, it cannot afford to be complacent by failing to observe the moves of its competitors. This is true even for the EU with its immense internal market, given that many of the financial services it consumes are provided by firms operating in third countries, such as the United States and—soon—the United Kingdom. When one of these financial centres relaxes its rules, the EU is faced with the unenviable choice of having to cut itself off from foreign liquidity or seeing its own firms being overrun by third-country competitors. Restricting market access for third-country firms may not pose many problems from a legal perspective, but is economically difficult where the domestic firms are not (yet) capable of providing enough liquidity for domestic businesses. The best option is therefore for the Union to critically reassess its own regulation in light of the deregulatory efforts in the third countries. Every rule that other regulators dispense with should be again put on the table and its necessity reappraised. That does not mean that all regulations should be tagged with a sunset clause. But over time, the regulatory rulebook has the tendency to accumulate slack that is no longer indispensable. Whoever leaves it in force risks losing out to its competitors.

Proportional regulation is thus not only necessary from a stability perspective. It is also inevitable if a state does not want to fall behind others in its attractiveness as a financial centre and precipitate an exodus of its domestic financial industry to other parts of the world. Given the many linkages between the financial industry and the manufacturing or service industry, this would ultimately have a backlash on its "real" economy. A strong economy without an equally strong financial industry is hard to imagine, unless one is ready to accept that credit and liquidity is provided by third countries over which one has little or no control. If, on the contrary and one wants to create and preserve a strong domestic financial industry, the adoption of proportional regulation is essential.

2 Legal Aspects of Proportionality

2.1 Proportionality as a Principle of Primary Law

Proportionality features prominently in a treaty that is of fundamental importance for the EU, namely in Article 5(4) of the Treaty on the Functioning of the European Union (TFEU). This position is important since primary law binds the legislative, the executive and the judiciary. As a consequence, not only the

supervisory authorities European Banking Authority (EBA), European Securities and Markets Authority (ESMA), European Insurance and Occupational Pensions Authority (EIOPA) and the European Central Bank (ECB) must comply with the principle, but the Commission, the European Parliament, the Council and the Court of Justice of the European Union (CJEU) as well. The latter has recognised the importance of the principle of proportionality for financial services for decades (see e.g. ECJ 10 May 1995, C-384/93, Alpine Investments).

According to Article 5(4) TFEU, the principle of proportionality means that "the content and form of Union action shall not exceed what is necessary to achieve the objectives of the Treaties". Although this provision directly concerns only the relation between the Union and the Member States, as opposed to that between the Union and individuals, one may glean that proportionality must be respected on two different levels: content (i.e. substantive requirements) and form (i.e. procedural requirements). If one transposes this dichotomy to finance, it becomes clear that both the regulation and the supervision of financial firms have to be proportional. The words "all Union action" indicates that Level 1, 2 and 3 acts alike have to comply with the principle.

In addition to EU measures, the proportionality principle also extends to national measures in two circumstances: First, where they interfere with fundamental rights, and second, where they implement EU law. In both instances, national measures must not go beyond what is necessary to achieve their objective, which must be in line with the Treaties.

2.2 Is Proportionality Incompatible with the Single Rule Book?

This chapter will briefly discuss the background of the Single Rule Book and the closely related establishment of the European System of Financial Supervision (ESFS), particularly with respect to the role of the European Banking Authority in connection with the Binding Technical Standards underpinning the Single Rule Book (see also: Moloney 2014; Singh 2015; Howarth and Quaglia 2016; Burns et al. 2018). We will focus on the question of whether the Single Rule Book leaves sufficient room to a proportional application of the regulatory framework.

The Single Rule Book aims at the establishment of uniform requirements for all financial firms in the EU. This aim seems to imply a one-size-fits-all approach that does not distinguish conceptually between small and large firms but in principle submits them to the same rules. The rationale of the Single Rule Book can thus clash with the principle proportionality. This is best explained by Dombret (2017):

> *The motivation for this one-size-fits-all-regulation was to have a single set of rules for the single market. The EU's primary goal of a common, single market meant that one single set of rules was preferred over differentiated sets of rules. Proportionality—the principle that rules must be proportionate to the issue they address—played only a secondary role.*

The author goes on to highlight that there were good political reasons to do so, but that this had serious "side effects" for smaller institutions. A more fundamental issue, however, remains open: Is proportionality indeed incompatible with having a single set of rules for the single market?

To answer this question, it is necessary to clarify the concept of the Single Rule Book. The concept was first promoted by the De Larosière Report (2009). The Council took it up in the context of the creation of the European System of Financial Supervision (ESFS) with three new European Supervisory Agencies, EBA, ESMA and EIOPA. One of the reasons that the Council cited for the ESFS was "establishing a European single rule book applicable to all financial institutions in the Single Market" (Council of the European Union 2009).

