PROPORTIONALITY IN BANK REGULATION

A Report by the EBA Banking Stakeholder Group

Table of Contents

PREFACE........6

EXECUTIVE SUMMARY........7

I. Analytical Framework........11

1. Scope of the Principle of Proportionality........13
2. The Importance of Proportionality........14
3. Legal Definition of Proportionality........15
4. Economic Concept of Proportionality........18
   - 4.1 The Endogeneity Problem........18
   - 4.2 Potential for Disproportionality........19
5. Five Pillars of Proportionality........20
   - 5.1 Objectives: Cost-Benefit Analysis........21
   - 5.2 The Totality of Regulation and Diminishing Marginal Returns........22
   - 5.3 Excess Complexity........23
   - 5.4 Differentiation........27
   - 5.5 Materiality........29
6. Conclusion drawn from the analytical framework........29

II. APPLICATION: CASE STUDIES........30

1. Supervisory reporting........31
   - 1.1 Sub-consolidation in cases of entities in third countries........31
   - 1.2 Reporting of credit institutions' funding plans........31
   - 1.3 Disclosure of the management body's number of directorships........32
   - 1.4 Solo and consolidated reporting in case of the LCR/NFSR........32
   - 1.5 FX reporting (interest rate risk, liquidity reporting)........33
   - 1.6 Intraday liquidity reporting........33
2. Liquidity........34
   - 2.1 Suitable recognition of the liquid assets from CIUs........34
3. External models........35
4. Governance relating to risk models........36
5. Leverage Ratio........37
6. Corporate Governance........39
   - 6.1 Mandates and Remuneration........40

6.2 Organisation and assessment of the board 40
6.3 Board Committees 40
6.4 Control Functions 41
III. COSTS AND IMPACTS ON STAKEHOLDERS 42
1. Cost of prudent risk and reward management 42
2. The incidence of the cost of regulation 44
2.1 Banks 45
2.2 Bank customers 46
2.3. Employees 47
IV. CONCLUSIONS 49
V. RECOMMENDATIONS 51

PROPORTIONALITY IN BANK REGULATION

This document was drafted by an Ad Hoc Working Group on Proportionality set up by the EBA's Banking Stakeholder Group and has been endorsed by all BSG Members.

A Report by the EBA Banking Stakeholder Group

PREFACE

The Banking Stakeholder Group (BSG) of the European Banking Authority (EBA) is appointed by the Board of Bank Supervisors and is composed of 30 members appointed to represent a range of stakeholders: Credit and Investment Institutions, Employees, Consumers, Users of Financial Services, Academics, and SMEs. The current BSG was appointed in October 2013 and serves for two and a half years. The BSG is consulted by the EBA on actions concerning regulatory technical standards and their implementation, and also consultation papers, guidelines and recommendations made by the EBA. The group may also submit opinions and advice to the EBA on any issue related to the work of the authority.

All of the submissions made by the BSG can be found on the EBA's website at www.eba.europa.eu/bsg.

The current BSG has made a large number of responses to the EBA's consultation and discussion papers on a wide range of regulatory issues, regulatory technical standards (RTS), and implementing technical standards (ITS). It is on the basis of this experience, and the variety of perspectives and expertise that its diverse membership brings to its work, that the BSG has considered the central issue of proportionality in bank regulation.

EXECUTIVE SUMMARY

The BSG would like to emphasise at the outset that it is in no way antagonistic to regulation, and that it is fully committed to regulation's core objectives of: enhancing the safety and soundness of banks; systemic stability; consumer protection and welfare enhancement. We also fully recognise that, given past regulatory failures and the costs imposed by the crisis, there has been a need for a major reform and intensification of the regulatory regime both in terms of lowering the probability of bank failures and minimising the social costs of those failures that might occur in the future (the new resolution regime). Furthermore, whilst this report indicates that the Principle of Proportionality may not always have been followed to the full extent possible, there are also areas (including consumer protection) where the detail of regulation may need to be strengthened since this is more a political choice than a matter of proportionality.

The BSG argues that, in the interests of effective and efficient bank regulation, the Principle of Proportionality has to be recognised and applied at every step of the legislative and regulatory process so that existing and new legislation and regulations are applied to banks and financial institutions in a proportionate way. The overall administrative resources and cost of new regulation – such as supervisory costs and new IT systems – have a substantial impact on all banking institutions, and an even more severe impact depending on criteria such as the size and complexity of institutions and their business models. As a result, disproportionate regulation could inhibit small banks from providing finance to the real economy to support innovation and growth.

We recognise that regulatory and supervisory agencies of banks (including the EBA – see its Annual Report of 2013, page 27) are fully committed to the Principle of Proportionality. The BSG does not question this commitment. However, we observe that in some areas this commitment has not been fully applied in all identified dimensions. The motivation and the intention of this report is to be a constructive contribution to this

important issue. The report presents six case studies to illustrate where we judge the Principle of Proportionality has not been followed to the full extent possible.

Our intention is to make a constructive contribution to this issue for the benefit of all stakeholders. In particular, our objectives are to:

- clarify the dimensions and nature of proportionality: what we term "The Five Pillars of Proportionality",
- construct an analytical framework for considering the five pillars,
- indicate a *prima facie* case that the Principle of Proportionality has not always been applied to the full extent possible,
- outline the costs of non-proportionality,
- identify six case studies illustrating where the Principle of Proportionality may not have been applied to the full extent possible,
- offer a set of high-level and more detailed recommendations, including the case for establishing a task force to consider the issues raised in this report and to make recommendations.

The report outlines the Principle of Proportionality from both a legal and economic perspective. As a matter of law, action in the EU must not go beyond what is appropriate or necessary; the least onerous measure must be chosen where a choice exists, and the costs and disadvantages must not be out of line with the aims pursued. The economic perspective takes a wider view and considers issues such as whether the proposed regulation is addressing a real problem with clearly-defined costs, whether it is the most efficient way of addressing it, and the broad costs and benefits to the wider economy.

Proportionality is related to balancing costs and benefits of regulation: if regulation is not proportionate in relation to its objectives, the cost-benefit calculation is likely to be worsened. Furthermore, it is important to take into account not only both the costs and benefits of each regulation independently, but also the cumulative costs, benefits and impact of the totality of regulation. This is because, whilst each regulation, when considered separately, might be justified in terms of cost-benefit analysis, what applies to each individual piece of regulation does not necessarily apply to the regulatory regime as a whole: the total net benefit/cost may be less/more than the sum of its parts.

Proportionality is also related to complexity. The complexity of regulation and its application can, in some cases, result in excessive costs of compliance. The size of an organisation seems in the majority of cases to be the critical element in the creation of the cost burden. Excess complexity means that regulation may become more complex than is needed to meet its objective and/or to appropriately address market failures. It also generates higher compliance costs, which could be disproportionate for some banks depending on their size.

After the Executive Summary, Part I sets the context of the BSG study by offering an analytical framework to assist in making judgements about the Principle of Proportionality. It outlines

why proportionality is an important issue; discusses the costs associated with non-proportionality, and identifies the various dimensions of the Principle of Proportionality as applied to bank regulation. Part II considers the practical application of the Principle of Proportionality and offers six case studies: Supervisory Reporting, Liquidity Requirements, External Models, Governance related to Risk Models, the Leverage Ratio, and Corporate Governance as examples of the most relevant areas of post-financial crisis regulation to which the Principle of Proportionality must be applied. Part III considers the costs of non-proportionality and its impact on stakeholders. Part IV offers conclusions. The main recommendations of the report are summarised in Part V.

The constantly-increasing regulation of banking and financial activity, whilst conferring important benefits, comes at a substantial cost to stakeholders. Considering the ultimate incidence of the cost of regulation, it is inevitable that a major part of the cost is in the end borne by bank customers through increased margins and fees.

Disproportionate regulation of the banking industry may not only unduly increase the cost charged to bank customers but also, in some cases, undermine banks' basic function as financial intermediaries. Whilst banks may be safer, their ability to meet customers' and society's need for banking services and financing may be compromised by non-regulated actors in the industry. It is partly for this reason that the case for regulating shadow banking activities is being considered by regulatory agencies. Bank customers, and in particular consumers and SME's, may in some cases find that the disadvantages may outweigh the benefits created by regulation.

Several recommendations, which are designed to achieve a better compliance with the Principle of Proportionality in banking and the financial industry more generally, are made throughout the report. The general high-level recommendations are outlined in Part V whilst more detailed recommendations related to the case studies are contained in boxes in the relevant parts of the report. Amongst these recommendations, the BSG has chosen five key points which it wishes the EBA to take into consideration:

- The principle of materiality and the definition of the Principle of Proportionality should be published in a harmonised, horizontal ESAs guideline and thus be consistently applied (and defined with a flexible scope).
- It is specially recommended that a high-level task force could be established by the European Commission in Level 1 to further elaborate on the issues within the concept of proportionality and to propose specific actions and recommendations for implementation in the financial industry. A detailed outline of a possible working mandate for the task force is also included. Some key functions of the task force could include, *inter alia*:
    - Description of how the Principle of Proportionality has been interpreted and implemented hitherto;
    - Description of proposed future applications of the Principle of Proportionality for regulation of the financial industry;

- Description of what impact, and which adjustments, the proposed application of the Principle of Proportionality would imply for the existing regulatory framework;
- Proposals for relevant further implementation actions, timeline and responsible bodies, as well as resources needed.

- In addition, there should be regular independent reviews (requested periodically by the Commission) of the issue of excess complexity, and of the application of the Principle of Proportionality and its balance with other objectives of financial regulation, in particular fair competition and a level playing field.

- There should be a systematic review of supervisory reporting requirements with a view in particular to removing unnecessary duplication and introducing more differentiation such as between different types of institutions.

- Proportionality is an area where systematic research and impact assessment (not only per regulation but also cumulative) is needed, and efforts in this area should be enhanced and organised accordingly. Impact analyses should themselves be proportionate with respect to the significance and complexity of the issue being addressed. The BSG believes that the processes for, and implementation of, cost-benefit evaluations should be clarified and improved. Cost-benefit analysis of new regulation should be commenced within regulatory and supervisory agencies very early in the policy cycle and be a continuous process throughout the cycle.

I. Analytical Framework

Although acknowledged at international level[1] and enshrined in European law, the full implications of the Principle of Proportionality remain in practice uncertain. It is a formal mandate established by the European Commission and other regulatory authorities that regulatory requirements should be "proportionate" and the legal background to this is outlined later in this report.

For purposes of this study, we identify five dimensions of the Principle of Proportionality (the *Five Pillars of Proportionality*) which are discussed at various points in this report: (1) Objectives, (2) The totality of regulation, (3) Excess Complexity, (4) Differentiations, and (5) Materiality. Although there is necessarily some degree of overlap between these five dimensions, each of them is briefly considered in the following sections.

In various papers issued by regulatory agencies (including the EBA and the EU Commission), reference is sometimes made to the concept of *materiality* though, to the best of our knowledge, this concept has not been given a precise definition. For purposes of this report, *materiality* is defined as: "the requirement that particular regulation should only be directed and applied to those institutions which are relevant to the issue being addressed by a proposed regulation". Thus, for example, a regulation that is intended to be addressed to systemically-significant banking institutions should not inadvertently also be applied to other institutions which are not deemed to be

[1] The Principle of Proportionality is acknowledged in the Basel Committee on Banking Supervision's core principles for effective banking supervision, Principle 8: "Supervisory approach: An effective system of banking supervision requires the supervisor to develop and maintain a forward-looking assessment of the risk profile of individual banks and banking groups, proportionate to their systemic importance; identify, assess and address risks emanating from banks and the banking system as a whole; have a framework in place for early intervention; and have plans in place, in partnership with other relevant authorities, to take action to resolve banks in an orderly manner if they become non-viable." See also, EU Commission *Better Regulation Guidelines* (2015), page 18.

systemically significant. It is our judgement that this principle has not always been sufficiently recognised, and we offer examples of this.

However, we identify that in some areas this commitment has not always been fully applied in the five dimensions identified above, and this has been the motivation of this report which is intended to be a constructive contribution to this important issue. The report presents several case studies to illustrate where we judge that the Principle of Proportionality has not been followed to the full extent possible.

Following the recent financial crisis, there has been an enormous increase in the volume and complexity of bank regulation and reporting requirements. Such regulation has been both intensive and extensive and has covered a wide range of business operations and business models. We emphasise that the BSG is in no way antagonistic to regulation and is fully committed to its core objectives of: enhancing the safety and soundness of banks; systemic stability; and consumer protection and welfare enhancement. We also fully recognise that, given past regulatory failures, the misbehaviour and the appetite for profit of some banks/top level bankers, and the costs imposed by the crisis, there has been a need for a major reform and intensification of the regulatory regime both in terms of lowering the probability of bank failures and minimising the social costs of those failures that might occur in the future.

