The supervisory review and evaluation process for smaller institutions and proportionality considerations

The banking supervision framework in the European Union has been comprehensively changed, amongst other things by the implementation of Basel III and the launch of the banking union, with the aim of achieving a more resilient banking sector. Against this backdrop of increased regulation, the question arises as to whether certain regulatory requirements can be relaxed for smaller banks with straightforward business models without compromising the resilience of the banking sector as a whole. In this context, the principle of proportionality in banking supervision has increasingly featured in the public discourse. According to the principle of proportionality, both the application of prudential requirements and the design of internal risk measurement and management procedures should be commensurate with the business model, size and riskiness of each institution, and the significance of the institution for the entire banking system should be taken into account.

The proportionality principle is an important element of the supervisory framework, as diversified and decentralised structures such as those in the German banking market, with its more than 1,600 credit institutions, require differentiated rules and supervisory practices. This allows both for a better risk orientation, ie determining the focus of supervision in relation to an institution's risk, and for the efficient supervision of market participants.

As part of the ongoing supervision of credit institutions, the proportionality principle has thus far mainly been applied in assessing the adequacy of the internal risk measurement and management procedures (Pillar 2 of the Basel framework). This article looks mainly at how the Bundesbank and the Federal Financial Supervisory Authority (BaFin) anchor concepts of proportionality in their supervisory activities. This concerns, in particular, the implementation of the European Banking Authority (EBA) Guidelines on the supervisory review and evaluation process (SREP). Furthermore, possible approaches to introduce more proportionality into banking regulation in future are discussed under the heading "small banking box".

Proportionality in banking supervision

The prudential supervision of large, internationally active banks is based on a three-pillar concept under the Basel framework. Pillar 1 contains the regulatory minimum capital requirements for credit risk, market risk and operational risk, in accordance with the criteria prescribed by supervisors, as measured using the standardised approach or the internal model method. Pillar 2 covers internal risk measurement and management procedures and builds on the first pillar by including other material risks. The task of banking supervisors under Pillar 2 is to assess, as part of the SREP, whether a bank's internal risk measurement and risk management system is adequate. This may also include supervisory interventions such as additional capital or liquidity requirements. Pillar 3 contains supervisory transparency requirements, according to which banks must disclose key information on their risk situation, their capital and liquidity situation, and on risk measurement and management. This is designed to enable other market participants and the general public to assess a bank's risk situation, with the aim of strengthening market discipline.

Due to the increasing complexity of the financial system, this regulatory framework as a whole has also grown more complex. At the same time, in the EU these rules are being applied to all banks, not just to those that are internationally active. Against this backdrop, the principle of dual proportionality pursuant to Article 74 (2) and Article 97 (4) of the Capital Requirements Directive (CRD) is of key importance. On the one hand, banks must implement internal risk measurement and management procedures that are proportionate to the inherent complexity of their business activities and the associated risks. On the other hand, microprudential supervisory activities should also have regard to the nature, scale and riskiness of a bank, as well as its systemic importance. While both components are closely intertwined, this article focuses on the supervisory aspect of this dual proportionality. In the supervisory framework, the principle of proportionality is mainly applied in Pillar 2.

However, against the backdrop of a growing volume of prudential regulation, discussions are increasingly looking at what regulatory approaches could be used to more strongly anchor the principle of proportionality in the requirements of Pillar 1 and/or Pillar 3.

The supervisory review and evaluation process – an overview

SREP: comprehensive assessment of an institution …

Under the SREP, an institution is subject to a comprehensive assessment. This involves an assessment of the institution's internal regulations, strategies and processes, as well as an assessment of its risks and its capital and liquidity resources. Ultimately, the aim is to determine whether sufficient risk coverage is assured for risks against which capital can be held and for liquidity risks through the presence of corresponding capital instruments and liquid assets, and whether an appropriate basis for future risk coverage is provided by adequate and effective risk management. The key elements here include the internal capital adequacy assessment process (ICAAP) and the internal liquidity adequacy assessment process (ILAAP).

… and determination of an adequate capital level

A key result of the SREP is the setting of the adequate capital level for each bank from a supervisory perspective, particularly in light of the risks entered into.

