Proportionality Principle

Proportionality in the context of current supervisory practice

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CRR Recital Art. 46

"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."

Proportionality Principle

What is it?

What does it mean for the institutions?

What does it mean for the competent authorities?

How do the competent authorities tackle it?

What is proportionality?

- In essence, the principle of proportionality is an overarching principle for every area of state intervention into the lives of its inhabitants.
- The principle of proportionality is also a fundamental application principle in administrative proceedings.
- However, in the area of banking regulation, the principle of proportionality takes on a specific meaning.

What is proportionality?

- In banking regulation the specific principle of proportionality creates a situation where regulatory requirements should be stipulated and interpreted proportionally to the specific circumstances of a supervised institution and the market it operates on.
- The vagueness of the stipulation creates risks for the institutions concerning the adequacy of their measures as well as for the authorities concerning the excessiveness of their requirements.

The Institutions

- It is very difficult to define what the principle of proportionality means for the institutions but we may safely state what it does not.
- The institutions certainly must not expect that the requirements, especially the quantitative ones, will be relaxed in any way and so they must fulfill all the requirements levied upon them by the laws and regulations.
- However, the principle of proportionality provides some alleviation of the regulatory burden.

The Institutions

- In the case of specific quantitative requirements (capital add-ons) issued by the authorities these should reflect the specific risk exposure and business model of the institution.
- More important is then the possibility to adjust the ways in which the qualitative requirements are fulfilled to reflect the specific situation of each institution – still it doesn‵t absolve the institutions from the obligation to fulfill requirement.

The Authorities

If you see the situation of the institutions as complicated, consider the dilemmas faced by the authorities.

- Unlike the institutions, the authorities have no gain from the relaxation of requirements while facing the full consequences in the event of a crisis.
- Furthermore, the authorities have to assess the adequacy of the measures adopted by the institutions to withstand the “bad times” in “good times” when any additional requirement may be easily seen as excessive.

The Authorities

- Even though the authorities are cost conscious, they inevitably err on the “safe-side”, and so tend to require “a bit more” just to increase the likelihood that the methods applied by the institutions will not result in unpleasant surprises under stress.
- The authorities also only have glimpses of the functioning of the institutions and so may not fully understand the intricacies of the functioning of the specific institution.

The Authorities

- And finally, the experts in the institutions are by nature risk averse and so view any uncertainty with instinctive distrust. In that they often view differently the complexity of the business model of institutions, especially when the environment is materially changing.
- The principle of proportionality should thus serve as a moderating agent when preparing the plan of supervisory activities towards institutions.

The Significance

- As a result of the different perspectives, both sides must have very different feelings about the principle of proportionality:
  - The institutions often see it as an underutilized rule,
  - The authorities often feel that the institutions are stretching the principle a little bit too much.
- The fact is that both sides may be simultaneously correct, simply due to a difference of perspective and the amount of specific knowledge they have.

The Significance

- The institutions cannot expect the authorities to tolerate breaches of regulatory requirements justified by “the principle of proportionality”. And, as well, they cannot take for granted that the authorities will have the same intimate understanding of the corporate governance of each institution as they do.
- On the other hand, institutions may increasingly expect a more pro-business (forward-looking) attitude of the authorities as long as the risks taken are properly addressed.

The Significance

- The authorities are moving towards holistic assessment of individual institutions, and so every component of corporate governance is expected to be “fitting” within the overall picture.
- Thus, even the most sophisticated methods of risk management may be deemed inadequate if the other corporate governance components do not work well with them – high sophistication of methods is no guarantee of compliance with regulatory requirements.

The Significance

- A simple product mix also doesn‘t necessarily mean it is a simple risk exposure institution:
  - Selling even simple products need not be easy,
  - Simple products will not necessarily have simple risk characteristics,
  - The business environment may present specific challenges.
- The authorities thus may have a different perception of the complexity of each institution.

Conclusion

- It may not be perceived as such, but the authorities do strive to apply the principle of proportionality regularly. It is the difference between perception and expectation that creates the feeling that it is not applied.
- The principle doesn’t change the overall aims of the regulations, which are the main driving factors behind all supervisory effort. The authorities also have to seek the proportionality of use of their resources when deciding what measures they would take as adequate.

Thank you for your attention

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