We also recognise that, whilst in some cases regulation may have been disproportionate in an upwards direction, in others the opposite might be the case. In other words, we look at the issue of proportionality mainly on a case-by-case basis although, in a later section, we also consider the totality of regulation.

Over time, finance has become increasingly complex and global in nature, with banks conducting an ever-wider range of business involving sophisticated and complex products and business models (Llewellyn, 2015). This has been followed by ever-more complex and extensive regulation of banks which, it might be argued, is inevitable if regulation is to reflect the complexity of regulated firms. In the case of the EU, the need to sustain a single market (and competitive neutrality between different jurisdictions) represents an additional dimension that is likely to add more complexity to bank regulation. Whilst recognising this, the issue arises as to whether some regulatory requirements may still be excessively complex: we therefore refer to "excess complexity" rather than complexity *per se*.

The BSG judges that it is now time for the actors in the European Union (and also in other jurisdictions) to take stock of how regulation has evolved since the onset of the financial crisis in 2007. The BSG seeks to make its contribution to the analysis of the reaction to the crisis and its potential impact on the economy. The central theme of the report is that, in some areas, current and future regulation needs to be adjusted in accordance with the Principle of Proportionality. We therefore propose that a high-level task force could be established to systematically and comprehensively study the issue of proportionality with respect to bank regulation and to consider and review how the Principle of Proportionality is applied.

1. Scope of the Principle of Proportionality

The regulatory regime has inevitably, and appropriately, responded to the banking crisis and the substantial costs that followed. The banking crisis showed that banks were offering more complex products and taking on higher risks in the period leading up to 2008. At the same time they were conducting an ever-wider range of business. This has since changed, as some banks are now offering a more limited range of services, and have exited some markets and changed their business models.

In the case of the EU, the aim of creating a single market (and competitive neutrality between different institutions and jurisdictions) is an important consideration that introduces an additional dimension in the regulatory design that could, however, add more complexity to many aspects of bank regulation. But this in turn raises the question of whether avoidable costs are being imposed by a degree of harmonisation that is more than is needed for the creation of a single market in financial services. Just as regulation might in some areas be disproportionate, so also might be the target degree of harmonisation.

In the process of striving for simpler, yet effective, rules, closer attention to the Principle of Proportionality may help policy makers to focus more clearly on the effectiveness and sustainability of new regulations. Proportionality is a vital part of effective legislation. As discussed in Part III of this report, regulation imposes costs on banks (compliance costs, IT costs associated with more demanding reporting standards, regulatory agency costs, costs related to customer products and services, etc.) which, in one way or another, at least in part, have to be passed on to consumers and users of banking services and products. The fairness of this fact can in some cases be disputed, but all costs have to be covered somewhere and by someone. Disproportionate regulations may also have an impact on business models and may restrict some banks whose business models are of a particular type (for example, savings and small retail banks).

Impact assessment systems are intended to ensure compliance with the Principle of Proportionality by establishing an evidence base for informed policy making. Such impact assessments can involve the use of a range of quantitative and qualitative analytical tools including cost-benefit analysis (CBA), cost-effectiveness analysis, compliance cost analysis, multi-criteria analysis and risk assessment. The choice of tools and method of deployment will also vary with the nature of the issue in question.

The Principle of Proportionality also contributes to the European Commission's Better Regulation Agenda[2] and its smart regulation agenda:

> *"The aim of smart regulation is to design and deliver regulation that respects the principles of subsidiarity and proportionality and is of the highest quality possible".[3] Smart regulation requires that: (i) rules must be clear, easy to understand and unambiguous; (ii) rules must achieve their*

[2] http://ec.europa.eu/smart-regulation/better_regulation/documents/com_2015_215_en.pdf
[3] European Commission, Smart Regulation in the European Union COM (2010) 543, section 2.

intended effect without causing unnecessary burdens on businesses, citizens or administrations (no 'goldplating'); (iii) where businesses and citizens need to comply with procedures, they should be able to do so swiftly and via electronic means; (iv) rules should guarantee that businesses and citizens find information and help and have access to fast and effective redress where needed.[4]

In other words, the Principle of Proportionality is far-reaching, has many different dimensions, and needs to be applied at all stages in the formulation of policy in general and detailed regulation in particular.

2. The Importance of Proportionality

All aspects of economic activity are either directly or indirectly affected by the banking system: this is the main reason why regulation in the sector, and the proportionality of banking regulation in particular, is a central issue in the economy. Bank regulation therefore has ramifications well beyond the banking sector itself.

More specifically, we identify several reasons why proportionality in regulation is an important requirement:

- Regulation imposes costs: resource costs of the regulatory agencies, compliance costs imposed on regulated firms (IT, employees in the compliance area and their training, use of regulatory consultants, etc.), customer costs to the extent that the costs of regulation are passed on to customers, and also broader economic costs. With respect to the last-mentioned, these could include raising the cost, and possibly compromising the efficiency, of the financial intermediation role of banks.

- Regulation might induce changes in bank business models which are not necessary for the achievement of the regulatory objectives. Of course, some regulation may be specifically designed to change the way banks do business. But there may also be unintended impacts in this area. A member of the Financial Stability Board's enhanced disclosure task force has argued that new regulation imposed on European banks make "huge swathes of traditional bank lending unprofitable… the profitability of European mortgages will now fall by about two-thirds while the profitability of lending to the strongest corporate customers will fall by three quarters… European banks will have to shrink dramatically…" (Samuels, Financial Times).[5]

- Disproportionate regulation might create the impression that regulators are effectively taking over the management of banks by limiting bank managers' discretion and *de facto* limiting the controlling role of the Board of Directors. While being potentially detrimental to competition, such an overlap between supervisors

[4] European Commission, Better Governance for the Single Market COM (2012) 259, para 2.1.
[5] http://www.ft.com/intl/cms/s/0/346cbe4c-9a79-11e4-8426-00144feabdc0.html#axzz3oRvukRsV

and supervised entities may limit the independence of the former which is needed to carry out an effective assessment of the banks' vulnerabilities. It also has the danger of leading to a degree of regulatory capture.

- Disproportionate regulation may induce arbitrage within the banking system if, for any reason, regulation impacts disproportionately on some types of banks. It is also likely to induce a process of disintermediation towards less-regulated institutions and the capital market. Whilst this is not necessarily to be condemned, the potential for such disintermediation to occur because of disproportionate regulation needs to be monitored.

- Disproportionate regulation may compromise competition in the banking system. An important study by the European Commission has argued as follows: "there is a risk that the rule will increase barriers to entry for market entrants. Regulation tends to impose a disproportionate burden on small players in the market and new entrants, which can make it harder for them to compete with more established players" (European Commission, 2014, page 260). Furthermore, regulation tends to be particularly costly for small institutions, partly because of the fixed costs that compliance systems involve. This may compromise the competitive position of such institutions and, to the extent that this induces more mergers in the banking industry, competition can be reduced. As put by Goodhart, et al (1999): "To the extent that regulation enhances competition and, through this, efficiency in the industry, it creates a set of markets that work more efficiently and through which consumers gain". However, the converse of this might also apply as a result of disproportionate regulation.

Disproportionate regulation may also generate wider costs on the economy whenever some of the basic functions of the financial system (financial intermediation, optimal risk shifting, etc.) are compromised or made unnecessarily costly. The potential dangers of inhibiting financial innovation, and making lenders unnecessarily more risk averse, may also be mentioned in this regard.

In the final analysis, proportionality is about balancing the costs and benefits of regulation: if regulation is disproportionate in relation to its objectives, the cost-benefit calculation is likely to be worsened.

3. Legal Definition of Proportionality

At its most abstract level, the Principle of Proportionality requires that an action undertaken must be proportionate to its objective. The principle was first developed by the European Court of Justice as a general principle of EU law where it was used as a basis for review of community measures. Later on, the principle was adopted by the Treaty of the European Union where it governed the exercise by the Union of its legislative competence. Therefore, the Principle of Proportionality has a dual aim under EU law to protect individuals, including

market participants, from action by the community institutions, and to limit the burden on Member States.[6]

The Treaty definition of the Principle of Proportionality is that the content and form of Union action shall not exceed what is necessary to achieve the objectives of the Treaties (*TEU, Art 5(4)*). According to settled case-law, the Principle of Proportionality requires that community measures:

(1) do not exceed the limits of what is appropriate and necessary in order to attain the objectives legitimately pursued by the legislation in question;

(2) when there is a choice between several appropriate measures, recourse must be had to the least onerous; and

(3) the disadvantages caused must not be disproportionate to the aims pursued.[7]

Therefore the Principle of Proportionality can be summarised in three words: *Suitability, necessity and proportionality* (*stricto sensu*). However, far from dictating a uniform test, proportionality is a flexible principle which is used in different contexts to protect different interests and entails varying degrees of judicial scrutiny. It is by its nature flexible and open-textured.[8]

In the founding regulation, the Principle of Proportionality is expressed in a number of key provisions that govern the rulemaking and supervisory powers of the EBA. According to Article 1(5) the authority shall contribute to improving the functioning of the internal market including, in particular, a consistent level of regulation and supervision. Furthermore, the EBA shall conduct open public consultations and analyse the potential, related costs and benefits in connection with the adoption of technical standards. However this obligation does not apply if such consultations and analyses are disproportionate in relation to the scope and impact of the standards concerned (see Articles 10 and 15). Finally, to allow for a proportionate response to instances of incorrect or insufficient application of Union law, the EBA's intervention powers under Article 17 consist of a three-step mechanism.[9]

Even though the endorsement regime of draft technical standards was originally introduced in order to ensure compliance with the Meroni-doctrine,[10] it is likely also to increase the EBA's awareness of the Principle of Proportionality. According to Recital 23 of the preamble draft, regulatory technical standards would be subject to amendment by the Commission *inter alia*

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[6] *Paul Craig & Gráinne de Búrca:* EU-law, 5. ed. (2011) Oxford University Press, p. 168.

[7] This 3-pronged formulation derives from Case C-331/88 R v Minister of Agriculture, Fisheries and Food, ex parte Fedesa [1990] ECR I-4023. Recent authorities include Case C-343/09 Afton Chemical [2010] ECR I-7027, paragraph 45; Joined Cases C-581/10 and C-629/10 Nelson and Others [2012] ECR I-0000, paragraph 71; Case C-283/11 Sky Österreich GmbH, paragraph 50; Joined Cases C-293/12 and C-594/12 Digital Rights Ireland Ltd and Others, paragraph 46.

[8] *Takis Tridimas:* The General Principles of EU Law, 2. ed. (2006) Oxford University Press, p. 173.

[9] EBA-regulation, preamble no. 28.

[10] On the Meroni-doctrine following C-270/12, *United Kingdom v Parliament and Council,* see *Valia Babis:* The Power to Ban Short-selling and financial stability: The beginning of a new ERA for EU agencies in The Cambridge Law Journal, vol. 73 (2014) issue 2.

if they did not respect the Principle of Proportionality. The Commission (Nava, 2014) has enumerated many areas that are explicitly covered by the Principle of Proportionality: this includes, for example, general provisions (CRR, Recital 46), reporting (CRR, Article 99), supervision (CRD, Article 79), internal capital adequacy assessment plans (CRD, Article 73), and recovery and resolution plans (CRD, Article 74).

As a consequence, proportionality and related policy-making tools such as cost-benefit analysis is embedded in the way that the EBA operates. For example, the Chair of the EBA (Enria, 2014) has outlined how proportionality is applied in the area of the EBA's jurisdiction: this includes, for example, setting materiality thresholds and differentiating reporting requirements across business models adopted by different banks (e.g., cooperative banks). The EBA applies the Commission's Impact Assessment Guidelines from January 2009 in its work. Regarding the application of proportionality, section 7.2 (pages 29-30) is of relevance. The three European Supervisory Authorities (ESAs), comprising the EBA, ESMA and EIOPA, also have their own guidelines. Although these guidelines were developed under the former Level 3 committees, they are still applicable and contain several guiding principles of relevance regarding proportionality in relation to technical standards and also to guidelines and recommendations.

On this basis, it should be noted that the Principle of Proportionality enables a differentiated application of regulation to institutions of different size and complexity but as a matter of law may not extend as far as to provide justification for the complete waiver or non-application of requirements. This means that if the Principle of Proportionality is not properly applied at the top level of the legislative process, there can be unfortunate cascade effects that cannot be corrected by use of the principle at a lower level and which may require legislative amendment.