This statement is not as unambiguous as it seems. One possible interpretation is that the Council wanted the same rules to govern all financial institutions. But one can also imagine that the idea was to enact the same rules throughout the EU, with the possibility of differentiating between diverging categories of institutions. Such an understanding is not entirely implausible given that the Council did not question the diverging rules that still apply today to banks and investment firms on the one hand and insurers on the other, despite the fact that all three have been made subject to the newly created European System of Financial Supervision. If such fundamental distinctions are possible, it could also be envisaged that the Single Rule Book will draw additional lines between small and large financial institutions.

Which of these interpretations is correct depends on the Single Rule Book's purpose. If its goal was to eliminate legislative differences between the Member States, then it would have sufficed to harmonise banking law in the EU, leaving open the possibility of providing different rules for different institutions. If the goal was to level the competitive playing field for banks across the EU, then it may seem to require at first sight the imposition of a uniform set of rules. However, one should not forget that the same rules have very different effects on small and on large firms (see: above 1.2). Thus, imposing uniform requirements on all types of institutions does not in reality level the playing field, but tilts it in favour of large institutions, which are most likely to emerge from the once diversified banking landscape.

These points make it unlikely that the Council intended to impose uniform rules across the board regardless of the type of institution. The term "Single Rule Book" must be conceptualised differently: Its goal is to strengthen supervision and regulation in the EU by eliminating differences between the Member States and between supervisory agencies, thus combatting regulatory arbitrage in the EU. This does not in any way exclude the possibility of distinguishing between different types of institutions as long as all institutions are treated the same regardless of their origin. The Single Rule Book can therefore have several chapters, each of which addresses different types of institutions.

2.3 The Requirements of Proportionality

At a theoretical level, the proportionality analysis can be divided in three steps (Alexy 2014). On the first step one verifies whether a measure is appropriate or suitable to achieve the objective intended, that is, whether it can reach its goal. At the next level, the necessity of a measure is subjected to a "least restrictive measure" test by controlling whether the measure is necessary to achieve the objective or whether there is a less restrictive measure with which the same objective can be achieved. Finally, there is the balancing test: the measure must not be excessive or disproportionate to the objectives sought.

The CJEU does not follow these three steps consistently. Measures by the Union are mainly subjected to the balancing test, while acts by national legislators and regulators tend to be submitted to the "least restrictive measure" test. Overall, the guiding principle is that the test applied will be stricter as the impact imposed by the measure increases (De Búrca 1993; Jans 2000). It follows, for instance, that the withdrawal of a banking licence will be subject to a much more scrupulous proportionality control than a mere request for information.

Within the balancing test, the weight of the objectives pursued by the regulator becomes relevant. In the current times, the objective of maintaining financial stability is of paramount importance. Yet this alone does not justify the imposition of any type of administrative burden or restriction on a financial institution. Proportionality also requires looking at the risk posed to financial stability by the institution. The rules must be tailored so that the burden and restrictions are not disproportionate to the risk caused. There is widespread agreement that the risk posed by an institution cannot simply be determined by looking at its size. Other factors must be included as well, such as the complexity of its business model, its connection to other institutions and its risk profile (Boss et al. 2018; Lautenschläger 2017). All of these factors should be looked at from a holistic perspective rather than in the abstract.

A crucial question is whether the complexity of regulation itself can be disproportionate. The regulatory wave following the financial crisis has produced myriads of rules on three different EU levels and at least as many levels of national law. A firm has to concurrently read these rules to know what is actually demanded from it, a task that can, for all practical purposes, only be managed by hiring expensive legal counsels. On an empirical level, more complex regulation leads to additional administrative burdens because it requires more time, staff and expertise to manage. Therefore, overly complex regulation is not only economically inefficient, but also contravenes the law because it violates the proportionality principle. Whether regulation is too complex cannot be determined in the abstract but depends on the complexity of the phenomenon regulated. As a yardstick, one can use the rule that a simple business model should lead to lighter regulatory and supervisory compliance burdens, provided that a certain level of minimal capital and liquidity requirements are maintained at all times. Large, sophisticated banks with a variety of offerings justify more complex regulation.

