EUROPEAN CENTRAL BANK

BANKING SUPERVISION

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**The principle of proportionality: application in the Single Supervisory Mechanism**

Honourable Member of the European Parliament, dear Mr Giegold,

As requested during the ECON hearing of 25 June 2015, please find overleaf an overview of how the principle of proportionality is applied in the Single Supervisory Mechanism.

Yours sincerely,

[signed]

Danièle Nouy

# The principle of proportionality: application in the Single Supervisory Mechanism

## A. Introduction

The SSM Regulation (SSMR)[1] confers supervisory tasks on the ECB with a view to contributing to the safety and soundness of credit institutions and the stability of the financial system, with full regard to the integrity of the internal market based on equal treatment of credit institutions. One of the main objectives of the ECB in its supervisory capacity is therefore to ensure consistent supervision of financial institutions throughout the Single Supervisory Mechanism (SSM). Consistency in this sense does not mean "one-size-fits-all" supervision, however. Rather, all supervisory activities and their scope and intensity need to be commensurate to the circumstances of the supervised credit institutions. This implementation of supervisory activities follows the principle of proportionality, which is a core principle in Union law, enshrined in EU Treaties and further developed by the jurisprudence of the Court of Justice of the European Union. It applies to all Union acts as well as the institutions of the EU and provides that "the content and form of EU action shall not exceed what is necessary to achieve the objectives of the Treaty".[2] The application of the principle of proportionality is further fleshed out in a Protocol to the Treaty.[3] As such it governs the use of Union competences and therefore constitutes an important guiding principle for the exercise of supervisory powers by the ECB.

The SSMR calls for an application of the principle of proportionality by the ECB in its supervisory approach. Specifically, it stipulates that the ECB should have "full regard to the diversity of credit institutions, their size and business models, as well as the systemic benefits of diversity in the banking industry of the EU"[4] in the performance of its supervisory tasks.

In practical terms, significant institutions (SIs) are directly supervised by the ECB through Joint Supervisory Teams (JSTs) headed by an ECB staff member and composed of both ECB and NCA staff. For less significant institutions (LSIs), national competent authorities (NCAs) are responsible for conducting direct supervision, under the oversight of the ECB.

The ECB has been entrusted with a wide range of tools by the SSMR. The use of these tools by the SSM is necessary in order to fulfil the supervisory objectives. As the use of supervisory tools can be very intrusive, it is crucial that the supervision of credit institutions is consistently guided by the principle of proportionality. For all supervisory measures that the SSM imposes on institutions, including for example Pillar 2 capital requirements, this means that each measure must be (i) necessary to achieve a legitimate aim and (ii) pursued in a suitable and reasonable manner.[5]

[1] Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions, OJ L 287, 29.10.2013, pp.63-89.
[2] Consolidated version of the Treaty on European Union (TEU), OJ C 83, 30.3.2010, p. 3; Article 5(4) TEU.
[3] Protocol (No 2) on the application of the principles of subsidiarity and proportionality, OJ C 83, 30.3.2010, pp. 206-209.
[4] Article 1 and Recital 17 SSMR.
[5] As developed in the case law of the Court of Justice of European Union.

This is in line with the Capital Requirements Directive (CRD IV),[6] the Capital Requirements Regulation (CRR)[7] and other relevant legislation applicable to credit institutions which foresee primarily three different ways in which proportionality has to be applied: first, rules and requirements should be proportionate to the type of institutions falling within their scope; second, the frequency and intensity of the Supervisory Review and Evaluation Process (SREP) should be proportionate to the size, systemic importance, nature, scale and complexity of the activities of the institution concerned; and third, supervisory measures must pursue a legitimate aim in a suitable and reasonable manner and the measures must be necessary to achieve this aim.

## B. Proportionality in the SSM framework

The overarching objective when setting up the SSM was to apply a single supervisory approach for all supervised institutions. Accordingly, all credit institutions in the SSM should be supervised according to a harmonised methodology, with due respect to the principle of proportionality.