The European Parliament's Committee on Legal Affairs (JURI) has raised some concerns over the application, not only of the Principle of Proportionality but also the Subsidiarity Principle, in its Draft Report on Annual Reports 2012-2013 on subsidiarity and proportionality (2014/2252(INI)).[11] Rapporteur Sajjad Karim, on behalf of JURI:

- Regrets therefore that the annual reports prepared by the Commission are somewhat perfunctory, and often do not delve into a more detailed consideration of how subsidiarity and, in particular, proportionality are observed in EU policy-making;
- Notes that legislative proposals may change dramatically in the lead-up to adoption by the institutions; recalls that a check on compliance with the principle of subsidiarity is only undertaken at the outset and not at the conclusion of the legislative process; further recalls that impact assessments more generally are only prepared for the initial rather than the final stages of the legislative process;
- Calls, therefore, for further subsidiarity checks and full impact assessments to be undertaken at the conclusion of legislative negotiations and in advance of the

[11] European Parliament's JURI Draft Report on Annual reports 2012-2013 on subsidiarity and proportionality (2014/2252(INI))

adoption of final texts, in order that compliance with subsidiarity can be guaranteed and that assessments including proportionality can be made. Such a 'cooling off' period would help policy-makers in assessing whether legislation complies with the principles of the Union, and would increase transparency about the results of periods of often rather intense negotiation.

These three recommendations from the JURI Committee to the European Commission should encourage the Commission to improve their application of proportionality throughout EU policy making, in particular allowing time for changes during the drafting and conclusion stages, so that the principle is applied once legislation becomes final.

4. Economic Concept of Proportionality

The economic perspective on proportionality considers issues such as whether the proposed regulation is addressing a real problem with clearly-defined costs, whether it is the most efficient way of addressing it, and the broad costs and benefits to the wider economy.

One way of conceptualising the economic perspective is to apply what might be termed the "three Es test". This involves an assessment of *Effectiveness* (is the proposed regulatory measure likely to have a significant impact on addressing the problem being identified?), *Efficiency* (have alternatives to the proposed measure – including alternative regulatory measures – been considered to determine whether the same objective could be achieved at a lower cost?), and *Economy* (are there potential wider costs and benefits for the economy as a whole).

With respect to the third "E", most bank regulation has impacts that go beyond the banking and financial system. On the benefits side of the equation (e.g., regulations enhancing the safety and soundness of the financial system and systemic stability) there are benefits to consumers, companies, and other users of banking services, which are likely to have a positive impact on economic growth by improving the financial system's ability to perform its basic functions. In such cases, whilst regulations are likely to impose costs on customers (as compliance costs and operational constraints translate into higher prices on bank products and services) this can be regarded as a payment for the benefits to be derived from regulation.

4.1 The Endogeneity Problem

There is a clear symbiotic relationship between bank business models and regulation: the two are interactive and causation operates in both directions. Thus, regulators react to a problem resulting from bank behaviour by a change (usually intensification) in regulation, which in turn induces banks to change behaviour so as to minimise regulatory costs (regulatory arbitrage), which in turn may call forth more regulation. This is known as Kane's *Regulatory Dialectic* (Kane, 1987) and the *Endogeneity Problem* (Llewellyn, 2013).

There is clear scope for regulatory escalation in this scenario. To some extent, problems resulting from bank behaviour may be at least partly endogenous to regulation, i.e. caused by the very regulation designed to reduce them. This arises as banks seek to circumvent

regulation through financial innovation and by changing the way that business is conducted. As regulation responds to the endogeneity problem by successive adjustments, the cost of regulation rises. The endogeneity problem is likely to raise the cost of effective regulation because it both engenders a rules-escalation strategy, and increases complexity.

The Principle of Proportionality does not necessarily help in cases of regulatory arbitrage which diverts its nature. Regulation is often shooting at a moving target, and the target moves partly because of regulation itself. For instance, the Basel capital regime (hailed at the time as a decisive breakthrough in the regulation of banks) created incentives for banks to remove assets from their balance sheets, for securitisation, the creation of structured investment vehicles and other off-balance sheet vehicles, excess gearing, and the use of credit risk-shifting derivatives. All of these featured as central aspects of the banking crisis. It is evidently the case that the kind of regulation at the time did not prevent the crisis and, to some extent, may have contributed to it.

4.2 Potential for Disproportionality

Several economic, political and psychological pressures can, under some circumstances, produce disproportionate regulation. Such pressures – that we believe regulation and supervision need to guard against – are briefly outlined as follows:

- Regulation is sometimes mistakenly perceived by stakeholders (and notably consumers) as a free good. This may happen because, whilst regulation has a cost, it does not have an observable price attached to it. This will tend to raise the demand for regulation which, combined with risk-averse regulators who may be induced to over-supply it, leads to disproportionate regulation.

- A further factor in regulatory escalation relates to the symbiotic relationship between bank behaviour and regulation, where regulation may cause different bank behaviour which in turn induces new regulation.

- Another possible source of disproportionate regulation may lay in the inability to recognise the trade-off between, on the one hand, regulation that is designed to lower the probability of bank failure and, on the other hand, regulatory measures (including the bank resolution regime) that are designed to lower the costs of bank failures. If the costs of failure are lowered (through effective bank resolution arrangements), the concern about the probability of failures is lessened. In the extreme (totally unrealistic) case that social costs of bank failures could be reduced to zero, the probability of failures would be of no concern, there would be no potential tax-payer liability, no need for bail-outs, and no moral hazard attached to bail-outs. Consequently, if the costs of bank failures are significantly reduced, regulation to lower the probability of bank failures could be less intensive. Policy makers may prove slow in understanding this new equilibrium.

- After a costly crisis, there can be strong public and political pressure for more regulation. In this regard, the swing in political sentiment between the periods before and after the recent crisis is marked. Thus, while the 1980s and 1990s were decades

of liberalisation of banking markets and operations, they have been replaced by a period of intensive regulation in the post-crisis era. In this "pendulum effect", the pendulum tends to swing alternately too far in both directions.

- The potential for excess harmonisation supposedly in the interest of establishing or consolidating a common market in financial services may also produce an environment leading to disproportionate regulation.
- Finally, some areas of duplication may exist between different regulatory authorities: (e.g., between the ESAs and the national authorities).

The argument being made is not so much that these pressures have in fact led to disproportionate regulation – this is an open issue and needs systematic research. Rather, they are pressures that may push towards disproportionate regulation and, as such, should be guarded against.

5. Five Pillars of Proportionality

The Principle of Proportionality has several dimensions each of which raise different issues with respect to costs and benefits for all stakeholders (including banks and consumers of banking services). We identify five pillars:

(1) Objectives: whether a particular regulation that is designed to apply to all regulated institutions is disproportionate in relation to the objective sought.

(2) The totality of regulation: whether the totality of regulation (as opposed to each regulation taken alone) is disproportionate for the key regulatory objectives, given the possibility of diminishing marginal returns that may emerge if regulation is taken beyond its optimal level in terms of scope and intensity. This also includes whether the cost-benefit analysis is applied to the totality of regulation, takes into account all relevant costs and benefits, and considers the costs and benefits of alternative measures.

(3) Excess Complexity: whether regulation is excessively and unnecessarily complex for the objectives that are sought and whether the same regulatory objectives could be achieved, and with the same degree of effectiveness, with less complex regulatory requirements.

(4) Differentiations: whether, in the application of a regulation, sufficient differentiations are made between different types of banks without compromising the objectives of regulation. Such differentiations might relate to, for instance, size, business models, ownership structures, etc. Imposing similar requirements (the one-size-fits-all syndrome) on small and large banks in certain aspects of financial regulation may result in undesired effects, as the former would face proportionately higher costs while their systemic significance is low.

(5) Materiality: whether a particular regulation either applies to institutions to which it should not be applied (the *materiality* principle) and/or to institutions which are subject

to a costly new regulation when they are only marginally exposed to the risks that such regulation aims to control.

Although there is necessarily some degree of overlap among these five dimensions, each of them is briefly considered in the following sections.

5.1 Objectives: Cost-Benefit Analysis

Externalities and other market failures that a new regulation aims to address need to be balanced against the possible inefficiencies that regulatory intervention itself may engender in market processes. The key issue is whether the latter exceeds the costs of the market failures that regulation is designed to alleviate.

Rigorous and comprehensive cost-benefit analysis provides guidance in addressing these valuations. However, it may prove difficult to precisely quantify the costs of the original market failures, as well as regulatory inefficiencies that need to be incorporated into the overall calculation.

While this is applied when assessing individual pieces of regulation, the problem becomes yet more complex when the focus is on the totality of regulation, as discussed in the next section. This is an area where systematic research is needed, and we urge the EBA and the Commission to undertake, or commission, such an analysis.

A further concern with cost-benefit analysis is that costs and benefits should be assessed by considering all the feasible alternatives to the regulation under consideration.

Having argued that, and given the resource constraints faced by European institutions, it is also reasonable to require that impact analyses and cost-benefit analyses *are themselves proportionate* with respect to the significance and complexity of the issue being addressed.[12] Cost-benefit analysis is a specific decision-making tool involving the quantification of costs and benefits. Proportionality is a broader concept which can apply even to cost-benefit analysis itself to tailor the extent or depth of the analysis to the relative size, impacts, and risks of the proposal. The European Court of Justice has noted that in cases involving risk management, a cost-benefit analysis is a particular expression of the Principle of Proportionality.[13]

Equally important in this regard is the role of regulation in enhancing, or compromising, competition in the banking and financial system. If regulation has the unintended consequence that competition is reduced (e.g. by causing regulatory arbitrage, by raising entry barriers, or having a disproportionate impact on some – perhaps small – banks), then this must be counted as a cost because it could reduce the functional efficiency of regulated firms and the industry.

[12] See the Impact Assessment Guidelines for EU Lamfalussy Level 3 Committees, issued in 2008 jointly by the Chairs of the Level 3 Committees.

[13] Case T-13/99 Pfizer [410]. Case T-13/99 Pfizer [410].

5.2 The Totality of Regulation and Diminishing Marginal Returns

The Principle of Proportionality usually relates to individual regulations, but it can equally be related to the totality of regulation. A situation can arise in any regulatory regime where each individual regulation might be justified on cost-benefit grounds and yet, due to a process of regulatory escalation, the totality of regulation might be disproportionate in terms of costs exceeding benefits. In other words, what applies to each individual regulation does not necessarily apply to the regulatory regime as a whole: the net cost/benefit may be more/less than the sum of its parts. With respect to EU regulation more generally, the European Commission recognises that "the entire stock of EU legislation" needs to be kept under review (COM(2014) 368 final, on "Regulatory Fitness and Performance Programme (REFIT): State of Play and Outlook").[14]

The problem may arise because of diminishing marginal returns as regulation is extended. As indicated in Figure 1, the total cost of regulation rises as regulation is extended, while benefits increase at first, then peak and begin to decline after a certain point is reached. The logic of this representation is that, at some optimum point, the marginal cost and marginal benefit of regulation are the same, but after that point the marginal cost exceeds the benefit. The key issue then is that the costs and benefits of adding an additional regulation to the existing quantum of regulation should always be measured at the margin.

While this may look trivial at first sight, focusing on marginal costs and benefits may become remarkably complex when several new pieces of regulation are being designed at the same time (as has been the case since the financial crisis, when governments and supranational regulators were eager to implement new rules in many different areas of financial intermediation). In such a context, the net marginal benefit of new rules can be overestimated simply because regulators are not fully aware that the contemporaneous implementation of several new regulations will generate a sudden shift towards the right-hand side of Figure 1, leading to significantly lower net benefits than anticipated.

[14] http://ec.europa.eu/smart-regulation/docs/com2014_368_en.pdf

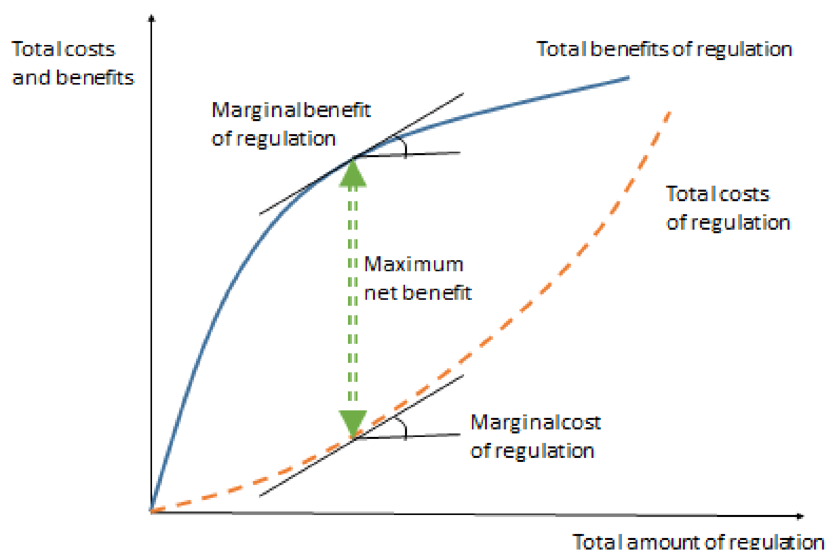

FIGURE 1: DIMINISHING RETURNS?

