Yannis Stournaras: Proportionality in European banking regulation

Keynote remarks by Mr Yannis Stournaras, Governor of the Bank of Greece, at the Conference on "Proportionality in European Banking Regulation", organised by the Bank of Greece and the University of Piraeus, Athens, 13 February 2017.

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Ladies and gentlemen,

It is with pleasure that I welcome you to this conference on the principle of proportionality and its relevance for banking regulation, supervision and resolution.

Of course, proportionality is a well-established general principle of European law. As a standard of public law, it has a long pedigree in both national and European law. And in more philosophical debates, it has always served as a point of reference for theories of justice. Indeed, the original formulations relating to proportional justice can be found in the writings of Plato and Aristotle. This arguably makes Athens an apt location for carrying on the debate in a contemporary context.

But why should proportionality be discussed in specific relation to banking regulation? And why has this particular debate only recently flared up?

The answer lies in the wide concept of proportionality, which informs the banking debate. The demand for proportional banking regulation goes beyond the technical legal use of proportionality as a standard of judicial review!

Regarding the narrower legal use of the concept, it is quite clear that lack of proportionality can be invoked as a ground for impugning particular legislative or administrative measures of the European Union, or national measures of the Member States which implement European law. However, the intensity of judicial review on this basis will typically be low, since for measures which entail policy decisions or involve complex assessments of the technical and economic situation, the courts will recognize a wide margin of appreciation to the legislative or administrative authorities and only overturn a measure if they consider that this is ‘manifestly inappropriate’. Now, the elaboration of prudential standards in the banking field is likely to entail precisely such complex technical evaluations on the part of the Union’s legislative and regulatory decision-makers; the same applies to a very large extent to the making of individual supervisory decisions. For this reason, the actual decisions of banking regulators are likely to be overturned by the courts only in rare and exceptional circumstances. And rightly so! A cautious and rather sparing judicial interference in the practical working of the banking regulatory and supervisory system, is fully justified by the comparative advantages of administrative, as opposed to judicial, decision-making in this field.

However, there is another, wider concept of proportionality that we should consider: that is, proportionality in the sense, not merely of a technical standard of administrative law, but of a broad constitutional ideal, which should guide all official actions in the Union.

This wider notion, which is more congenial to the thinking of economists like me, is explicitly entrenched in the text of the Treaty on European Union. Indeed, article 5 of the Treaty states clearly that “[t]he use of Union competences is governed by the principles of subsidiarity and proportionality”. The same provision further clarifies that, “[u]nder the principle of proportionality, the content and form of Union action shall not exceed what is necessary to achieve the objectives of the Treaties.” The provision was inserted in the Treaty primarily with the intention to regulate the Union’s legislative and general policy-making measures, rather than the administrative decisions, through which the European rules, standards or policies are applied to individual cases at the supranational and national levels.

This wider concept of proportionality as a regulative principle of European standard-setting, requires careful and responsive policy- and rule-making. More to the point, it requires the selection of the least burdensome or restrictive approach in order to achieve our regulatory objectives. This can only be achieved through a careful balancing of interests –the promotion of public objectives versus the rights and legitimate interests of private individuals and enterprises; the exercise of European competencies versus the preservation of the policy autonomy of the Member States– and the weighting of the potential costs against the benefits of particular policies and tools. To put it differently, proportionality requires properly calibrated European responses to well-identified problems and is inimical to heavy-handed, blanket, one-size-fit-all approaches to legislation and regulation. In this demanding but valuable sense, proportionality is closely linked to notions of equality and equity, also including the notion of proportional equality, which requires us to treat similar cases in the same manner, but to differentiate between dissimilar ones. It is also linked to the need for respect for fundamental rights and Treaty freedoms, including the right to property and the freedom of economic activity.

Proportionality, then, stands here as a short form for a constellation of closely related principles and values, which, we, as regulators and supervisors, have a duty to serve: equality, legal certainty, individual rights, and good administration. This concept of proportionality has recently become a major theme in pan-European discussions of banking regulation – and for good reason. It subsumes more specific discussions on better regulation, simplification and the need for differentiation. And it provides a framework for the evaluation of existing rules and practices, and a compass for their elaboration and improvement.