That said, the principle of proportionality also guides the SSM beyond its day-to-day supervisory work, for instance in developing the reporting requirements imposed on credit institutions regarding supervisory financial information, as well as in designing its methodology on the calculation of supervisory fees to be levied on supervised entities.

**Supervisory reporting:** The process regarding supervisory data collection for SIs and LSIs is defined in the ECB Regulation on reporting of supervisory financial information of 17 March 2015.[8] The ECB applies the principle of proportionality by categorising banks and subjecting them to differentiated reporting requirements. The scope and frequency of information requests vary depending on the nature of an entity (e.g. consolidated entity, entity belonging to a significant group or LSI). SIs on a consolidated basis are subject to the highest harmonised supervisory reporting requirements. For subsidiaries of SI groups in non-participating Member States or third countries, an asset-value threshold has been established that exempts the SI group from financial reporting concerning those subsidiaries. For a further proportionate differentiation of LSIs, the same asset-value threshold has been established which triggers lower reporting requirements for LSIs below this threshold. In addition, the ECB has staggered the implementation dates of the reporting requirements to give more time to LSIs to prepare, also in application of the principle of proportionality.

**Supervisory fees:** The SSMR provides that the ECB levies an annual supervisory fee on credit institutions and that the fees shall be based on objective criteria relating to the importance and risk profile of the credit institutions. The ECB decided to differentiate the amount to be recovered from credit institutions based on their significance, imposing a lower fee on LSIs.[9]

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[6] Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC, OJ L 176, 27.6.2013, pp. 338-436.

[7] Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012, pp. 1-337.

[8] Regulation (EU) 2015/534 of the European Central Bank of 17 March 2015 on reporting of supervisory financial information (ECB/2015/13), OJ L 86, 26.3.2015, p. 13.

[9] Regulation (EU) No 1163/2014 of the European Central Bank of 22 October 2014 on supervisory fees (ECB/2014/41), OJ L 311, 31.10.2014, p. 23.

## C. Application of the principle of proportionality to the direct supervision of SIs

The SSM guide to banking supervision emphasises that proportionality is one of the general principles of the SSM supervisory approach.[10] The following examples demonstrate how the proportionality principle is applied in the SSM's direct supervision of SIs.

**Adequate minimum levels of supervisory activity:** First, applying proportionality in banking supervision means engaging in adequate minimum levels of supervisory activity for all supervised credit institutions. The ECB determines an adequate minimum level of supervisory activity for all types of SIs, irrespective of the perceived risk of failure.

**Commensurate supervisory practices:** Second, applying proportionality means that supervisory practices must be commensurate not only with the systemic importance (which is reflected in the minimum levels of supervisory activities), but also with the individual risk profile of each credit institution under supervision. Accordingly, the intensity of the ECB's supervision varies across credit institutions, with a stronger focus on institutions with a higher risk profile, on the largest and more complex systemic groups and on the more relevant subsidiaries within an SI banking group. This is consistent with the SSM's risk-based and consolidated supervisory approach. In practice, this is reflected, for example, in the different amounts of human resources allocated to the different JSTs.

**Methodology for determining adequate engagement levels for the supervision of SIs:** Based on the two dimensional approach outlined just above, the SSM has developed a methodology for tailoring the intensity and frequency of supervisory activities to the SI's potential impact on the financial system and its intrinsic riskiness. Via the strategic and operational internal planning processes, the results of the SREP feed into the determination of the range and depth of off-site and on-site activities that are carried out for a given institution. This is reflected in the Supervisory Examination Plan that sets out the planned activities for the SIs.

**Proportionate supervisory measures:** Besides being used for determining the future level of intensity of supervisory activities for each institution, the outcome of the SREP also forms the basis for taking supervisory measures. Again following the proportionality principle, all supervisory measures taken, including Pillar 2 capital add-ons, are clearly tailored to the individual situation of each institution, i.e. its risk profile and its deficiencies.