The cost connected to one particular regulation or directive may seem acceptable when compared to the expected benefits. However, as already suggested, if the cumulative effects and costs of all regulations are considered and weighed against the expected cumulative benefits, the cost-benefit equation may be different (Figure 1).

The Bank of England gives an analysis of the interaction between marginal costs and benefits of capital regulation (Bank of England, 2013).[15]

5.3 Excess Complexity

In the aftermath of the banking crisis, regulation has become not only more intensive and extensive, but also more complex. We have already noted that this is in part a reflection of the complexity of banking business. Indeed, there is a two-way causation between the two. However, in an earlier section a distinction was made between complexity in banking regulation and *excess complexity*: i.e. regulation which is more complex than it needs to be in order to achieve its objectives. The focus of this report is on the latter. Haldane (2012) argues that the optimum response to complexity in finance may be simple solutions. To quote:

> *"Modern finance is complex, perhaps too complex. Regulation of modern finance is complex, almost certainly too complex…as you do not fight fire with fire, you do not fight complexity with complexity… Because complexity*

[15] http://www.bankofengland.co.uk/pra/Documents/publications/ps/2013/ps713.pdf

generates uncertainty, not risk, it requires a regulatory response grounded in simplicity not complexity." (Haldane and Madouros, 2012).

Haldane is not alone in the regulatory community arguing that regulation has probably become excessively complex. A former Chief Economist at the US Securities and Exchange Commission has argued as follows:

> *"Financial regulation benefits from an emphasis on simple rather than complicated rules that avoid creating needless distortions, undertake serious cost-benefit analyses, use transparent rule-making processes, and emphasise disclosure and incentives." (Spatt, 2012).*

There are several reasons for concern about the potential for excess complexity, some of which have been raised by some regulators and academic analysis:

- The consensus appears to be that complexity of regulation and its application can, in some cases, result in excessive costs of compliance.[16] Hence the term 'burden of regulation'.
- The arguments pertaining to the proportionality of regulation typically, but not exclusively, relate to the disproportionate costs of compliance to smaller organisations vis-a-vis their larger counterparts. The size of an organisation is a critical element in determining the cost burden.
- This may in turn have the effect of raising entry barriers in the industry and, in the process, compromise the competition objective.
- It can make compliance more superficial, turning it into a box-ticking exercise.
- Haldane and Madouras (2012) argue that complex rules often have high costs of information collection and processing. Again, this is likely to be a particular burden for smaller institutions.
- Complex rules have the potential for regulatory arbitrage and greater gaming of regulation by regulated institutions making it more difficult to identify when rules are being gamed. As suggested by Aikman, et al. (2014), "such arbitrage may be particularly difficult to identify if the rules are highly complex". By contrast, "simpler approaches may facilitate the identification of gaming and thus make it easier to tackle".
- Complexity can add opacity to banking business, making it harder for outsiders to appraise risks: this is the case with, for instance, the internal models that many large European banks are allowed to use for market and credit risk (under the internal

[16] See Commission Staff Working Document Economic Review of the Financial Regulation Agenda, page 269 para. 3

ratings-based (IRB) approach), where apparent inconsistencies across banks have emerged.[17]

A more general feature suggested by Haldane and Madouras (2012) is that “the more complex the environment, the greater the perils of complex control.” [A related point is also made by Gigerenzer (2010)]. They argue further that “because complexity generates uncertainty, not risk, it requires a regulatory response grounded in simplicity, not complexity”.

Complexity is measured through a cost-benefit analysis which is an integral part of the impact assessment within EU policy making. It is very important, however, that the Principle of Proportionality takes account of the risks faced by bank customers. In the current climate, where banks are seeking to re-establish trust between themselves and users of financial services, the adoption of proportionality should not lessen the protection of consumers and other users.

Complexity should also be addressed from the point of view of the business activities of the institutions. When products and services of an institution are simple, where the terms and conditions are easy to understand and transparent for the average consumer and user of banking services, less complex, standard regulations might be applied in some cases. Nevertheless, that treatment should not be applied to the more complex products or positions of the institution, e.g. non-standard derivatives or securitisations. Furthermore, smaller material exposures, positions and events should be exempt from the reporting requirements if they are related to less complex activities. However, they should be included in the internal reporting if they bear relevant operational risks.

The requirements of the European single market, and the need to maintain competitive neutrality, add a dimension that is not present in other jurisdictions, making regulatory requirements more complex and detailed. The local regulatory institution in each Member State also adds to this complexity, especially if local rules deviate from central rules and/or are not implemented simultaneously. Banks operating in many countries with centralised business systems are especially exposed to extra cost due to such differences. Different regulatory practices and rules in Member States are also giving banks different cost levels, and are thereby not competitively neutral or contributing to creating a common market with equal business rules for international banks. Additionally, local regulatory agencies in each Member State may gold-plate common rules which injects even more complexity into the overall regulatory regime.

For institutions which sell products covered by more than one regulatory agency, it could be argued that the approach chosen is fundamental: adopting an approach per product (instead of by typology of provider, for instance) could contribute to limiting the excess of complexity. For example, while an investment product is to fulfil a particular need for an end-user and this end-user needs to be protected when acquiring and handling this product, there are a number

[17] By increasing opaqueness, excess complexity may also weaken the value of market discipline. For instance, Barclays Capital (2012) reports that more than half of all investors do not understand, and do not trust, banks’ risk weights.

of regulatory agencies depending on whether the provider offering this product is a bank, an insurance company, or an investment company.

Finally, the divided organisational responsibility for different financial products (the multi-tiered structure of the ESAs, coupled with national authorities) implies high implementation costs and a probability of having to "dig the road twice" when it comes to implementing a regulation (e.g. in IT systems). Responsibility for regulation at the European level is divided between the three ESAs; EBA, ESMA and EIOPA, in addition to the European Systemic Risk Board. Although the work is coordinated through the ESAs Joint Committee, the probability of experiencing differences, duplication and uncorrelated rules for the three main areas dealt with by the ESAs is substantial.

Financial institutions have differing business models involving different financial systems. However, many institutions are adding new products to their portfolio. IT systems for management, transaction processing and reporting are in many financial institutions therefore dealing with all or most regulated products. Even small differences in regulatory definitions and implementation procedures may therefore cause extra costs for the institutions affected.

A particular example of pending complex regulation can be found in the mortgage lending value (MLV) for which the EBA is required to develop draft regulatory technical standards (pursuant to Article 124(4)(a) of Regulation (EU) No 575/2013 of 26 June 2013) on prudential requirements for credit institutions and investment firms (Capital Requirements Regulation). Pursuant to this provision, the EBA is required to develop draft regulatory technical standards to specify the "rigorous criteria for the assessment of the mortgage lending value". Art 4(74) CRR defines MLV as 'the value of immovable property as determined by a prudent assessment of the future marketability of the property taking into account long-term sustainable aspects of the property, the normal and local market conditions, the current use and alternative appropriate uses of the property". Detailed national MLV regulations exist only in Germany, Spain, Poland and the Czech Republic. The appropriate valuation inputs and adjustments vary throughout Europe, and even within a country as well as between and within different property sectors, and can only be properly and accurately derived by an experienced and properly trained valuer following an in-depth analysis of the local market. To draft RTS which take into account all country characteristics is an enormous task. To require harmonisation of the currently very-different levels of MLV regulations across the EU is, therefore, an example of disproportionate regulation.

Overall, in some circumstances, and especially in situations of uncertainty (where knowledge and understanding is limited), simplicity is superior which implies that, at least in some areas, there are elements of excess complexity in regulation. In such cases, the Principle of Proportionality should lead to adopting the simplest possible regulation. For instance, when ranking of riskiness cannot be made with confidence, assets should be aggregated.

Principles, processes and systems are important, but not infallible, safeguards against regulatory excess. Later sections of this report discuss specific measures in the emerging Single Rulebook where it is open to question whether in practice the Principle of Proportionality has been properly applied. It is also relevant to note that the European Commission has recorded

some dissatisfaction with the way in which associated procedures have functioned, such as lack of detailed feedback on consultations and the frequently perceived lack of high-quality cost-benefit analysis. Its 2014 report on the operation of the European Supervisory Authorities (ESAs) and the European System of Financial Supervision (ESFS), calls upon the ESAs to "ensure high quality cost-benefit analysis" and systematically to submit draft technical standards "to public consultations".[18] But the ESAs require support, including realistic time-frames and adequate resourcing, if they are to meet these expectations. The ESAs need to be adequately resourced: bad regulation can be delivered cheaply while good regulation may be expensive to deliver, and yet it can be money well spent in order to deliver adequate regulation.

Financial products and financial activity have become more complex, and regulation will necessarily have to reflect this fact. However, our judgement is that regulation is in many cases becoming more complex and detailed than the regulated business and products require. It is in this sense that we focus on "excess complexity". The level of detail that is required to meet the purpose of the regulation seems to have lost the law-makers and regulators' attention in their efforts to avoid the repetition of the latest financial crisis. Excess complexity adds to the cumulative cost of regulation.

5.4 Differentiation

A major dimension to proportionality relates to differentiation: the extent to which regulation applied to particular classes of banks should reflect their particular circumstances (including business models, size, risk profiles and systemic significance). This is clearly recognised in recital 46 of the CRR:

> *"The provisions of this Regulation respect the principle of proportionality, having regard in particular to the diversity in size and scale of operations and to the range of activities of institutions... Member States should ensure that the requirements laid down in this Regulation apply in a manner proportionate to the nature, scale and complexity of the risks associated with an institution's business model and activities".*

Differentiation is, to some extent, already reflected in many bank regulations, including capital requirements dictated by the Basel Accord: different regimes are available, e.g., for credit risk measurement, where large banks are incentivised to develop their own internal ratings while smaller institutions are provided with a simplified approach relying on external credit assessments. More generally, capital charges are graduated according to each bank's portfolio mix including, for example, equity holdings, project finance exposures, retail loans, etc.

This general principle is applied in several aspects of regulation: an example relates to reporting requirements, which can be particularly onerous for relatively small banks, and which look less justified for simpler banks operating on a local basis. Accordingly, the regulation states that certain reporting obligations are applicable only to institutions using

[18] COM (2014) 509 p. 6.

complex approaches to risk modelling. Similarly, some of the most burdensome requirements are imposed only on those banks which have significant risk exposures or significant activities.

While the need for differentiation is clear, it is sometimes difficult to implement when regulators are faced with a wide heterogeneity of banks with respect to size, business models, complexity, ownership structures, business mix, and degree of interconnectedness. Nevertheless, the dangers of a one-size-fits-all approach are clear: such an approach may lead to unintended consequences in that, for instance, the costs of regulation fall particularly heavily on small banks (because of the fixed cost element of the necessary compliance infrastructure) and yet mostly these institutions pose less systemic risk.

The need for differentiation seems to have permeated US regulation (particularly on capital requirements) more than in Europe. Basel II, for instance, has been implemented in the US only by the 19 largest banks; in Basel III, the requirements will be modulated according to bank size.[19] In particular, Basel III will not be applied to small banks (with less than USD 500 million in total assets) and will be less stringent for Community Banks. It is also envisaged that regulation on liquidity and governance standards will be made less stringent in the US for small and less complex banks.

In the UK's House of Lords' European Union Committee's 5th Report of Session 2014–15A,[20] Recommendation 12 reads as follows:

> *"Smaller firms, some financial services providers (including certain asset managers) and non-financial firms have been disproportionately affected by EMIR, AIFMD and CRD IV/CRR. Inappropriate definitions and requirements have been put in place which have significantly increased the operational costs for Real Estate Funds, Private Equity Funds and Venture Capital Funds in particular. This demonstrates the dangers of a lack of proportionality in financial regulation, and the need to keep in mind the specific features of the financial sectors in question. We repeat our call for better quality Impact Assessments before further significant reforms are introduced."*

This reference to the issue of a lack of proportionality in regulation which has a knock-on effect on certain financial institutions is concrete evidence that, without the correct application of the Principle of Proportionality, it will have a diverse impact on the European banking sector.