Why has this debate gained traction now, and not in the past? I believe that three specific aspects of the post-crisis regulatory architecture explain, and also justify, the emergence of proportionality as a core concern in European banking regulation.

These three aspects of the post-crisis European regulatory architecture have greatly increased the significance of the matter:

- First, the shift from the old approach to prudential standard-setting for credit institutions, which was based on no more than a minimum harmonization at the European level, to a new system of almost full Europeanization of the applicable norms. The intensive legislative activity which followed the Global Financial Crisis, culminating in the enactment of the Capital Requirements Directive IV and the Capital Requirements Regulation, has resulted in much greater uniformity, verging to full harmonization, of the regulatory norms. The new state of things is epitomized in the construction of a Single Rulebook of pan-European applicability, with the EBA acting as the Rulebook's custodian and key developer.
- Second, the considerable expansion of the prudential regime to cover new aspects of a bank's organization and business activity. This thematic extension is evident both in the Basel regime, which, beyond the usual capital adequacy requirements, now encompasses global standards for liquidity and leverage, as well as in the host of European legislative initiatives of recent years. As a result, the net of supervisory controls over the activities of credit institutions and other financial intermediaries has become much denser than what it used to be. This makes the question of proportionality of the regulatory requirements all the more pressing.
- Third, the move from a system of national responsibility for supervision to the streamlined, and largely centralized, new supervisory architecture of the Banking Union.

Under the pre-existing system, the European norms, such as they were, could be individuated and amplified at the national level, thus leaving the question of diversification and proportional implementation largely within the responsibility and discretion of national legislatures and competent authorities. In contrast, in the new environment of maximum harmonization, comprehensive prudential controls and centralized supervision, these concerns need to be addressed primarily at the European level.

For this reason, the proportionality of the Single Rulebook's primary directives and regulations and numerous delegated and implementing acts, has rapidly emerged as a key concern of the banking industry. In this context, a number of specific issues have come to the forefront over the past two years, concerning, for instance, the implementation of Basel III in Europe, the detail and frequency of the new reporting requirements, the timeframe and pace of the transition to the fully-fledged regime, the treatment of small banks with simple business models, the treatment of cooperative banks, and so on. It is a sign of the responsiveness of the new European regulatory structures that these concerns have gained the full attention of the EBA, which has examined the issue in two special supervisors' workshops and a significant report of the Banking Stakeholder Group. The influence of the debate is also evident in the EBA's consultation papers and RTSs.

Ladies and gentlemen,

In its dual capacity as central bank and national competent authority, the Bank of Greece is naturally fully cognizant of the financial industry's strong and persistent demand for less burdensome, more proportionate and more fit-for-purpose, prudential requirements. And we recognize the justice of certain arguments concerning the difficulties and heavy costs of compliance with the new regime, especially for smaller institutions, characterised by simple business models, modest scale of business and non-complex systems and controls.

Of course, our primary consideration is the safety and soundness of the banking system, both domestically and at the European level. The Bank of Greece is strongly committed to robust and effective prudential standards, which can deliver systemic safety, market discipline and proper incentives for banks' internal decision-makers. For this purpose, it has been fully supportive of the post-crisis efforts to reregulate the banking sector and has sought unflinching commitment to the faithful and complete national implementation of the new standards, despite the acute difficulties presented by our country's economic predicament and the need to support and repair the banking system, which has been gravely affected by the crisis.

But at the same time we share with the banking industry the concern for proportionality. We consider excessive complexity to be part of the problem, not of the solution, in so far as it increases costs and uncertainty for the regulated institutions, without thereby generating additional benefits in terms of systemic or individual safety. We support regulatory approaches that allow for differentiation where appropriate, and apply criteria of materiality in order to determine the applicability or otherwise of particular rules to different classes of institutions. And we recognize the need for consistency across the various components of the prudential, resolution planning and reporting regimes, to avoid conflicts and duplication.

More generally, we have all along expressed scepticism with regard the one-size-fits-all approach to regulation – an approach whereby uniform prudential standards are set at the same level for all credit institutions, as well as for other financial institutions such as investment firms. In particular, we have been sceptical of a uniform model-based approach to financial risk, based on the generic risks faced by a notional universal banking group, of unspecified (but probably large) size, carrying on mixed activities, including extensive securities and derivatives exposures, and displaying a relatively high degree of interconnectedness with other participants in financial markets.