## D. Proportionality in the SSM approach to the oversight of LSI supervision

As mentioned earlier, the direct supervision of LSIs is performed by the NCAs, while the ECB exercises oversight over the supervision conducted by NCAs. The ECB applies proportionality both in its own oversight activities as well as in the guidance that it develops for NCAs for their day-to-day supervisory activities. This guidance takes the form of supervisory standards to be applied consistently by NCAs and which ensure that NCAs apply proportionality in the intensity of their supervision and in their risk and capital adequacy assessment.

[10] Available on the ECB's website.

There are about 3,500 LSIs operating within the SSM, with a great diversity in terms of size, complexity, business models and other characteristics. In this context, the ECB has developed several approaches to ensure an effective and proportionate oversight of NCAs' supervision.

**Prioritisation of LSIs:** The main tool used by the ECB to ensure that it performs its oversight over the NCAs' supervision in a proportionate manner is the assignment of priority ranks to LSIs. Indeed, the ECB has categorised LSIs as high, medium or low priority. This categorisation is subject to an annual review in cooperation with NCAs. The prioritisation of LSIs is based on, first, the impact of the LSI on its domestic financial system and, second, the intrinsic riskiness of the LSI. Hence, higher riskiness and a bigger potential impact on the financial system require more intensive supervisory attention to the respective LSI. The ECB uses this prioritisation of LSIs to apply the principle of proportionality in a number of its oversight tasks including the development of supervisory standards and policies for LSI supervision, or in relation to notifications and reports from NCAs on the performance of their supervisory tasks and the oversight of individual LSIs.

**Development of supervisory standards and policies for LSI supervision:** The development of supervisory standards and policies for LSI supervision is a key tool for the ECB to ensure a consistent application of high supervisory standards by NCAs and to ensure a continuum between the supervision of SIs and LSIs. When developing such standards and policies in coordination with NCAs, the ECB takes into account the priority rank of LSIs to ensure that the envisaged approaches are proportionate to the objectives sought. In general terms, more stringent or detailed requirements are to be applied with regard to the supervision of high-priority LSIs compared with, for instance, low-priority LSIs. Furthermore and if necessary to ensure the consistent and proportionate application of high supervisory standards, the ECB may also issue legal instruments including guidelines, regulations, general instructions or recommendations addressed to NCAs.

**Notifications and reporting framework:** The SSM Framework Regulation provides for certain *ex-ante* notifications and *ex-post* reporting requirements by NCAs to the ECB to ensure that the ECB can adequately exercise its oversight over the functioning of the SSM. In application of proportionality, NCAs' submissions of *ex-ante* notifications are limited to material supervisory procedures and material draft supervisory decisions concerning high-priority LSIs only. The principle of proportionality is also an important criterion for the ECB when assessing incoming *ex-ante* notifications and determining the intensity of the review to be performed. The ECB assesses the impact of the planned measures from a supervisory and risk perspective and also whether the measures themselves are proportionate. As regards regular *ex-post* reporting requirements, the ECB requires NCAs to submit institution-specific information as well as information related to their supervision of LSIs only to the extent that is deemed material and proportionate. Hence, the depth and frequency of *ex-post* reporting is adapted to the priority rank of the LSI.

**Oversight of individual LSIs:** The ECB has developed a framework for the institution-specific oversight of LSIs, which is also based on the prioritisation of institutions. A less granular and less frequent assessment is normally conducted for those banks which have been assigned a low or medium priority rank. However, this does not imply that the requirements must be *per se* always lower for less prioritised institutions, as some less prioritised institutions – based on an exceptional individual analysis or thematic reviews – may prove to be more risky and complex than expected *a priori*. In this case, the principle of proportionality requires at least partially stricter and more complex internal methods and controls in the business areas affected. Furthermore, if the analysis reveals a higher level of risk or complexity, the initial prioritisation should be reviewed.