3 The Current Approach of the EU to Proportionality

3.1 Proportionality with Regard to the Banking and Insurance Sector

The most important reason to develop the Capital Requirements Regulation (CRR) and Capital Requirements Directive IV (CRDIV) legislative framework has been the need to adopt the standards as laid out in the Basel III accord on capital and liquidity of 2010 (BCBS 2010a Capital; BCBS 2010b Liquidity) as well as the standards of the Financial Stability Board for a framework for supervision of systemically important institutions (FSB 2010). With these important main standards, the lessons from the financial crisis have been incorporated in a much more stringent prudential regime for banks and other financial companies in Europe applicable from 1 January 2014. Many other policy considerations are the foundation of the turnaround of banking legislation in the last decade. The establishment of the ESFS in 2010 is to be mentioned as an important cornerstone of the completely reshaped regulatory landscape for the European banking industry. Amongst others, the establishment of EBA and the delegation of powers to the European Commission in framework legislation have contributed to the establishment of a massive body of substantive banking law comprised in the Single Rule Book that

applies, in principle, to any business in the Union that meets the definition of a "credit institution".

CRR and CRDIV, together with all binding technical standards adopted by the European Commission based on mandates included in the Level 1 framework legislation, are significant constituent parts of the Single Rule Book for banks. The substantive rules contained in these legislative instruments are, in principle, to be applied by each bank established or active in the EU. The current bank substantive law, generally, does not differentiate between types of banks nor does the law uphold thresholds that reduce the scope of applicability.

The insurance sector provides a counter-example. There, thresholds operate to reduce the scope of applicability of the European prudential framework to the larger insurers established or active in the EU. The Solvency II Directive (Directive 2009/138/EU) defines the scope of applicability by looking at the volume of revenue (premium income) and size of the risks (technical provisions). Member states are obliged to incorporate such thresholds in their national legislation, which therefore means that national laws in the EU should embed the principle of proportionality by making only the larger insurance companies subject to the harmonised European prudential framework. This concept of differentiation in the scope of applicability of European prudential rules is not a feature of banking regulations.

3.2 Elements of Substantive Proportionality in Banking Regulation

The absence of a generic operator to define the scope of applicability of bank prudential rules in the CRR and the CRDIV does not mean, however, that application of the rules is required in each case. An important feature of the prudential rules enshrining proportionality is embedded in the modular approach of the capital requirements imposed on banks. This modular approach is in its nature a translation of the principle that rules imposed on banks are not going beyond what is necessary in order to achieve the objective of prudential supervision. The modular approach is based on a number of concepts that are included in the legislative framework.

Firstly, quantitative capital requirements apply for banks aligned with the type of risk taken by banks. From the outset, Article 92 CRR, which is the core provision dealing with capital requirements, defines capital requirements in accordance with the various risk exposures that are identifiable by a bank in view of the type of activities undertaken and services offered by banks. For instance, a bank that does not deal on own account in financial instruments

shall not be subject to the rules addressing market risk in trading portfolios. Such a bank shall not be required to apply the CRR provisions that define the quantification of market risk and the capital requirements following from such quantified risk. A bank that is not offering mortgages to corporate businesses shall not be dealing with the various rules concerning the definition of the risk exposures in the commercial mortgage financing sections of the CRR.

Secondly, and importantly, the current framework for prudential rules for banks is based on the foundations of the different approaches towards quantification of risk as developed by the Basel Committee and which were launched in 2004 following the adoption of the Basel II accord. Such different approaches permit the application of rules following the standardised approaches or quantification methods based on internal models. Standardised approaches provide for supervisory methods to quantify the risk exposures in the main risk families, that is, credit risk, market risk and operational risk.

Within these three risk families, detailed methodologies may be applied for sub-sections of the risk exposure categories. For instance, differentiated approaches may be applied within the credit risk family for the assessment of securitisation exposures, applied financial collateral in the context of credit risk mitigation and other sub-segments of this risk family. A comparable framework exists for the other risk families, which allow banks to choose between either applying a standardised method or their own modelled risk quantification methods.

Thirdly, in certain instances, competent authorities may exercise discretion to exempt banks from the application of prudential rules set out in the CRR and CRDIV. For instance, the liquidity management rules set out in Part Six CRR apply to each credit institution on an individual basis. Based on Article 8 CRR, the competent authorities may waive in full or in part the application of Part Six to a bank (and all or some of its subsidiaries) if the liquidity supervision is exercised on consolidated basis. Such a waiver will provide relief from reporting requirements in a significant way for the individual institution concerned. In other cases, this exemption follows from the provisions of the CRR and may be applied without the need for the exercise of discretion by the competent authority. For instance, the provision of Article 84(6) CRR exempts credit institutions affiliated in a network or a central body and institutions established within an institutional protection scheme from the required deductions from capital of cross-guarantees. Such an exemption, therefore, facilitates the manner of capitalisation of such groups of credit institutions and provides relief from the stringent effects of CRR that aim to reduce the dependency on interbank funding.