[19] Masera, 2013

[20] House of Lords' European Union Committee Report: The post-crisis EU financial regulatory framework: do the pieces fit?
http://www.publications.parliament.uk/pa/ld201415/ldselect/ldeucom/103/103.pdf

5.5 Materiality

In various papers issued by regulatory agencies (including the EBA and the European Commission) reference is sometimes made to the concept of *materiality* though, to the best of our knowledge, this concept has not been given a formal definition. We have not tried to make a legal definition, but for purposes of this study we define materiality as the requirement that particular regulation should only be directed and applied to those institutions which are relevant to the issue being addressed by the proposed regulation. Thus, for example, a regulation that is intended to be addressed to systemically significant banking institutions should not also inadvertently be applied to other institutions which are not deemed to be systemically significant. It is our judgement that this principle has not always been sufficiently recognised and we offer examples of this.

Differentiation requires that rules be made easier to implement in the case of smaller, simpler, less systematically-significant banks. We recognise, however, that while this decreases the burden imposed on such institutions in terms of compliance costs, it may also generate complexity in the regulatory architecture, as different approaches are taken to the same problem (e.g., the measurement of operational risk or the treatment of securitisations) and individual bank data become less comparable across the board.

The concept of materiality can be seen as a special case of differentiation, where some rules are waived, rather than applied in a simplified or less prescriptive way, whenever an institution is only marginally exposed to the risks that those rules are designed to control.

In order for materiality not to become a source of regulatory arbitrage, waivers should incorporate an automatic trigger, whereby the exemption ends whenever risks increase in significance. For example, banks should be exempted from detailed reporting on some types of exposure not because they are small (in terms, say, of total assets) or operate on a local basis, but because (and as long as) that type of exposure does not exceed some maximum threshold. In this way, the waiver will automatically terminate as soon as the bank's involvement in that type of business increases to significant levels.

6. Conclusion drawn from the analytical framework

The purpose of this part of the report on proportionality has been to define the term and its key dimensions and to establish a broad analytical framework to the Principle of Proportionality as well as to offer "warning signs" of the potential for disproportionate regulation that regulators need to be conscious of. Overall, our analysis shows that the principle, when carefully defined and constantly enforced, provides powerful guidance in the efforts to improve the effectiveness of new regulations without giving way to excess complexity. Our "Five Pillars of Proportionality" paradigm suggests that the concept of proportionality is wider, and encompasses a wider set of issues, than is often assumed.

II. APPLICATION: CASE STUDIES

In Part II of this report, six case studies have been created where we investigate the role and importance of the Principle of Proportionality and illustrate its application: (1) Supervisory Reporting, (2) Liquidity, (3) External Models, (4) Governance related to Risk Models, (5) the Leverage Ratio, and (6) Corporate Governance. Specific recommendations are outlined in boxes within the text. The case studies are, of course, not exhaustive as every legislative and regulatory initiative brings with it a new opportunity to apply the Principle.

In this regard, the new regulatory framework's application, known as the CRD package, is a prime example of the acknowledgement of the diversity of the EU banking system through the application of that principle. The recitals of the new CRR (recitals 43, 46, 127 and 128 in particular) and the CRD IV (recitals 66 and 92 in particular) explicitly mention that its provisions should respect the Principle of Proportionality and that Member States, the Commission and the EBA ensure that all RTS and ITS are drafted in such a way that they are consistent with, and uphold, the Principle of Proportionality.

As developed in the previous section, the Principle of Proportionality is a relative concept which requires a case-by-case application, taking into account the specific circumstances of each case. This is why the balance that the Principle of Proportionality comprises would be best reached by examining the European banking landscape's diversity on a case-by-case basis in order, where relevant and appropriate, to adapt regulatory requirements to particular sub-sets of institutions. To comply with this demanding task, both regulators and supervisors should detect the provisions/practices where this principle should be applied.

1. Supervisory reporting

Supervisory reporting requirements are designed for submission only to supervisory authorities, and are an integral component of the supervisory process. They will typically provide a greater level of detail, and address more issues, than public disclosure requirements. It is often the case that certain portions of the supervisory reporting requirements serve as the public disclosure requirements mandated by the supervisors.

With this in mind, there is a clear imperative for the Principle of Proportionality to be applied as financial institutions of less complexity and/or smaller balance sheet size usually pose less of a risk to the economy. A proportionate approach to supervisory reporting would allow authorities to obtain the information that they require to accurately evaluate the financial institutions without enforcing a disproportionate cost on institutions. The question arises as to whether the costs of reporting requirements imposed on small institutions are disproportionate to the value of such reporting.

1.1 Sub-consolidation in cases of entities in third countries

In Article 22 of the Regulation on prudential requirements for credit institutions and investment firms (known as CRR), subsidiary institutions shall apply the requirements laid down in Articles 89 to 91 and Parts Three and Four on the basis of their sub-consolidated situation if those institutions, or the parent undertaking where it is a financial holding company or mixed financial holding company, have an institution or a financial institution as a subsidiary in a third country, or hold a participation in such an undertaking.

With regard to sub-consolidation in cases of entities in third countries, the Principle of Proportionality should be applied in a way where a materiality threshold is included in order to avoid huge added costs (all reporting requirements with the exception of liquidity and leverage ratio need to be fulfilled at a sub-consolidated level) which is disproportionate in terms of the value added for regulators. If, for example, the total assets or profits of those institutions or financial institutions triggering the sub-consolidation do not exceed a threshold of 10% of the subsidiary institution, the sub-consolidation requirement could be omitted in order to reduce the cost burden.

1.2 Reporting of credit institutions' funding plans

The EBA published on 30 June 2014 its final guidelines on harmonised definitions and templates for funding plans of credit institutions[21] on the basis of Article 35 of the EBA Regulation. These were for the purpose of ensuring compliance with paragraphs 1-5 of Recommendation A.4 of the European Systemic Risk Board Recommendations of 20 December 2012 on funding plans of credit institutions ("ESRB Recommendation A.4").

These Guidelines aim to harmonise the reporting of funding plans across the EU. In summary, the EBA is introducing a set of templates that contain harmonised definitions of the data items

[21] https://www.eba.europa.eu/-/eba-publishes-guidelines-on-harmonised-definitions-and-templates-for-funding-plans-of-credit-institutions

to be reported by institutions to their competent authorities, and from there to the EBA. The set of templates and definitions will assist the competent authorities in assessing the feasibility of the funding plans of credit institutions, and their impact on the supply of credit to the real economy, as well as enabling the EBA to discharge its duty to coordinate the assessment of funding plans at EU level, and assess the viability of these plans for the European banking system. As a rationale for these guidelines, the EBA states that funding conditions for credit institutions have been significantly affected by the global financial crisis and that credit institutions have responded to this situation by making changes to their balance-sheet structures and the way they fund themselves. However, this is not true for some banking institutions which have a very conservative funding approach by using its deposits as the main source of funding.

The ESRB has set threshold criteria that require a competent authority to collect data from institutions that represent 75% of a banking system's total consolidated assets.

Based on the Principle of Proportionality, and in order to lower the burden of reporting, funding plans should only be required for those banking institutions that have a different funding plan (than the traditional funding approach) and have a Loan to Deposit Ratio greater than 100%. In addition, given the liquidity support within banking groups and institutional protection schemes (IPS) or other mutual solidarity systems, submitting the funding plans at a consolidated, IPS, or other mutual solidarity systems level only should be sufficient.

1.3 Disclosure of the management body's number of directorships

Here we refer to the draft guidelines on materiality, proprietary and confidentiality and on disclosure frequency under Articles 432(1), 432(2) and 433 of Regulation (EU) 575/2013.

Requiring the same disclosures for all institutions is not consistent with the Principle of Proportionality and causes a big administrative problem for some banks. It should be encouraged that a specific exemption - Article 435(2a) CRR - is granted to small and medium institutions from the disclosure of the number of directorships held by members of the management body.

This example, although not too burdensome by itself, becomes a significant challenge for banks when taking into account all cumulative extra reporting requirements.

1.4 Solo and consolidated reporting in case of the LCR/NFSR

The operational requirements for solo reporting are outlined in Articles 6(4) and 11(3) for consolidated reporting. The requirement for consolidated reporting could result in a disproportionate effort in cases where the entities to be consolidated are fairly insignificant. The burden for consolidation lies in operational efforts and obtaining the relevant data in the first place. The situation becomes yet more complex in cases where the entity that needs to be consolidated is not subject to CRR requirements.

To address this issue, the requirement for insignificant entities could be waived. This would entail a definition of "insignificant" which could, for example, use already-existing approaches

applied in other legislative areas such as CVA-charge or non-centrally cleared derivatives. The use of thresholds based on metrics which reflect the significance of an entity could reduce complexity and excess burden for these credit institutions. As a suggestion, in the particular case outlined above, a possible metric could be the size of the solo balance sheet expressed as a percentage of the total consolidated balance sheet. If the entity is truly insignificant, key indicators of the LCR/NFSR should not show much variance when applying the solo versus consolidated approach.

1.5 FX reporting (interest rate risk, liquidity reporting)

The reporting requirement for interest rate risk on foreign currencies is based on the SREP requirements of the relevant competent supervisor according to which reporting is obligatory for currencies which are above a certain threshold of the assets or liabilities, including off balance sheet items.

Such a threshold should reflect the relevance of the interest rate risk and liquidity risk of the currency. The SREP requirements will soon be harmonised and the following example for a proportionate treatment of interest rate risk could be taken into account.

Currently, interest rate and liquidity risks are reported separately for each currency. This means that the interest risk (e.g. in terms of earnings at risk and value at risk) is computed under certain scenarios. Also, the liquidity profiles for the different currencies have to be computed without taking into account their respective relevance. This applies even in the obvious case that there is no risk in the respective currency.

Instead of going through the calculations and concluding that there is no risk involved, it would be more appropriate and proportionate to look at indicators beforehand (e.g. delta-profile per bucket) and to run the scenario analysis only in cases where a relevant indicator implies that a risk is involved.

Regarding the requirement for an institution to provide maturity profiles in all applicable currencies (which stems from the ILAAP) it would be more proportionate to apply this requirement to significant currencies only. A currency could be deemed insignificant where the internal policy and risk limits of the institution prohibit any mismatch or curtail it at an insignificant level.

1.6 Intraday liquidity reporting

The monitoring reporting requirements as published in the final paper of the Basel Committee on Banking Supervision ("Monitoring tools for intraday liquidity management") are designed for internationally-active banks. The EBA work programme for 2015 contains item WP 346 (referring to Article 59 (5) EU/909/2014) which relates to the Committee's paper.[22] WP 346 requires the development of a regulatory technical standard to further specify the details of the frameworks and tools for the monitoring, management, and reporting of the credit and

[22] http://www.bis.org/publ/bcbs248.pdf

liquidity risks, including those which occur intraday. The requirements are cumbersome and have added value only in cases where significant international activity is involved.

The application of the potential RTS should be proportionate with regard to the significance of the international activity of the credit institution/CSD: in cases of insignificant international activity, the reporting requirement could be waived. This is because it would otherwise impose unnecessary costs on such institutions in terms of time, diversion of personnel, etc.

2. Liquidity

The European Commission released in October 2014 the Delegated Act on the implementation of the LCR (2015/61 of 10 October 2014) to supplement the CRR (regulation 575/2013 of 26 June 2013). The outcome has been rather positive with regard to proportionality, in the sense that the pool of assets to be considered as liquid has been enlarged, including a larger scope of financial instruments to be eligible, and including instruments which have closer ties with the real economies such as covered bonds and asset-backed securities. This will help to ease the work of banks which may have a greater stake of these instruments in their balance sheets.

It is important that the Principle of Proportionality reflects the diversity of the balance sheet of banking institutions which contribute to the financing of the economy.

2.1 Suitable recognition of the liquid assets from CIUs

A large number of small institutions have no direct holdings of securities. These institutions have neither the human nor organisational capacity to manage these securities, and have outsourced all securities to investment companies. They are invested in special funds and public funds. Under the provisions of Art. 15 1. b) of the Commission Delegated Regulation (EU) No …/… (10 October 2014) shares in special funds shall be eligible for recognition as liquid assets up to an aggregate amount of EUR 500 million provided the special fund has invested entirely in liquid assets (the sole exception being the liquidity reserve).

Regarding a special fund with only one investor (i.e. a 100% shareholding with one bank), in terms of the recognition of liquid assets there will be a different treatment compared to the banks' own securities portfolio. Firstly, there is the upper limit. In addition to this, from now on, the high quality liquid assets (HQLA) funds created will have to be "pure". This will trigger the need for comprehensive re-groupings. Particularly for smaller and medium-sized banks, such an approach will incur considerably higher costs. However, with regard to a special fund with only one investor, due to the rights of direct access, the respective liquid assets can be realised just as easily as the own securities portfolio. Furthermore, contrary to publicly-offered funds, a potential sale of liquid assets will not be detrimental to other investors, since there are none.

This differential treatment therefore appears to be inappropriate. From a proportionality perspective, a special approach to the actual application of the look-through principle should be permissible, i.e. recognition of the liquid assets should be possible even if the special fund is not exclusively invested in HQLA.

