Proportionality as the Core Principle in the Supervision of a Heterogeneous Banking Sector

Lessons Learned From the Supervision of Roughly 2,000 Banks

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Proportionality in Regulation and Supervision

The principle of proportionality is a very important part within the Pillar 2 requirements and the banking supervision in general. Indeed, the organisational requirements and their supervision depend on nature, scale and complexity of the banks and their activities.

The respective German supervisory concept for Pillar 2 is based on a principle based approach. Therefore, the framework is laid down in section 25a of the Banking Act ("An institution must have in place suitable arrangements for managing, monitoring and controlling risks and appropriate arrangements …") and the "Level 2" BaFin circular "Minimum Requirements for Risk Management" (MaRisk) which is the central element of the organisational and procedural requirements (somewhat a "basic rulebook" for credit institutions and investment firms which addresses the main risk management issues). These requirements serve as the framework for the proportional regulation/supervision of individual institutions. Such a concept is not primarily focusing on precise thresholds or numbers, but on a holistic assessment of the risk situation of the bank. This enables the supervisory authority to apply this framework in a flexible manner according to the risk profile of the bank. For example: a small credit union with relative standardised credit business (as the major feature of its business model), and only a few simple trading transactions per month, can implement the MaRisk requirements concerning the trading business (which normally requires several, separated functions distributed over several organisational units) in a relative simply way (only one part time trader and a certain control function which must be located in a different department). If such a credit union (theoretically) would start complex trading, such as high frequency trading, the MaRisk framework requires a comprehensive trading organisation with a complete risk management regime. These strict requirements must be implemented by the credit union even if it remains a small bank since its activities are complex.

Having said that, it became clear, that we face the challenge to elaborate proportional requirements for an extremely heterogeneous banking system – with roughly 2,000 banks, different bank business models and governance structures. Therefore, we do not group the institutions into fixed clusters with respective diverging requirements. Indeed, we do believe that it is hardly possible to reflect all dimensions of proportionality in any detailed approach of categorisation which is in line with the business model of a bank at the same time. In order to avoid possible regulatory distortion, we have rather chosen: i) to publish with the MaRisk comprehensive qualitative requirements for all institutions; ii) to enable flexibility within these requirements; and iii) to scrutinise the institutions on an intensive case-by-case approach. Therefore, these rules allow a "light" implementation according to a low risk profile of a small bank and require a strict implementation with additional features for an international active and large bank. Noteworthy, small does not mean low risk. Hence, a sophisticated implementation is also required for a small bank with complex activities.

In order to enable an overview and a proportional supervision, BaFin and Deutsche Bundesbank use a categorisation with two dimensions: assessment of systemic relevance and assessment of the "quality" of the institution (risk level, risk control etc.). The result is a 3x4 matrix. The criteria of the first dimension reflect the G-SIB criteria such as size, intensity of interbank relationship, and degree of international activity. Size-thresholds, however, are only guidelines, and assessment is case-by-case and holistic. Categorisation according to the latter dimension is based on a case-by-base analysis and reflection of the individual risk situation, the capital resources and the risk management. The classification of an individual bank in the matrix determines the supervisory intensity, i.e. increases with systemic relevance and low "quality" of the institution.

Since the establishment of the concept of qualitative supervisory requirements in the mid 90s of the last century the banks and banking associations developed a number of concepts and proposals to implement these requirements. Furthermore, the German banking supervisory authorities (BaFin and Bundesbank) launched a large number of on-site inspections (for example, in 2012 there were 154 MaRisk inspections out of 273) to check and assess to which extent the MaRisk are implemented in an appropriate way by the individual banks. These inspections were supported by information coming from the long form report of the annual external audit of the banks (for which we require a comprehensive assessment of the control environment and the risk management organisation of the banks). Additionally, the German banking supervisors are in close contact with the banking industry, an expert panel for small institutions, and single banks, on various issues concerning the application of the MaRisk. The long experience and the various sources of information enable a holistic assessment of the risk profile of the bank and the related implementation of the MaRisk. Moreover, this long history of qualitative rule making supports a common understanding of the entire concept on bank level as well as on the supervisory level.