3.3 Procedural Proportionality

Notwithstanding these "indirect" manners of applying proportionality with regard to substantive requirements, in the area of procedure, there is a more explicit reference to proportionality. This concerns, in particular, the application of the rules on the engagement of the supervisory authorities with the individual institution in the context of the review and evaluation process to be conducted by the competent authorities, the so-called SREP. Pursuant to Article 97(4) CRDIV, proportionality must be taken into account when applying the SREP. The provision reads as follows:

> *Competent authorities shall establish the frequency and intensity of the review and evaluation referred to in paragraph 1 having regard to the size, systemic importance, nature, scale and complexity of the activities of the institution concerned and taking into account the principle of proportionality.*

This provision may be seen as an implementation of the proportionality principle in the sense of primary EU law, particularly in regard to the "form" of the proportionality, as explained in para. II.2. The reiteration of this principle in Article 97(4) CRDIV emphasises the need of compliance not only by EU institutions, but by member states and national competent authorities as well. EBA has provided the EBA SREP Guidelines on the application of the provision of Article 97 CRDIV, which also address the proportionality principle of the fourth paragraph of this CRDIV provision as cited above.

In the EBA SREP Guidelines, a further methodology is provided on the application of the SREP observing the principle of proportionality. EBA developed a model to apply methodologies on the basis of proportionality and classification of institutions depending on size, complexity and cross-border activity. EBA classifies banks in four separate categories according to their systemic importance and the level of cross-border activity. Within these four categories, distinctions are made with respect to the supervisory engagement and the several types of stress testing, ranging from "a simple portfolio level sensitivity or individual risk level analysis to comprehensive institution-wide scenario stress testing" (Guidelines, p. 8). Based on the supervisory engagement model, as laid out in the Guidelines, smaller banks are supposed to obtain a different and lighter touch treatment in respect of the SREP (less frequent and less detailed) than a large internationally active bank, which is considered to be systemically important (at least once per year and following templates with great granularity). The overall model developed by EBA per-

mits a differentiated approach and suggests a significant alleviation of the burden for smaller institutions and, therefore, a proportionate approach.

It is not clear in which way the model developed by EBA is actually applied in practice by the supervisory authorities in the Union. At any rate, the ECB has endorsed the guidelines and has promulgated the application of the principle of proportionality in its approaches to the SREP for the directly supervised banks in the SSM (see ECB 2017). Furthermore, in 2018, the ECB provided guidance to the national competent authorities in regard to the SREP methodology for "Less Significant Institutions" (LSI) (see ECB 2018, p. 3, "The underlying principles of the SSM LSI SREP methodology"), in which an explicit reference is made to the proportionality principle when applying the SREP. This guidance of the ECB should serve to steer the national competent authorities that are directly supervising the LSI's to apply a differentiated approach (as set out in the EBA SREP Guidelines) when conducting the annual SREP review.

3.4 Proportionality in the Context of Better Regulation and Regulatory Fitness and Performance (REFIT) Programme

In the context of the execution of the Better Regulation and REFIT agenda of the Juncker Commission, a call for evidence was organised in 2015 to obtain views and opinions on the market and of the member states as to the combined impact of the new regulatory environment for the financial sector adopted after the financial crisis. The Call for Evidence listed fifteen areas where the Commission solicited the views of the market and member states on the impact and constraints experienced with the application of the body of financial law. Two of these topics particularly concerned the topic of proportionality and the burden created for market participants under the headlines "Proportionality/preserving diversity in the EU financial sector" and "Excessive compliance costs and complexity".

The former topic aimed at investigating whether EU rules prevented the development of a sufficiently diverse financial sector throughout Europe and whether these rules are sufficiently adapted to the "emergence of new business models and the participation of non-financial actors in the market place" (Call for Evidence, p. 6). The latter research field focused on the prescriptive nature of rules introduced after the financial crisis and the question as to whether these rules weaken the sense of individual responsibility.

The Call for Evidence produced a substantial response from the market and member states, where the topic of proportionality has been one of the main areas of discussion. The ensuing report of 2016 paid specific attention to the many comments made by participants during the consultation on the topic of proportionality and the excessive burden for the financial sector. The conclusion of the Commission, based on the contributions made in this consultation, has been that the overall legislative framework for the financial sector works well, but that in certain areas further improvements or a shift in policy is needed (Call for Evidence Report, p. 3). The four main areas in which improvements of the existing legislative framework must be sought are:

1. reducing unnecessary regulatory constraints on financing the economy;
2. enhancing the proportionality of rules without compromising prudential objectives;
3. reducing undue regulatory burdens; and
4. making rules more consistent and forward-looking.