3. External models

Because of the different business models of banks, it is appropriate that diverse approaches are used by different banking institutions when drawing up their rating models.

The main reason why institutions to be taken into consideration for proportionality[23] (ICPs) have difficulties in implementing an IRB model is that they do not have the large number of customers or defaults that are essential for a rating model that must be validated from a statistical point of view.

Whereas for Loss Given Default (LGD) it remains possible to make estimates based on the experience of the institution, this is almost impossible for Probability of Default (PD). Two concrete examples are given:

(1) A portfolio of residential mortgage credits with 2.000 files, and 10 (or less) defaults per year: an analysis of these defaults shows that in eight out of ten defaults, relationship problems of the borrowers (e.g. divorce) are at the origin of the default. The definition of the probability of default is especially challenging here.

(2) An SME credit portfolio of 4.000 files with twenty defaults per year: the problem in this case is how to obtain a probability of default that is relevant from a statistical point of view.

These examples show that for smaller institutions it is almost impossible to operate an IRB approach. This creates an un-level playing field, because it is the 'internal' part of the IRB approach that causes difficulties for ICPs, as their low-complexity model should be based only on external ratings.

Simplified methods should allow current standardised (SA)-institutions to calculate the capital charges for credit risk, without being obliged to take into account a Pillar 2 capital add on. This would allow SA-institutions to cover the same risks as under the Internal Ratings Based (IRB) approach but in a more simplified way.

The Principle of Proportionality would encourage the development of an intermediate approach (between the standardised approach and the IRB-approach) for the calculation of the risk weights. This would have the advantage of preventing ICPs from being "punished" by the application to portfolios/risk of "excessive" risk weights which are taken from the standardised approach.

[23] The denominations 'larger' and 'smaller' may be misleading as size is not the only criterion to determine proportionality.

The following steps are suggested:

1. Create a prudential framework which offers the possibility of an intermediate approach, by applying the following methodology:
   - Selecting an already existing and generally known risk framework (for example: S&P Risk Adjusted Capital Framework);
   - Adapting the risk weights using other registered models (e.g. the Ooghe failure prediction model);
   - Adapting the weights using simple internal statistical calculations that have been validated (e.g. the average default-history).
2. Give a description of the intermediate standard framework.
3. Develop the intermediate standard framework for each risk.
4. Lay down a procedure for the internal overrides of the risk weights from the intermediate standard framework.

An intermediate approach would make it possible to apply a weighting to all material risks: credit risk, market risk but also Pillar 2 risks such as interest rate risk, concentration risk, diversification risk, wrong-way risk, correlation risk, mark-to-market loss, etc.

In addition, the proposals outlined in the box should reduce the un-level playing field between standardised and IRB banks, which would contribute to the promotion of the Principle of Proportionality.

4. Governance relating to risk models

ICPs should be able to apply external models when calculating their capital requirements. While we agree that most of the minimum requirements for IRB models should also be applicable to these external models, we believe that in the field of governance, modifications are such as to introduce a proportionate treatment.

1. Reduce the risk weight of credits covered by a mortgage mandate:

Standardised banks should be given lower risk weights to credits covered by mortgage mandates. The risk weight for such credits can be based on information obtained from the supervisor or on historical LGD information of the institution itself (or on a mix of both).

Example: If the historical LGD information of the institution shows that in 70% of the defaults the institution was not too late to convert the mandate in a mortgage, 70% of the credits would get the risk weight of mortgages and 30% would be treated as other retail.

2. The standardised risk weight of 35% does not take regional differences into account:

The 35% level is set as an international standard. Is it appropriate that this factor does not depend on the situation of the real estate market?

A lower risk weight could be applicable in regions with a sound and healthy real estate market, and a higher risk weight in regions with a more vulnerable real estate market (risk of a bubble, or a macro-economic situation that will put pressure on real estate prices).

By using such a model, the un-level playing field between standardised and IRB banks in economies with a mature real estate market would be reduced.

Whereas IRB models are based more upon historical information, the S&P approach is based more on prospects for the future evolution of real estate prices, which is more appropriate in order to determine the capital adequacy to cover future defaults.

We fully subscribe to the need for validation of a model, be it an internal or an external model. However, the cost of validation of a model can, in some countries, be extremely high as a result of the lack of third parties which can deliver a sufficient qualitative validation.

Without doubt, the validation of a model is an integral part of the framework for a model-based approach in prudential requirements. As a result, it should not be left to market forces to define the number and quality of companies which can exercise such a service. Consequently, in cases where there is not a sufficient number of qualitative market parties (an estimated 4 as a minimum), regulators should take responsibility for the validation of the model.

5. Leverage Ratio

The introduction of the leverage ratio as a compulsory minimum ratio will ultimately have an impact on the business structure of credit institutions. The adjustment to the new requirement will potentially result in higher costs and might entail unintended consequences, such as the availability and price of credit. The availability could be suppressed as the possibility to provide credit will, given an unchanged amount of capital, be restricted by the

leverage ratio requirement. Given its outline and design as a Pillar 1 requirement, the leverage ratio might especially harm banks with low-risk but high-volume business.

The European Commission is due to publish a report on the impact and effectiveness of the leverage ratio by 31 December 2016 (Art. 511 (1) EU/575/2013), which might be accompanied by a legislative proposal on "the introduction of an appropriate number of levels of the leverage ratio that institutions following different business models would be required to meet" (Art. 511(2) EU/575/2013). In the run-up to the Commission's action, the EBA was tasked to provide a report by 31 October 2016 on, amongst other issues, "(identification of) business models that reflect the overall risk profiles of the institutions and on introducing differentiated levels of the leverage ratio for those business models". This would include the question, "what would be the appropriate level for the leverage ratio for each of the business models identified in accordance with point (b)." (Art. 511 (3) (b) (i) EU/575/2013).

With a view to the upcoming requirements, some credit institutions are already anticipating the likely impact on their business models and are already adapting their structure to the future introduction of a compulsory non-risk-based minimum ratio. For those banks operating in the above outline segment (low-risk, high volume) and being specialised credit institutions, the leverage ratio is likely to become a binding constraint. As Recital 95 of EU/575/2013 states:

> *"When reviewing the impact of the leverage ratio on different business models, particular attention should be paid to business models which are considered to entail low risk, such as mortgage lending and specialised lending with regional governments, local authorities or public sector entities."*

Given that a differentiated approach is considered during the preparatory work and analysis of the EBA and the European Commission, the following options could be contemplated in the application of the leverage ratio to the different business models:

- A differentiated level of the leverage ratio for business models, reflecting its actual level of risk; or
- A longer implementation period for institutions. Whilst this would probably not mitigate the upward pressure on pricing, it might enhance the availability of credit as the longer adjustment period would enable credit institutions to sustain their business function during the transitional period. When setting the appropriate implementation period for different business models (e.g. as in the FPC proposal of the Bank of England[1]), the EBA could, for instance, take into account the additional capital requirement relative to the capital requirement without the leverage ratio, and the different options available to credit institutions to access capital (which might be restricted for some credit institutions due to legal reasons/articles of association).

In its August 2013 consultation paper on "Strengthening capital standards: implementing CRD IV", the Bank of England also supports the idea of a transitional period for banks to be "as

smooth a transition as possible to the new CRD IV regime and has therefore sought to implement transitional provisions where the PRA considers them to be appropriate and proportionate, having regard to the regulatory principles".[24]

The European legislator has recognised the vulnerability of this segment and we urge that extra care and attention be given when analysing the impacts.

As required by the CRR, further consideration should be given to adopting a differentiated leverage ratio for different business models so as to more accurately reflect the actual level of risk, and the implementation period should be lengthened as implied by the findings of the analysis carried out during the observation period.

6. Corporate Governance

One of the main areas where proportionality could be further applied is corporate governance as the systems used reflect the diversity of the business models and organisations. Several official and academic studies have identified weaknesses in corporate governance as a significant factor in the banking crisis. As a result, there has been a regulatory response to address several aspects of corporate governance in regulated firms, some of which may be problematic with regard to the Principle of Proportionality.

In the application of the principles of internal governance to "institutions to be taken into consideration for proportionality" (ICPs) it is essential that a balance is struck between (i) the principle of functional separation[25] and (ii) the risk of a silo management of an institution. While functional separation is estimated to be an appropriate way of managing governance in large institutions, it should be kept in mind that one department of a large institution may be as large as, or larger than, an integrated ICP.

Within ICPs, care is needed to avoid the danger that an exaggerated functional separation (e.g. compliance, audit, risk management, etc.) leads to a situation whereby managers are unable to oversee the overall position of an institution. This leads to the alienation of managers from the underlying core activity and consequently impedes a good and proper management of the institution. Instead, we defend an integrated management style whereby managers of ICPs can keep the overview of their institution and where emphasis is put on qualitative (risk-minded) management of an institution instead of formalism.

We consider four particular aspects of governance arrangements where the Principle of Proportionality may have been compromised in recent regulation:

[24] http://www.bankofengland.co.uk/pra/Documents/publications/cp/2013/cp513.pdf, page 26, paragraph 6.34

[25] BSG response to EBA/CP/2014/36 on assessment methodology for NCAs regarding compliance to the use of the IRB Approach: Response to Q2, page 6, which illustrates the difficulties of small institutions to separate functions of model validation and other personnel.

6.1 Mandates and Remuneration

Among other things, the CRD IV package regulates aspects of mandates and remuneration. Although CRD IV provides mandatory restrictions only for important (large and complex) institutions, the legislation in some countries imposes the restriction as a first step on all institutions. Concentrated efforts are needed to achieve a statutory rule in line with CRD IV and according to the Principle of Proportionality. This example may reveal the challenges faced when European regulation is transposed into national law. In the context of compensation, similar problems exist with respect to national implementation.

It is important to stress that by far the greatest proportion of employees in the financial sector does not receive excessively large bonuses or other kinds of variable remuneration which give rise to systemic issues.

Therefore, the implementing measures should introduce a somewhat sharper distinction between the treatments of normal wages for ordinary employees on the one hand, and the remuneration of high-ranking risk takers and managerial staff on the other. This relates both to the involvement of, for example, compliance, as well as shareholders. In relation to ordinary wages, there are no special systemic or other special issues that make them relevant for detailed involvement of compliance, shareholders etc. A more general oversight should be appropriate for this part of the wage structure. Likewise, this also makes it more difficult to see any need to recommend voluntary expansions of the rules for identified staff to ordinary employees.

6.2 Organisation and assessment of the board

According to numbers 55 and 57 of the Consultative Document “Guidelines – Corporate Principles for Banks” (BCBS 294), the board should structure itself in terms of leadership, size and the use of committees (see number 5.3 below) in order to effectively carry out its oversight role and other responsibilities. To support its own performance the board should carry out regular assessments of the board as a whole, its committees and individual board members.

With regard to the Principle of Proportionality, and in the interests of effective and efficient bank regulation, these requirements should only be recommendations to banks of large size, risk profile or complexity.

6.3 Board Committees

In number 62 of the Consultative Document BCBS 294, the board shall establish certain specialised board committees, unless it can demonstrate to the supervisor that it can effectively accomplish the described goals without such committees.

In consideration of the Principle of Proportionality, the requirement to establish board committees (audit committee, compensation committee or other board committees) should depend on the size and internal organisation of a company as well as the nature, scope,

complexity and risk potential of a company's business activities. It should not be mandatory for all institutions.

6.4 Control Functions

In recent years, banks' internal processes and organisational structures have become increasingly influenced by regulatory requirements. This has led to the emergence of numerous novel organisational functions, most of them accompanied by dedicated appointees taking responsibility for a wide array of topics ranging from compliance over anti-money laundering to whistle-blowing. Evidently, smaller institutions are at a significant disadvantage compared to larger ones when implementing these requirements as installing or expanding a control function will always require a minimum of fixed costs. These costs are proportionally higher the smaller a bank is.

In this context, the Chief Risk Officer (CRO) may serve as an example. Both the EBA Guidelines on Internal Governance (EBA-GL 44) as well as the Basel Committee's Consultative Document BCBS 294 require large, complex and internationally active banks to establish an exclusive CRO at senior management level.

According to the Principle of Proportionality, the corresponding requirements (e.g., the prohibition of 'dual hatting') should not apply to smaller banks with less complex, low-risk business activities.