In all these respects, we consider that proportionality can enhance the effectiveness and efficiency of the prudential regime. We do not see it as a step back from the post-crisis commitment to high standards of prudence, or relaxation of the new regime. This is not a question of trade-offs between safety and market-friendliness, but a matter of optimal institutional design for safety and soundness.

Last but not least, we consider that the further development of the prudential regime should take into consideration the implications of regulatory requirements –including the phasing in of their implementation– for the real economy. Especially in the euro area, with its largely bank-based financial system, the ability of credit institutions to extend credit is critical for the vigorous performance and growth of the real economy. The need to sustain bank financing to the real economy acquires added importance in the present environment, when the European recovery is still fragile and the banking systems of several Member States are still struggling with the legacy of the crisis.

Moreover, even the capital market depends on the profitability and competitiveness of the banking sector for its smooth operation and deepening, because banks are involved as both service providers and users at various stages of the securities and derivative intermediation chain. In this sense, the Capital Markets Union should be seen, not as an alternative, but as a complement, to a well-functioning Banking Union.

Ladies and gentlemen,

This conference was conceived from the very start as a forum for discussing in depth these issues. As things have turned out, the discussion now takes place in the context of the European Commission's banking reform package, which was made public on November 23. This includes proposals for the revision of the main (Level 1) instruments of the Union's Single Rulebook, that is, the Capital Requirements Directive IV, the Capital Requirements Regulation and, in so far as the resolution regime and, especially, the resolvability and loss-absorbing capacity of credit institutions is concerned, the Bank Recovery and Resolution Directive and the SRB Regulation. The Commission's package enhances and brings up-to-date the post-crisis prudential regime by transposing into European law those elements of the global Basel III standards which have been fully specified after the enactment of the Capital Requirements Regulation in 2013. It thus includes substantial new rules on a binding 3% leverage ratio, detailed provisions on credit institutions' liquidity requirements, and provisions, requiring institutions that trade in securities in derivatives to maintain more risk-sensitive own funds. Moreover, it implements the Financial Stability Board's new Total Loss-Absorbing Capacity (TLAC) standard for the 30 global systemically important institutions, almost half of which are European.

In a very promising development, the Commission used this opportunity in order to introduce significant elements of proportionality in the Single Rulebook. Based on extensive public consultation and impact assessments relating to the CRD/CRR regime, it has included in its package a set of important proposals that are explicitly intended to make the prudential regime more proportionate and to reduce the burden faced by smaller and less complex credit institutions. The proposed amendments affect, in particular, the disclosure, reporting and trading-book-related capital requirements. Furthermore, they differentiate the treatment of certain financial instruments, such as covered bonds, high quality securitization instruments, sovereign debt instruments and derivatives used for hedging, with a view to reducing the costs of issuing or holding such instruments, thus enabling the continuing participation of banks in the relevant securities markets. In this manner, the regulatory regime is differentiated to facilitate the deepening of European capital markets and the creation of the Capital Markets Union.

One could argue that the inclusion of strong elements of proportionality in the banking reform package marks a move away for the traditional tendency of European law to regulate financial institutions through uniformly applicable rules, in the name of competitive equality. The Commission explicitly and forcefully asserts the relevance and significance of proportionality as a regulative consideration that informs its proposals. This is most welcome, and we should all work to bring the review of the Single Rulebook to rapid and successful conclusion.

This, of course, will not exhaust the quest for more sophisticated, proportionate and cost-efficient regulatory solutions. Our regulatory job is to pursue simultaneously a variety of objectives – systemic stability and bank-level safety, equivalent and consistent treatment of the credit institutions and other regulated persons, appropriate differentiation and diversification of the regulatory and supervisory regime, and a financial environment conducive to economic growth.

This is a demanding task – in fact, a permanent task, requiring continuous effort and adaptation. In all cases, it must be pursued under the light of the principle of proportionality, which should be incorporated into our forward-looking thinking and turned into a necessary consideration informing the design of all regulatory norms and policies in the future.