The Commission confirmed in the Call for Evidence Report that the views expressed in the Call for Evidence have been integrated into existing legislative initiatives, where an explicit reference is made to the running proposals for the revision of CRR and CRDIV. Other legislative initiatives concern the adoption of the further measures in connection with the Capital Markets Union and the rules and regulations governing derivatives (European Market Infrastructure Regulation, EMIR).

Noteworthy is the explicit reference to the enhancement of proportionality in the list of objectives for the follow-up on the Call for Evidence. However, it should be stressed that the enhancement process will be required to preserve the general prudential objectives of the new legislative framework. In other words, the Commission makes the introduction of more flexible and proportional rules subject to the preservation of the stricter prudential environment shaped after the financial crisis.

Neither the comments supplied during the Call for Evidence consultation nor the remarks of the Commission in this context contain reasoning as to the fundamental question of whether the same banking rules should apply to all the credit institutions established or active in the EU no matter their size, business model or complexity of the relations of these banks in the financial sector. In the concrete proposals for the amendment of CRR and CRDIV, however, the Commission has suggested a proportional application of certain rules where the eligibility criterion to proportional application initially focused on the size of the institutions concerned. As we will see in the follow-

ing paragraph, this criterion is also likely to be supplemented with qualitative criteria, so that the size of the firm alone is not the only determining factor to apply the principle of proportionality.

3.5 Proposals for Reform: CRR2 and CRDIV

Additional measures to increase the proportionality of some of the requirements for banks under the existing CRR and CRDIV framework have been introduced in the proposals for CRR2 and CRDV by the Commission of November 2016 as part of the Risk Reduction Package. These measures relate to reporting, disclosure and remuneration.

Regarding *supervisory reporting*, EBA will be tasked with preparing a report to the Commission as to the development of a revised supervisory reporting framework which considers the burden of banks and that allows a differentiation in reporting obligations taking into account their size, complexity and the nature and level of risk of their activities. Such report should in any event consider the development of flexible rules for banks that are defined as "small". The definition of a "small bank" is comprised in a new Article 430a CRR2 that serves as a pivotal provision in connection with the other rules introduced to enhance proportionality in the CRR framework. A "small institution" is defined in the proposed Article 430a CRR as "an institution the value of the assets of which is on average equal to or less than EUR 1.5 billion over the four-year period immediately preceding the current annual disclosure period". Small institutions shall be relieved from semi-annual supervisory reporting. This relief relates to the Common Reporting (COREP), specific reporting obligations on losses stemming from exposures pursuant to Article 101 CRR, reporting on asset encumbrance and reporting on large exposures pursuant to Article 394 CRR. In addition to the lesser frequency of the reporting, EBA is also tasked with preparing proposals for a modular approach concerning supervisory reporting, which reduces the degree of granularity in the reporting items, where the least detailed report shall be applicable for small institutions.

As to *disclosure*, a new Article 433b CRR is suggested to reduce the disclosure requirements for small institutions by reducing the frequency of reporting to (broadly speaking) an annual exercise and furthermore to permit less detailed disclosures by such institutions. This provision aims at reducing the burden of the disclosures for small institutions as a response to the otherwise intensified and increasing obligations pursuant to CRR2 for the larger institutions. In other words, the disclosure requirements for larger institutions under

CRR2 become stricter and require much more detailed disclosures than is currently the case. To alleviate the burden for smaller institutions, they will be permitted to omit compliance with these stricter requirements once CRR2 comes into force.

As to *remuneration*, a bespoke regime will be introduced in the revised CRDIV provisions that are supposed to be implemented in the legislation of the member states. The provision of Article 94 CRDV amends the current regime applicable to all banks (and investment firms) to the extent that banks with a value of assets which is on average equal or less than EUR 5 billion over the four-year period immediately preceding the current financial year or an institution where variable remuneration does not exceed EUR 50,000 per individual shall be permitted to apply derogations from the requirements to (1) distribute a portion of variable remuneration in the form of (financial) instruments issued by the institution and (2) briefer retention periods with regard to the variable remuneration distributed to employees.

The proposals of the Commission set out in CRR2 and CRDV have been subject to considerable debate in the preparation of the trilogue negotiations. The European Council adopted in May 2018 the Presidency Compromise text, in which a number of amendments to the original proposals were included. In reverse order to the discussion above of the Commission's proposals, the following amendments had been proposed.

As to the *remuneration*, the Council proposes to emphasise that any derogation from the remuneration rules may not be applied if the bank concerned qualifies as a large institution within the meaning of Article 430a CRR2. In this way, the Council has ascertained that the group of banks for which enhanced compliance with rules is mandatory (the large institutions) may not benefit from derogation of the remuneration rules. Furthermore, derogation may not be applied if the aggregate remuneration of staff per individual exceeds EUR 150,000, whereas the Commission proposed this number to be EUR 200,000.