For such banks alternative solutions can be appropriate: typically, either a senior manager carries other responsibilities besides the risk control function (e.g., the CFO), or a senior person below management board level is entrusted with the CRO role in accordance with the current EBA-GL 44. In addition, Article 27 of the EBA Guidelines on Internal Governance (GL 44) also requires that an "institution shall appoint a person, the Chief Risk Officer ("CRO"), with exclusive responsibility for the risk control function (RCF) and for monitoring the institution's risk-management framework across the entire organisation".[26] This idea of having a senior person below management board level is also supported in the August 2013 consultation paper on "Strengthening capital standards: implementing CRD IV", published by the Bank of England, which states "Firms must have a risk management function that is independent from its operational functions, where appropriate and proportionate. The function is responsible for assessing all material risks, with direct access to the management body. It is also to be involved in elaborating the firm's risk strategy and in all material risk management decisions. The function is to be headed up by a dedicated independent senior manager. If having a dedicated independent senior manager is disproportionate, another senior person within the firm may be appointed, provided there is no conflict of interest".[27]

[26] http://www.eba.europa.eu/documents/10180/103861/EBA-BS-2011-116-final-EBA-Guidelines-on-Internal-Governance-%282%29_1.pdf

[27] http://www.bankofengland.co.uk/pra/Documents/publications/cp/2013/cp513.pdf, page 18, para 4.12(3)

III. COSTS AND IMPACTS ON STAKEHOLDERS

In Part III we consider some aspects of costs and impacts. Overall, the issue of proportionality cannot be divorced from the application of cost-benefit analysis. In the final analysis, of course, and as argued by the EU Commission, "…what really matters is whether the reform delivers net societal benefit and results in a more stable, responsible and efficient financial system as a whole" (EU Commission, 2014).

A central purpose of regulation is to protect customers and society from the negative effects of failures of financial institutions, by reducing the probability that they should happen. A failure may imply a direct loss of customer capital due to the uncovered counterparty risk. A failure of a financial institution could imply that customers (by also being tax-payers) have to share the cost of a government rescue operation through the tax bill. For society, a failure, especially of a larger financial institution, will in most cases create negative effects in other sectors of the economy and in many cases imply negative operational consequences related to the financial infrastructure. Although the benefits of regulation may be difficult to trace when the economy is working normally, regulation offers the benefit of a degree of confidence that banks remain safe. To the extent that this enhances users' confidence in dealing with banks this in turn generates general benefits for the economy as a whole.

1. Cost of prudent risk and reward management

Common to the banking and non-banking industries is that the higher the risk, the higher the expected reward. As with any other business, the privately-owned financial business seeks to maximise the return for their owners. The reward systems for top management are normally

focused on encouraging high earnings, and thereby indirectly high risk. However, well-managed institutions normally also have a strong focus on the risk of not being able to meet their commitments, which would imply the failure of the business. For this purpose all prudently operated business activity has to incur a certain cost of establishing and operating risk-management systems to identify and monitor key enterprise risk elements.

Taking appropriate action to mitigate unwanted risks normally comes at a cost for any business institution. The Board of Directors of all corporates have an overall responsibility to ensure that appropriate risk management systems are in place, not only to accommodate shareholder interest, but also to ensure that the company complies with public law and regulation. The responsibilities are yet stronger in the case of financial firms because of negative externalities (failure of a single bank may have a contagious impact on the financial system as a whole) and resultant negative feed-back loops involving the banking system and the real economy.

A number of failures and major loss incidents in financial institutions can be related to a lack of effective internal reporting, control and risk management routines. Despite the existence of a highly detailed regulatory framework, financial institutions may still fail due to a lack of compliance or lack of proper internal risk management systems initiated and monitored by the Board of Directors and the executive management. Adequate risk management for a financial institution will therefore always have a cost element. In addition, putting efforts into developing appropriate products could contribute to a reduction in market failures: rules on product governance and remuneration in the sales process are essential to achieve proportionate regulation.

The main issue when discussing proportionality is which of the risk elements in a financial institution should be vital or core for "risk management by regulation" and which risk elements and risk management procedures should be left to the Board of Directors and the executive management to govern.

In very simple terms, the implicit "social contract"[28] between the financial industry and the authorities is that the industry operates a proper risk management system based on prudent business principles, and that regulatory authorities impose certain additional costs in the form of mandatory risk management and reporting requirements. As a consideration for these additional costs, the authorities support a guarantee system for deposits from bank customers, provide access to liquidity when needed, and initiate countercyclical measures to stabilise the economy.

One of the definitions of proportionality in regulation states: "Regulators should intervene only when necessary. The remedies should be appropriate to the risk posed, and costs should be identified and minimised".[29] This implies that goals should be clearly defined and that cost and benefits are central considerations when evaluating any new regulation. In this statement

[28] "Redrawing the Banking Social Contract"- Speech by Paul Tucker, Deputy Governor, Bank of England, 30.6.2009

[29] Better Regulation Commission UK 1997

we take it that regulators also accept that size and nature of the risk in individual institutions should be evaluated when imposing regulations.

The risk and complexity of regulated products and trading should be considered in order to avoid excess complexity in the regulatory framework, and to evaluate the degree of detail needed to achieve the stated goals of the regulations. Regulators should also be clear about the role and responsibility of the Board of Directors of the institution with regard to establishing proper governance for the institution and establishing proper procedures for compliance with the general regulation of the industry.

The Principle of Proportionality establishes that cumulative benefits of the regulatory burden to the industry should outweigh the additional risk management cost imposed on the industry. The stakeholders in regulation (i.e. authorities, the financial institutions, customers and employees) should all feel that regulation is creating value. This implies that the cumulative benefits of the regulations should be larger than the cumulative cost, and that the cost of additional regulation should contribute positively to value creation. In a recent report, the House of Lords has argued: "We are concerned that the compliance costs of such a vast set of regulatory reforms may have been underestimated, and that consequently their value for money was not properly assessed" (House of Lords, 2015). In addition, assessing the regulation during the implementation (undertaken by the European Commission through its reviews) is also of great value and contributes to enhancing the quality and the proportionality of regulation.

Regulation is equally important to prevent market failures, such as financial products that are not suitable for the needs of end-users, conflicts of interest and resulting mis-selling practices, overpriced services for end-users or financial exclusion. Such market failures impose an immense cost on end-users and society as a whole. The prevention of bank failures also avoids indirect costs which need to be assessed besides costs imposed on taxpayers including, for example, macro effects such as loss of employment or unavailability of key public services due to austerity resulting from expensive bank failures. These factors should be taken into account to make the cost-benefit analysis results conclusive enough on whether a piece of regulation or the totality of regulation are proportionate.

Measuring the net value (i.e. the costs and benefits) created by regulation is a challenging task. However, in the context of the Principle of Proportionality, the stated goals of regulation, and the cost of compliance, this issue needs to have a larger focus than in some cases it has had hitherto. Lawmakers, regulators and all other stakeholders have an interest in pursuing this challenge. It is partly for this reason that we believe that creating a Task Force could assist in systematically considering all aspects of the Principle of Proportionality and its application.

2. The incidence of the cost of regulation

As already mentioned, measuring the cost of regulation is not easy, especially when considering the cumulative effects. On the other hand, the EU Commission has argued that "…the combined costs are less than the sum of the individual requirements" (EU Commission,

2014). Furthermore, the Commission argues that "a part of these costs are temporary adjustment costs during transition to a more stable and responsible financial system" (EU Commission (2014, page 15). In addition, the Commission argues that "…there are severe data limitations that impede the quantitative assessment of many reform measures. For this reason, it would not be possible to come up with a reliable and comprehensive quantitative estimate of the total costs and benefits of regulation."

Likewise it might be difficult to precisely quantify the costs and the benefits of regulation. Any assessment of regulation (including cost-benefit analysis and the issue of proportionality) must necessarily be grounded in what the objectives of regulation are: i.e. on what regulation is trying to achieve. While regulation has costs it also has an important range of economic benefits which means that it is reasonable and rational for stakeholders (including customers) to, in one way or another, explicitly or implicitly, pay for regulation.

The marginal effect on costs and benefits of adding another law or directive referring to the same goal of regulation may be difficult to establish. The question to be asked is what regulatory actions are best suited and necessary for achieving the targets of reducing the core risks, and how these targets can be achieved at the lowest possible cost for the stakeholders, including regulatory authorities.

It should also be asked which institutions and which products or business processes are the most important contributors to the core risks defined and the aggregation of such risks in the financial system. Banks and financial institutions have different business models, different categories of customers and different geographical presence. The cost of regulation is highly dependent on how authorities define the core risks, the aggregation principles of risk including correlation effects, and how to manage the total risk in the financial system. Defining the risks that matter is key to the Principle of Proportionality and the implementation thereof.

2.1 Banks

The cost of compliance is likely to impact smaller institutions more than larger ones. The cost burden will normally emerge as an increase in the number of people working in the area of compliance and reporting to regulatory authorities. As a ratio to the total number of employees, a large institution will normally show a lower share than a smaller one.

IT costs are large and necessary in order to deliver banking services to customers, to manage the balance sheet and risk for internal purposes, and to report to regulatory authorities. With limited resources, the increased demand for systems adjustments to meet regulatory demands may imply conflicts with other prioritised IT improvements, such as functions related to customer interfaces.

All costs imposed by regulations tend to have an economies-of-scale effect on regulated institutions, and therefore might (unintentionally) have effects on the structure of the financial industry. The absence, or the incorrect application, of the Principle of Proportionality within many areas of the regulation of the financial industry implies that the tendency of merging smaller institutions into larger ones will be further encouraged. The cost (and

particularly fixed costs) connected to heavy regulation may also prevent the entry of new financial institutions.

The increase in costs is highlighted in the EBA's discussion paper on SMEs and the SME Supporting Factor, which gives as an example a study[30] which uses data for 250 large banks in the euro area, and finds that banks forced to increase their Core Tier 1 ratio by 1% had an annualised loan growth (over the 9 month period of the exercise) that was 1.2% lower than unconstrained banks. To sum up, there is some early empirical evidence that suggests that reductions in individual bank lending are indeed one of the possible short-run costs of binding risk-based capital requirements.[31] On the other hand, although there are on-going costs of regulation, some of the costs imposed by recent regulation are associated with the introduction of a raft of new regulation in the immediate post-crisis period. The impact of bank regulation on the SME sector needs to be monitored.

Regulated institutions are spending more and more management time, system resources and consultants to interpret the rules, implementing them and performing the required reporting. The overall complexity in laws and directives related to regulation may force smaller institutions to hire expensive consultants rather than relying on in-house expertise, making smaller institutions less competitive and management less competent in regulatory issues. Whether all this is strictly proportionate might be questioned.

Small firms have fewer resources to follow the changes in the regulatory environment. In small institutions the division of labour is considerably less than in large ones, employees are not as specialised, and one person is often responsible for several functions. When there is a general pressure on costs, small institutions are less capable to pay for the relevant specialists.

2.2 Bank customers

The immediate incidence of most of the costs of regulation is on regulated entities. Some parts of this cost may be charged to the public through the taxation system. As with all costs, banks have to seek to cover the costs of regulation in their margins, the fees they charge, or through increased productivity. An important issue is the precise incidence of regulatory costs: i.e. who ultimately pays. In the final analysis, regulatory costs end up as increased expenses for bank customers. In 2013, KPMG conducted an impact analysis of the accumulation of regulation on the Belgian banking sector. One conclusion was that, given market dynamics, banks might attempt to partly transfer the cost of regulation on to customers.[32]

Regulators' costs are either a charge on regulated institutions in the form of a levy or fee, or recovered through taxation. The total cost of regulation which is not recovered through

[30] Aiyar, S., Calomiris, C. W., & Wieladek, T. (2014). Does Macro-Prudential Regulation Leak? Evidence from a UK Policy Experiment. Journal of Money, Credit and Banking, 46(1), 181-214

[31] http://www.eba.europa.eu/documents/10180/1153414/EBA-DP-2015-02+Discussion+Paper+on+SME.pdf

[32] http://www.kpmg.com/BE/en/IssuesAndInsights/ArticlesPublications/Documents/The-impact-of-regulation-revised.pdf

increased productivity is ultimately passed on to customers in the form of increased margins or fees on products and services purchased from financial institutions.[33]

Although the total cost of regulation may be regarded by society and customers as an insurance premium for avoiding the negative impacts of a bank failure, the issue arises as to whether this implicit insurance premium has become excessive. It follows that any particular regulation (or regulation in aggregate) that is not proportionate imposes excessive costs on firms, consumers and other users of banking services, thereby implying an excessive insurance premium.

Regulation will, in most cases, represent a pressure on margins and earnings in the regulated industry, in particular if banks need to comply with new IT systems. The compensation for decreased margins is often sought through efforts to reduce costs: for example by reducing the number of employees, automatizing tasks, changing business models, or other measures to lower costs. The ultimate incidence of the cost of regulation is, therefore, absorbed by employees and customers of regulated institutions.

Customers and authorities legitimately demand safe and well-functioning financial institutions. Customers are also the main beneficiaries from the risk-reducing effects of regulation. However, the marginal benefits to customers from the introduction of new regulations, in many cases covering overlapping risk elements, are not always evident.

