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Proportionality in banking regulation

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Introduction

Many thanks for the invitation to participate in this prestigious forum.

I am very happy in this distinguished company to have the chance to discuss issues relating to financial regulation. Working for the BIS in Basel, I see my role as providing a global perspective on current policy challenges in the financial domain.

I think that there is a general sense that the post-crisis regulatory reforms have already made substantial progress in meeting their objectives. While it would be a mistake to claim "mission accomplished", the time has certainly come to shift the emphasis from standard setting to ensuring an effective implementation of the agreed reforms.

Within the broad topic of implementation, an area that has attracted much attention worldwide is the question of which institutions should be subject to the new prudential standards.[2] Or, to put the question differently, what scope do we have to tailor the requirements to a specific subset of institutions that lie outside the perimeter where the Basel standards normally apply. This issue is often referred to as the application of proportionality to banking regulation.

In my remarks I will review the concept, motivation and the constraints associated with the proportionality principle, and I will compare the different approaches in various jurisdictions. To this end, I will make use of some work we've recently done at the BIS's Financial Stability Institute (FSI).

The concept

The concept of proportionality, embedded in all legal systems, stems from the need to keep the level of public intervention – in the form of rules, restrictions or sanctions – appropriate to what is actually needed to achieve the desired social objectives.

In the field of financial regulation, authorities tend to use the concept of proportionality to justify adjusting the rules imposed on a subsector of regulated institutions in order to lighten their regulatory

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1 I am grateful to colleagues at the FSI for helpful discussions and comments on an earlier draft. The views expressed are exclusively my own and do not necessarily represent those of the BIS or the Basel-based standard-setting bodies.

2 See Powell (2017), Lautenschläger (2017), Nouy (2017), Quarles (2018) or Dombret (2018).

burden. In some domains, such as insurance regulation, proportionality aims at promoting the diversity of market participants, the development of the industry and even financial inclusion. In this domain, therefore, proportionality is effectively a formula for weighing different, and potentially conflicting objectives.

In banking regulation, the concept of proportionality is more frequently used to justify the application of simplified prudential requirements for small or non-complex institutions to avoid excessive compliance costs. This concept of proportionality entails, in principle, only an adjustment to the complexity of the rules but not necessarily a lower degree of stringency. We will come back to this issue later.

It is interesting to note that the concept of proportionality, when applied to banking *regulation*, is different to the one used when referring to banking *supervision*. The latter is roughly a synonym for risk-based oversight and focuses on the adjustment of supervisory intensity to the risk profile of each institution. Proportionality in supervision thus relates to the objective of employing authorities' scarce resources efficiently while proportionality in regulation refers to reducing the costs faced by the institutions themselves. These two concepts should not be conflated.

The aims

In the debate on the role of proportionality in banking regulation, as a way of reducing compliance costs for small and unsophisticated institutions, three types of argument are often heard.

First, a political argument: regulation should recognise the social role that small institutions play in facilitating access to credit – and financial services more generally – by households and small firms and their contribution to the development of local and regional economies.

Second, a financial stability argument: concentrated and undiversified banking systems in which a few large institutions prevail are more exposed to systemic crisis and to the *too-big-to-fail* problem.

And, finally, an economic argument: excessively burdensome regulation for small firms – if not sufficiently justified on prudential grounds – may damage their competitiveness, thereby undermining the level playing field and potentially harming the interest of consumers of banking services (Joosen et al (2018)).

Arguably, not all the above arguments are equally convincing. In particular, the political argument is based on the assumption that large institutions are less able or willing than smaller banks to offer credit and other services to retail customers or small businesses in local communities. However, to my knowledge, there is no compelling evidence that access to credit in concentrated banking systems[3] (like those of France, Canada or the Netherlands) is generally more cumbersome than in countries with a more diversified banking industry (such as that of Germany).

Some caveats could also be raised in relation to the financial stability argument. In fact, small institutions typically run less diversified business models and are therefore more exposed to adverse developments in specific regions or economic sectors. Moreover, a proliferation of small institutions does not always imply a more diversified banking sector. Indeed, in the recent past, systemic crisis have occurred as a consequence of the simultaneous failure of several small or medium-sized institutions running similar business models, which were all jointly exposed to the same type of shock, such as the collapse of the housing market. Finally, recent work by the Financial Stability Board to tackle the too-big-to-fail-problem suggests that this issue can be addressed with an adequate resolution framework for larger firms.

[3] The conceptual arguments are reviewed in Petersen and Rajan (1995).

The economic arguments are probably more solid. Basel standards are, in principle, meant to be applied to internationally active groups. Those banks have complex business models that are subject to a variety of risks, including the ones posed by their own operational complexity. As a consequence, in order to achieve sufficient risk sensitivity, the regulation of large banking groups requires more intricate methods to properly measure those risks in order to determine their coverage.

Yet the Basel standards are often applied to a wider set of banks which may or may not be internationally active. The desire to widen the application of Basel in the domestic markets, even in jurisdictions with no internationally active banks, may be driven by the goal of achieving sufficient homogeneity of the domestic prudential rules as well as promoting the international recognition of their national regulatory framework.[4]

The complexity of the rules implies costs which may be disproportionately higher for smaller – and typically less complex – institutions, as these have less scope for exploiting the economies of scale associated with the compliance function. This is precisely the group of institutions for which risk-sensitive regulation does not need to be excessively complex.