As to *disclosures*, the Council made adjustments to the proposal of the Commission by deleting some of the derogations from disclosure requirements, therefore slightly taking back the effect of the alleviation from these requirements as compared to the original Commission proposal.

With regard to reporting, the Council more or less upheld the proposals from the Commission, which means that EBA is required to produce a report as to the differentiation of reporting obligations, both in terms of frequency and granularity, where small institutions should receive a proportional treatment and should at least be defined in the category of institutions with the lowest burden in respect of supervisory reporting.

The most interesting amendment to the Commission text as proposed by the Council relates to the redrafting of the definition of "small institution" as contained in Article 430a CRR2. Instead of simply referring to the size of the value of assets not to exceed the amount of EUR 5 billion, which represents a considerable increase in comparison to the Commission's proposal of just EUR 1.5 billion, the Council provided for additional criteria that define the eligibility of a bank to be considered to be "small". Further, cumulative, criteria concern:

1. the limited size of the trading book of the bank (the dealing on own account business);
2. the requirement that more than 75% of the bank's exposures must be with counterparties located in the EEA;
3. the application of standardised methods only for the assessment of risk exposure amounts and the refraining from the use of internal models; and
4. being subject to simplified obligations in relation to recovery and resolution planning in accordance with article 4 of Directive 2014/59/EU (BRRD).

The Committee on Economic and Monetary Affairs of the European Parliament issued its reports on CRDV and CRR2 on 28 June 2018 (Ref: A8-0243/2018 respectively A8-0242/2018). As to remuneration, the proposals of the Commission are more or less upheld, although the Committee increased the threshold from 5 to 8 billion euro to define the bank's size. In other words, the Committee relaxes the proposal to permit smaller institutions to derogate from certain remuneration rules.

The Committee furthermore suggested redrafting the CRR2 text and move the definitions of "small institution" and "large institution" to the definition apparatus of article 4 CRR. In a rephrased definition of the expression "small and non-complex institution" contained in Article 4(1)(144a) CRR2, the Committee upholds the balance sheet total of 5 billion euro as constituting the definition of a "small" bank as proposed by the Council (which deviates from the lower threshold of 1.5 billion of the Commission proposal). In addition to the criteria proposed by the Council to supplement the definition of a small and non-complex institution, the Committee also proposes to define a threshold for the volume of derivatives transactions entered into by the bank. Additionally, the Committee suggests to provide both the institution and the competent authority the power to object against the qualification as small and non-complex institution.

Finally, and most importantly, the Committee also proposes the introduction of a discretionary power of the competent authority to lower the 5 billion euro threshold to a lesser amount, if "it is [also] necessary to consider the size and risk profile of a small and non-complex institution in relation to the overall size of the national economy in which that institution primarily operates". With this proposal, the Committee aims to introduce the ability to incorporate domestic circumstances in the judgement as to whether banks are to be considered small and non-complex. If the banking sector in a member state consists of many smaller banks, lowering the quantitative threshold to a number below EUR 5 billion euro will enable the competent authority to retain the full powers to scrutinise the largest number of banks established in its territory. For these banks, less frequent and less granular reporting shall not be permitted. We consider this proposal a response to the "Too-Many-To-Fail" syndrome, where the prudential supervisory authorities may have concerns about their ability to supervise large numbers of smaller banks within their territory and the risk that leniency regarding the requirements to those banks may increase the risk of failure of one or more of the institutions with spill over effects to other institutions.

As for supervisory reporting, the Committee proposes to amend the language of the various provisions to include the defined concept of "small non-complex institutions", but refrains from recommending material amendments to the original concepts of the Commission. Therefore, the European Parliament seems to endorse the idea of introducing a proportional application of supervisory reporting for smaller and non-complex banks. The same conclusions may be drawn from the proposed amendments to the provisions dealing with disclosures.

3.6 Net Stable Funding Ratio for Small Non-Complex Institutions

Specific attention should be given to an additional proposal put on the table by the Committee to address proportionality for small and non-complex institutions. The Committee proposes an innovative alternative to the application of the new rules on the calculation and maintenance of the Net Stable Funding Ratio (NSFR) simplifying the burden for small and non-complex institutions.

The NSFR is a new ratio to underpin proper liquidity management by banks and stems from the Basel 2010 Liquidity standards. The NFSR requires banks to maintain sufficient stable funding to meet the maturity calendar of

outstanding assets. One of the objectives of the CRR2 amendments concerns the introduction in Europe of the NSFR as contained in the 2010 standards of the Basel Committee.