Another important aspect to consider is the comparison between the cost of regulation and the cost of non-regulation for consumers. It should be avoided that consumers buy inappropriate products by giving them adequate information (e.g. pre-contractual information requirements on the key features of the products, expressed in plain language).

The cost-benefit analysis must therefore properly represent the customer point of view and the costs and benefits to the customers, in particular consumers and SMEs.

2.3. Employees

A certain number of developments regarding work conditions and employment patterns can be recognised as consequences of regulation. The previously-mentioned KPMG study concluded that there is pressure on banks to reduce costs further with possible negative consequences for employment in the sector.

Regulation often increases administrative work implying a shift of the workload from traditional banking tasks to compliance, control and reporting. This is often especially the case when additional tasks are not addressed by additional recruitment but simply by an additional workload. A European project on the impact of MIFID[34] has evidenced this intensification of

[33] http://ec.europa.eu/finance/general-policy/docs/committees/140808-esfs-review_en.pdf, page 11

[34] http://apf.fiba.it/mifid.nsf

The project was led by APF-FIBA/CISL with the participation of: BBDZ (Hungary), FES-UGT (Spain), OSPPP (Czech Republic), OTOE (Greece), OZPPaP (Slovakia), UNITE (UK) and UNI Europa.

Ute Meyenberg et Lionel Zusatz, 08/2011; La directive MIF: Bonnes et mauvaises pratiques dans la banque commerciale en France.

work through increased reporting: increased reporting has a direct influence on the organisation of work. It is a rather contradictory aspect of the directive: on the one hand, better traceability and a better follow up of clients, investment decisions and product development is a welcome development from regulation. However, additional reporting and follow up obligations translate generally into an additional workload for employees. The understaffing of certain support functions can in the long run increase operational risks: lack of counselling, forced sales, etc., for commercial practices, but also errors in back offices or increased risks in case of system failure because of an overload of work.

The focus on operational risks and the inclusion of internal processes into financial regulation has brought about a change in employment patterns. As a consequence, control functions in relation to regulation (internal control, compliance, risk functions) have increased in absolute terms and relative to other support functions.[35]

[35] Dan Chelly, Stéphane Séboulé ; Mars 2014 ; Les métiers du risque et du contrôle dans la banque; Observatoire des métiers dans la banque.

IV. CONCLUSIONS

There is no doubt that regulation for the safety and soundness of financial institutions, systemic stability, and consumer protection is needed. However, the issues discussed in this paper relate to questions about the extent to which the overall benefits outweigh the cost and negative impacts. The key issue is whether the objectives of regulation in the perspective of the political environment, society and the immediately-affected stakeholders could be achieved by alternative measures, by less complexity, less detailed regulation, or by rigorously applying the Principle of Proportionality to a greater extent? This also implies commitment being given to how improved use of cost-benefit analysis could be of further assistance to regulators in deciding what regulations are needed and at what level of detail? In general, the need for an analysis and review of the regulatory system in pursuit of simplifications, without renouncing the key objectives and benefits of regulation, seems to be justified.

In the interest of better transparency, less costly bureaucracy, and lower compliance, excessive complexity should be avoided, and rules should be analysed with a view to simplification without compromising the intended purposes and objectives of regulations.

The Principle of Proportionality says in plain words that involvement from the EU institutions should be limited to what is needed to achieve the objectives of the treaties and reiterated in legislation. Applying the Principle of Proportionality in the case of regulation of financial institutions implies that regulation should be limited to what is needed to be regulated in order to achieve the targeted objective.

The envisaged cost-benefit analysis of regulatory activity is not always undertaken in a proper way, especially with regard to the cumulative costs and benefits of regulations. Further attention and improved processes for cost-benefit evaluations should be implemented.

The burden of compliance in financial institutions can be reduced if excess complexity is addressed. There seems to be an unexploited potential for cost savings even with a starting point that the same level of benefits and regulatory goals should be maintained.

Evaluation of costs and benefits, as well as tracing excess complexity in regulations, might be enhanced by an improved explicit and clearly-stated definition of the specific goal and purpose of each regulation.

V. RECOMMENDATIONS

The intention of this report has been to give an analytical framework related to the Principle of Proportionality as applied to the financial industry,[36] and to present case studies where there is *prima facie* reason to believe that the Principle has not been applied to the full extent possible. Our judgement is that the Principle has only to a limited extent been used as guidance when implementing new regulations for the industry. This has resulted in rules with an excessive degree of complexity that are not suitable for all financial institutions, as shown in the case studies. The implementation and compliance with the high number of detailed and complex regulations comes at a substantial cost for financial institutions and stakeholders.

The Banking Stakeholder Group of the European Banking Authority supports the increased focus on regulation which followed from the financial crisis. It recognises that some of the costs of recent regulation are associated with a one-off shift in the regulatory regime in the wake of the crisis. One way of conceptualising this is that a distinction needs to be made between the stock-adjustment effect associated with moving from one regulatory regime to another, and the new steady-state position once the full adjustment to the new regime has been made. Nevertheless, there will doubtless be more new regulation, and in any case there are continuing costs of existing regulation in the new steady-state regime.

In addition to the specific detailed recommendations made earlier in the report, we submit a set of more general recommendations to decision-makers and supervisors in order to contribute to an extensive and efficient application of the Principle of Proportionality:

[36] However, under the impetus of President Juncker, a Better Regulation Package was issued on 19 May 2015 which encourages undertaking comprehensive, cumulative impact assessments. This aims to ensure that the legislative framework (both existing and upcoming) is fit for its purpose.

- The principle of materiality and the definition of the Principle of Proportionality should be published in a harmonised, horizontal ESAs guideline and thus be consistently applied. This has become even more important due to the banking union and the work on single rulebooks and supervisory handbooks. Banks and financial institutions, to which the Principle of Proportionality should apply, should be defined with a flexible scope. As argued in earlier sections, several criteria could be used, such as bank: size, business models, degree of interconnectedness, availability of substitutes for services, the extent of global (cross-border) activity, complexity, liquidity risks, maturity mismatches, and group structure/ownership structures.

- To avoid unnecessary constraints on the European Commission and ESAs in day-to-day implementation of proportionality issues, there should be an enhanced focus on future Level 1 rules being introduced with a view to providing a reasonable degree of flexibility. This would allow the European Commission and ESAs to avoid the "hard", quantitative constraints that in some cases have been dictated by EU directives and regulations (e.g., on remuneration) and which can result in clear violation of the Principle of Proportionality. There is some danger that introducing an element of greater flexibility might undermine the democratic legitimacy of the legislative process. A balance needs to be struck.

- A particular dimension to be considered is the extent to which a proposed regulation might not be competitively neutral. In particular, consideration should be given to making adequate differentiations between different types of institutions, and especially whether some regulations impose a disproportionate cost on some types of institution (in particular small firms) without generating any significant benefit in terms of regulatory objectives.

- The BSG welcomes the Better Regulation Initiative of the European Commission and urges it to always recognise and implement the imperative of proportionality in regulation, while taking into account the benefits of regulation for public interest. A high-level Task Force could be established by the European Commission in Level 1 to evaluate and describe how the Principle of Proportionality should be interpreted for the regulation of the financial industry. Sufficient resources (manpower and financial) could be allocated to secure a quick response to its defined mandate (see Box 1 below) which could include, *inter alia*:

    - Description of how the Principle of Proportionality has been interpreted and implemented hitherto;

    - Description of proposed future applications of the Principle of Proportionality for regulation of the financial industry;

    - Description of what impact, and which adjustments, the proposed application of the Principle of Proportionality would imply for the existing regulatory framework;

- Proposals for relevant further implementation actions, timeline and responsible bodies, as well as resources needed.

- We also recommend that regulatory agencies establish within their organisations a semi-autonomous Proportionality Review Group accountable directly to the Chair and Chief Executive of the agency. In addition to making regular reports to the Chair and Chief Executive, these internal groups should also be consulted at an early stage, and become an integral part of the process when new regulations are being proposed.

- There should be regular, independent reviews of the issue of excess complexity, and of the application of the Principle of Proportionality and its balance with other objectives of financial regulation, in particular fair competition and a level playing field. Such reviews should be requested periodically by the European Commission to third parties, such as major consultancies or academics, and their results should be made public and considered by the Commission and the ESAs in their future work plans.

- Proportionality is an area where systematic research and impact assessment (not only per regulation but also cumulative) is needed, and efforts in this area should be enhanced and organised accordingly. Impact analyses should themselves be proportionate with respect to the significance and complexity of the issue being addressed.

- Cost-benefit analysis should be applied not only to individual regulatory requirements but also to the totality of regulation. The processes for, and implementation of, cost-benefit evaluations should be clarified and improved. Cost-benefit analysis of new regulation should be commenced within regulatory and supervisory agencies very early in the policy cycle and be a continuous process throughout the cycle. Regarding the evaluation of costs and benefits, the costs and benefits related to banks, customers and regulators should be taken into account, as well as the global cost of regulation versus assumed benefits of the global regulatory regime. Evaluation of costs and benefits, as well as tracing excess complexity in regulations, could be facilitated by an improved and explicit definition of the specific goals and purposes of each regulation. The customer perspective, with particular emphasis on consumers and SMEs, should always be part of cost-benefit analyses.

- As required by the CRR, consideration should be given to adopting a differential leverage ratio for different business models to reflect the actual level of risk, to the extent that this is supported by the conclusion of the observation period, and the implementation period should be lengthened.

- There should be a systematic review of supervisory reporting requirements with a view in particular to removing unnecessary duplication and introducing more

differentiation between different types of institutions. Earlier in this report, several particular areas of “excess reporting” are considered.

The BSG believes that these recommendations would contribute to an enhancement of the widely-accepted need for regulation to explicitly follow the Principle of Proportionality.

BOX 1

MANDATE OF THE HIGH LEVEL TASK FORCE

- Describe how the Principle of Proportionality is interpreted and implemented, and proposals for corrective measures:
  - Immediate actions to start a simplification project to remove excess complexity in current regulations;
  - Definition of principles for defining categories of banking and financial institutions to which the Principle of Proportionality should apply (Common ESAs guideline);
  - Areas of regulation where the ESAs could better coordinate rules;
  - Common rulebooks for the ESAs;
  - Possible reorganisation of the current ESAs structure with the aim to better coordinate regulation.

- Describe proposed future applications of the Principle of Proportionality for regulation of the financial industry, including:
  - The purpose or objective of the regulation;
  - An explicit statement of the importance of the regulation to achieve the target;
  - Alternative actions or regulations to achieve the objective;
  - The impact on financial companies, their customers and society in general;
  - Review mechanisms for the implementation of the Principle of Proportionality;
  - The overall cost and benefit for all stakeholders.

- Describe what impact, and what adjustments, the proposed application of the Principle of Proportionality would imply for the existing regulatory framework: for instance, risk-taking in financial institutions in relation to regulation and the Principle of Proportionality:
  - The Total Risk (the Risk Appetite) of a financial institution – what impact should it have on regulation;
  - What are the risks that matter to society (and regulators) in relation to financial institutions?
    - Risks related to their role related to infrastructure;
    - Risks related to their role as financial intermediaries and lenders to the economy;
    - Risks related to counterparty issues (lender and borrower);
    - Risks related to profitability due to market movements.

- Discuss the role of the risk management function in financial institutions, based on commonly accepted principles for enterprise risk management (ERM), in relation to the regulation regime and the Principle of Proportionality
  - Can the role of the Board of Directors, Management, Chief Risk Officer and Compliance Officer (or similar functions) be defined to better ensure that the overall targets of certain regulations are met through imposing and implementing certain documented risk management governance principles and procedures within the financial institution, thereby avoiding detailed end excessive regulation?;
  - Can regulation of the total risk (Risk Appetite) in financial enterprises to a certain extent contribute to implementing the Principle of Proportionality, and make certain detailed regulations for individual risk factors (or silo risk areas) superfluous?;
  - Could regulation, control and supervision of compliance to certain internal governing documents in the financial institution, based on regulated and documented minimum-risk management standards, be a possible way to avoid detailed and complex regulation? Discuss if such measures could contribute to customise risk management to the activity of the relevant institution and thus complying with the Principle of Proportionality (the financial institution defines what risk management measures should be implemented, subject to prior approval and supervision from regulatory authorities).

- Discuss the various recommendations brought forward in the report of the EBA BSG (this report) and propose actions, responsibilities and relevant implementation processes to each of the issues which are proposed in this report.

- Propose relevant further implementation actions needed, timeline and responsible bodies, including the organisation of future work and estimate of resources needed to complete implementation of the Principle of Proportionality within the area of financial industries.

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