Background of the MaRisk framework

The core German Pillar 2 requirement is the MaRisk. Without going into detail, the MaRisk has similarities with the EBA "Guidelines on Internal Governance" (GL 44); however, it is usually more granular – with a general part and special sections addressing, for example, the lending- and trading business. In addition, the circular integrates several other special requirements such as requirements on internal audit, liquidity management, outsourcing or foreign-exchange lending. Hence, there is one set of rules for nearly all risk management issues instead of a bunch of several special regulations.

Only few further requirements/guidelines are needed "on top" of the MaRisk. For example, BaFin is working on a further circular on algorithmic trade. Basic principles of the Internal Capital Adequacy Assessment Process (ICAAP) are laid down in the MaRisk, and further specified in the additional guideline "Supervisory Assessment of Bank-internal Capital Adequacy Concepts". Consistently with the MaRisk, BaFin also decided to use a proportional and flexible supervisory approach.

All in all, it is a consistent and comprehensive risk management framework; it does not only hamper regulatory gaps, but also enables a flexible and proportional supervision since the implementation depends on the nature, scale and complexity of the banks and their business activities within the ICAAP requirements.

Noteworthy, there are only few explicit thresholds and clear-cut definitions. Instead, BaFin lays down the central principles, and in a second step, every institution has to elaborate its own risk management and ICAAP since the institutions remain responsible for the implementation of their own risk management. In a third step, institutions are monitored by supervisors whether their systems are compliant with the principles, and appropriate for the institution. BaFin decided that implementation and supervision depends, in general, on a case-by-case analysis. This enables a "double proportionality", i.e. proportional requirements and supervision.

This approach allows a tailored risk management and proportional requirements. The basic thought behind it is that the bank should elaborate ideas of its own. For example, due to uncertainty and imperfect models, the result of any ICAAP numbers (elaborated by banks or supervisors) will never perfectly quantify the risk nor lead to the optimal equity ratio. Nevertheless, when calculating on its own (independently of the numbers delivered to the authorities), the bank will be able to "get a feeling" of its risk exposure. This is of upmost importance for the internal risk management. We believe that this approach is a valuable regulatory requirement – if combined with the Pillar 1 requirements, the capital buffers, and the future leverage ratio. To sum up, regulators will set minimal requirements but institutions will continue to elaborate their own risk management on a proportional manner.

In addition to the MaRisk and ICAAP requirements, there are special requirements for remuneration and liquidity. These are exceptions where we believe that "hard criteria" are appropriate. For example, the requirements on remuneration are only applicable for institutions beyond a threshold which is based on the balance sheet, and the liquidity regulation defines liquid assets.

How can we avoid arbitrariness by keeping flexibility? The heterogeneous German banking system allows supervisors to compare risk management implementations of their peers (peer group analysis). In practice, we believe that the internal structure of BaFin (see the organizational chart) enables peer analysis within the sections and departments. Moreover, guidance is provided by the policy department, and Deutsche Bundesbank (conducting the on-site inspections on behalf of BaFin) provides for quality conformance of inspections. We believe that this is more adequate than defining whether a business is complex or "simple" or provide for check-lists, i.e. extremely granular organisational requirements. The approach we have chosen rather requires that supervisors know the banks' business models, their risks and risk management. Indeed, an intensive supervisory process is needed. Reflecting recent experiences, we believe that this approach was appropriate, proportional and successful – at least with regard to the bank business activities of German banks in Germany.

Recommendations

We are in favour of a principle based approach as the major Pillar 2 concept in the European Single Rule Book because it will be applicable for the heterogeneous European banking system. In general, we recommend to elaborate definitions and requirements which should serve as cornerstones, and which are flexible enough to cover a wide scope of business models and management approaches instead of a single list of special requirements. This may help to establish a flexible, proportional and risk-based banking supervision. The further elaboration of the EBA Guidelines on Internal Governance would serve as an adequate starting point for the Pillar 2 base of the European Single Rule Book.