Small and non-complex institutions will, in accordance with the proposal of the Committee, be permitted to establish simplified ("less granular") calculations of the NSFR which, in conformity with the principle of proportionality, will on the one hand maintain the prudent ratio calculation by such smaller and non-complex banks, but on the other hand permit less rigorous calculations. The proposed amendment to Article 428b CRR2 reads as follows:

> Small and non-complex institutions may choose to calculate the ratio between an institution's available stable funding as referred to in Chapter 4a of this Title, and the institution's required stable funding as referred to in Chapter 4b of this Title, over a one year period and expressed as a percentage.

Chapters 4a and 4b Part Six CRR2, as proposed by the Committee, contain a rigorous simplification of the ordinary rules to calculate available stable funding and required stable funding by reducing the number of categories for which the calculations of both factors need to be made. The simplification takes away the granularity of the calculation method and permits, in brief, quicker and less complex assessments of the assets and liabilities, the maturities, inflow and outflow factors and considerations attached to such balance sheet items.

This important proposal adds, therefore, another element to the amendments to CRR as is currently proposed to address the principle of proportionality. The proposal for a specific and bespoke NSFR regime for small and non-complex institutions by its nature reduces the risk sensitivity of the liquidity ratio. The Committee believes that the lesser complexity of the banking books of small and non-complex business justifies such reduced risk sensitivity, while also maintaining a prudent standard of liquidity management for group of such banks.

3.7 State of Play as Regards Proportionality in the Single Rule Book

The original proposals for CRR2 and CRDV of the Commission to address proportionality with respect to reporting, disclosure and remuneration that were launched in 2016 have evolved to a framework that, if the proposals of the European Parliament are upheld, creates higher thresholds for the applica-

tion of flexibility in respect of remuneration, and introduces a more sophisticated definition for the scope of application of less stringent rules on supervisory reporting and disclosure for smaller banks. The purely quantitative criterion as proposed by the Commission has been supplemented with qualitative criteria in both the CRR2 amendment proposals of the Council and the European Parliament. These qualitative criteria seek to identify complexity in the business model of banks, for instance, by looking at the proportion of the bank's business related to the (risky) dealing on own account and the application of derivatives for other purposes than to hedge the (corporate) risk of the bank. We find that this development of quantitative and qualitative criteria to define the distinction between banks eligible for proportional treatment and banks that are not eligible is steering the discussion in the right direction.

We nevertheless note that the utilisation by the European legislator of both quantitative and qualitative criteria, where the threshold of the quantitative criterion is set at EUR 5 billion (or the lower amount set by the competent authority if the European Parliament proposal is followed), does prevent the assessment of cases of larger banks with a purely domestic and non-complex business model. In our view, also such banks should be eligible for a more proportionate application of various rules stemming from the Single Rule Book. There are no convincing reasons to subject banks with larger balance sheets with a very low risk profile to the full application of the CRR and CRDIV rules. This becomes even more relevant if such banks refrain from taking deposits from the general public or, as is the case in many member states, are part of the public treasury infrastructure with the objective of differentiating the funding sources for public finance. Historically, such banks tend to be fully owned by the member state and should therefore be considered as belonging to the body of public authorities, even if they are organised as a commercial bank. Often, such banks have limited purpose activities (such as financing local governments, utilities and public infrastructure) and are prohibited from increasing the risk profile of the bank by developing other (commercial) business. The risk profile of such banks is low, and by means of statutory embedding of restricted activities objectives, it may be expected that such banks will continue to keep a low risk profile.

Another development that has to be welcomed is the introduction of additional elements in the Single Rule Book for which proportional application of rules by small and non-complex banks is permitted. The proposals define two sets of rules to calculate the NSFR differentiating between a model with great granularity and one with less detail. These suggestions must be applauded. They introduce proportionality in an area of compliance that is perceived to

be extremely cumbersome and, in view of the original framework stemming from Basel 2010-Liquidity, a true overshooting of rules for smaller and non-complex banks. This proposal is a clear response to the complaints by the market participants in respect to the original proposals for CRR2 and CRDV of November 2016 that the application of proportionality to a few areas (reporting, disclosure and remuneration) was not far-reaching enough and should have been extended with other areas as well.

Where recent developments with respect to the Single Rule Book point in the direction of a better and more comprehensive application of the proportionality principle to the rules included therein, the question remains whether there are justifications to take even a further step for banking regulation, in particular the introduction in Europe of a Two-Tier Single Rule Book.