As a consequence, the universal and complete application of the Basel standards within a banking system may generate market distortions as it may unduly penalise the competitive position of a group of entities, without any strong prudential justification.

The constraints

From my vantage point, it may make sense to adjust the regulatory requirements applied to smaller and/or less complex institutions in order to alleviate the excessive regulatory burden that they would otherwise face.

Yet, to be unambiguously positive from a social point of view, the design of such a proportionality regime will need to meet a number of conditions.

First, it should not water down institutions' capacity to absorb losses or face liquidity shocks. Any proportionality regime must focus on reducing complexity without undermining the fundamental prudential safeguards in order to avoid compromising financial stability.

And second, the proportionality regime should not overprotect small or medium-sized institutions against competitive forces. In particular, proportionality should not generate spurious incentives for banks to remain small or simple if there are competitive forces that promote consolidation, potentially leading to a more efficient banking industry. Technological developments and overcapacity in some jurisdictions are examples of competitive forces that help to shape market structure.

The modalities

Naturally, different proportionality regimes can work towards the desired objectives in various ways, while meeting the relevant constraints.

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4 In particular, the application of Basel standards is typically appreciated by international organisations when conducting country assessments, as well as by credit rating agencies and large institutional investors and asset managers.

In a recent FSI study (Castro Carvalho et al (2017)), we looked at how proportionality is applied in several jurisdictions. The first relevant observation made in the study is that the scope of application of the Basel standards is quite diverse, ranging from a limited application to a few large international banks in the United States to a much wider perimeter in the European Union.

The approaches to tailoring regulatory requirements to different classes of institutions also vary markedly across jurisdictions. Nevertheless, they could be broadly classified into two main types: what we call a *categorisation approach* – followed for instance in Switzerland and Brazil – under which banks are classified into a few categories according to their size, or complexity, and a specific set of rules is applied for all banks within each category; and a *specific standard approach* – now used notably in the European Union and to some extent the United States – for which exceptions are applied to each relevant regulatory obligation (eg liquidity, market risk or reporting requirements) for banks meeting specific criteria. While the former approach is certainly simpler and more transparent, the latter permits a finer adjustment of the requirements to the characteristics of the supervised institutions. In particular, it allows exemptions or simpler versions of specific requirements to be adopted only for banks for which the original rules are considered unnecessarily complex from a prudential point of view.

The study also shows that, in most jurisdictions, the proportionality regime affects a variety of regulatory requirements. In particular, within Pillar 1, the standards on market and liquidity risk are the ones most often tailored to specific institutions. Within Pillar 2, proportionality often affects stress testing requirements and procedures for the supervisory review process. Proportionality regimes also typically include simpler reporting and disclosure requirements for small firms.

The analysis shows that proportionality does not normally imply reduced minimum capital ratios for smaller or less complex institutions. Yet the application of some simplified approaches to assess the solvency, liquidity and risk profile of the institutions and the reduced reporting and disclosure requirements may collectively have prudential relevance. In particular, the reduced frequency of reporting requirements for small institutions – as is already allowed in some jurisdictions and a subject of discussion in the European Union – may hamper the ability of supervisors to properly monitor emerging risks (Angeloni (2018)).

In view of these prudential considerations, some jurisdictions are considering the possibility of accompanying the application of simplified requirements to some institutions with the introduction of a more demanding coverage of risks. A case in point is the recent legislation passed by the US Congress[5] in which institutions with a balance sheet below US$ 10 billion may be exempted from meeting standard minimum risk-based capital ratios – which must be calculated in terms of risk-weighted assets – if they keep their leverage ratios – whose calculation is simpler – substantially above the ones required under the Basel standards. This combination of simplicity with additional stringency would seem to be a promising formula for the calibration of proportionality regimes and one that might be well worth exploring in other jurisdictions.

Some final considerations

To conclude, the increased complexity of the Basel standards strengthens the case for moderating the requirements in some cases – in particular, for institutions where the desired resilience can be ensured without invoking the framework's full complexity.

5 The Economic growth, Regulatory relief, and Consumer Protection Act, 24 May 2018.

Yet, there is always a risk that the principle of proportionality could be misused to give a significant regulatory advantage to small institutions. As we have seen, this may not only be unwarranted from a prudential point of view but could also distort competition and prevent a necessary restructuring of the industry.

Arguably, the latter effect may become particularly relevant when technological innovation is likely to disrupt the market, as this will most likely modify the competitive position of traditional banks in varying ways depending on each institution's size, business model, adaptability and other characteristics. In order to exploit all potential social benefits associated with this innovation, regulation should aim to address emerging risks while minimising the impact on market dynamics and removing obstacles to an efficient restructuring of the sector.

In that context, the European banking sector faces specific challenges. In addition to the disruption that technology is likely to unleash on market structure, the sector may need to enter a phase of consolidation in order to gradually correct the current overcapacity.

For those reasons, the ongoing review of the European prudential legislation should ideally deliver a measured application of the principle of proportionality that is consistent with an orderly reorganisation of the industry.

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