4 An Outlook: A Differentiated Approach to EU Bank Regulation and Supervision

The main consequence that follows from the application of the principle of proportionality to the area of banking law is the inadequacy of a "one-size-fits-all" approach. Smaller institutions pose less risk and are comparatively harder hit by regulatory burdens than big ones. The rules governing such institutions must reflect this difference. An indiscriminate enforcement on all financial actors irrespective of their size, complexity and risk profile would not be proportional and contradict primary law.

Differentiating between institutions is therefore, in our view, a legal imperative. The question is how such differentiation shall be implemented. Two conceptually different models are possible. On the one hand, it is possible to start from the presumption that the same rules apply to all financial institutions, and then grant some exemptions for smaller banks. This is the method followed by the EU in the CRDIV/CRR, and though the exemptions will be amplified, the method will be kept for the revisions after adoption of CRDV and CRR2. The other method is to suggest different sets of rules for different categories of banks. The rules for one category may be a source of inspiration for the other, but the starting presumption would be that the rules that apply to large and complex banks are not the same as those applying to small and simple businesses.

Which of these two methods is to be preferred? Having a single regime for all banks with some exemptions for smaller institutions may be said to be in line with regulatory efficiency because it avoids drafting two completely dif-

ferent sets of rules. It also seems, at least superficially, to correspond to the need of a competitive level playing field (but see above: 2.2). Furthermore, providing individual exemptions has the advantage of giving flexibility, as they may be tailored to different types of businesses by the use of different conditions to be fulfilled. Finally, this model is also easier to sell at the political level (Boss et al. 2018).

Yet creating exemptions for smaller institutions does little to change the main deficiency of the current law, which is regulatory complexity. On the contrary, adding exemptions here and there even increases the abundance of existing rules. If the conditions of these exemptions are drafted divergently, their application will raise intricate challenges for compliance and supervision. Firms and supervising authorities will have to constantly monitor whether the conditions of the exemptions are (still) fulfilled. Moreover, taking the existing rules of the CRR and the CRD IV and also applying them in principle to smaller banks misses the basic problem that these rules have been crafted in the framework of Basel III for large and internationally active banks. To use them as the starting point for small institutions belies a misunderstanding of the requirements of proportionality.

For these reasons, a separate set of rules for different types of credit institutions is to be preferred (Joosen et al. 2018). This can take different shapes and forms. One model would be a "small banking box" (Dombret 2017). The "Pillar 1 + Approach" developed in Austria goes in the same direction (Boss et al. 2018). Another possibility is a two-tier banking law (Joosen et al. 2018). The last model would have the advantage of aligning substantive requirements with the already existing distinction of significant and non-significant institutions in supervision. Moreover, a simple threshold definition coupled to balance sheet size formed the original threshold definition for the proportional application of certain CRR provisions to smaller banks. It may be questioned as to whether the size of a bank alone is a sufficient criterion to shape a body of substantive banking law with different levels of application (see Joosen et al. 2018). In our view, a large, but exclusively domestically operating bank with a very simple business model should also be eligible for proportional treatment of banking laws. At the same time, we recommend that a small bank with significant cross-border presence and a complex business model may not necessarily be eligible for a more lenient approach. Therefore, we welcome the further developments in the CRR2 text, introducing, next to the size-criterion, a set of qualitative criteria that should be taken into account to define "small and non-complex banks". We would like to suggest that such qualitative criteria should rather be proposed as an alternative to the "size-criterion" as we believe that the dosage in the application of substantive rules

for banks and the procedural supervisory processes should be determined by the complexity of the bank and not its size.

The separation into different sets of rules creates the problem of regulatory arbitrage. Firms could try to game the criteria used for distinguishing between the two sets of rules to switch into the lighter regime. Although the possibility of circumvention is not totally absent when exemptions are provided from individual rules, this danger is mitigated by the different conditions of each exemption, which make it difficult to play with them simultaneously. The problem is, however, not unsolvable. The SSM Regulation provides a mechanism that allows the ECB, on its own initiative, to extend its supervision to institutions that do not fulfil the criteria of a significant institution (Article 6(4) sub-paragraph 3 SSM Regulation). A similar mechanism could also be used for the substantive regime.

In sum, a differentiated approach to banking regulation and supervision is the only way to comply with the requirement of proportionality of primary European law. At this point, a two-tier approach seems the most promising and sufficient to comply with primary law. We would hope that less complex banks be able to benefit from a similar simplified prudential supervision regime as now will be introduced for investment firms by the introduction of the IFR/IFD framework. In the future, it may be possible to improve the regime even further and distinguish between three or even more types of institutions. The limit of such distinctions is reached when the distinctions themselves result in overcomplexity.

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