European guidelines issued by the EBA

Harmonised European provisions for the SREP are found in the guidelines issued by the European Banking Authority (EBA/GL/2014/13). According to these, the core of the supervisory tasks in Pillar 2 is the business model analysis as well as the assessment of internal governance and the risks to capital and liquidity of an institution or group of institutions. The guidelines have been applicable since January 2016. The

processes relating to the supervision of less significant credit institutions – which in Germany fall under the responsibility of BaFin and the Bundesbank – have been adjusted and/or supplemented on the basis of these guidelines. For example, a greater focus is now placed on the business model analysis. However, the most significant change for institutions concerns the supervisory measures that are set on the basis of the SREP. In contrast to the supervisory approach used in Germany until 2015, these measures now include a mandatory setting of a capital add-on for risks that are not covered by the Pillar 1 capital requirements. The aim of the German supervisory authorities is to uphold the principle of proportionality and ensure that an individual institution's circumstances are adequately taken into account. As the ICAAP of each institution is itself a key element of the SREP, proportionality is already taken into account up to a certain point. In addition, the approach presented in this article and practised in Germany has the clear advantage that the ICAAP can continue to be the main instrument for internal governance.

Institution-specific risk profiles – a key element of ongoing supervision

Risk profile as a central supervisory analysis and assessment tool

Under the SREP, the Bundesbank, in consultation with BaFin, draws up an institution-specific risk profile, which serves as a central supervisory analysis and assessment tool. This includes an overall assessment of the respective institution in light of all risk-relevant factors known to supervisors. A key information source is the audit report for the annual accounts. Additional supervisory information is also incorporated, for example from discussions with senior management, surveys and requests for information, and on-site inspections. The structure of the risk profile is based, in particular, on the EBA's SREP guidelines. Accordingly, four assessment areas are defined for supervisors: the business model analysis, the assessment of internal governance, the capital adequacy assessment and the liquidity adequacy assessment.

Elements of the risk profile

Taking into account the business and capital planning of an institution, the business model analysis focuses on viability (12-month perspective) and sustainability (3-year perspective). In addition to internal factors (including ownership and corporate structure, profitability, strategic orientation and planning assumptions), the analysis also incorporates external factors (such as the macroeconomic environment and the competitive landscape). This results in a holistic and forward-looking analysis of the business model from both a quantitative and qualitative perspective, with the supervisory authorities taking a neutral stance towards the specifics of the business model.

The internal governance element involves assessing the adequacy of corporate governance and internal capital adequacy management. This is based, in particular, on the requirements for a proper business organisation pursuant to Section 25a of the German Banking Act *(Kreditwesengesetz)* in conjunction with the Minimum requirements for risk management (*Mindestanforderungen an das Risikomanagement* – MaRisk). In this context, for example, supervisors assess the adequacy of the internal control system, the compliance and risk control function, internal audit, and compliance with reporting and disclosure requirements. In the area of internal capital adequacy management, an assessment is made of the ICAAP's scope of application and methodology, as well as of reporting and the review of internal capital adequacy management.

The risks to capital are broken down into credit and counterparty risk, equity risk, interest rate risk in the banking book, other market risk, operational risk and other material risks. For the risks to liquidity, both short-term liquidity risk as well as medium to long-term funding risk are considered. In each case, supervisors assess both the level of risk and the adequacy and ef-

fectiveness of the procedures for managing and monitoring these risks.

Materiality and proportionality as guiding principles

The risk assessment is conducted in line with the principle of materiality. For instance, in the case of small credit institutions that conduct only traditional deposit-taking business, there is generally no need to assess other market risks. In addition, the depth of both the analysis and the assessment of the risk profile hinges on the principle of proportionality; in other words, it is much more intense for large, complex institutions with a high degree of risk than for smaller or low-risk institutions.

Scoring and categorisation

A score of 1 (no/very low risk; strong risk management) to 4 (high risk; weak risk management) is given for each of these four assessment areas and any additional sub-areas.

Overall assessment: …

As well as presenting the above-mentioned institution-specific factors (quality dimension), the final, overall assessment also reflects the importance of the institution for the entire banking system (systemic dimension).

… quality dimension and systemic dimension

The key idea behind the overall score for the risk profile in terms of the quality dimension is the risk of an institution's status as a going concern being jeopardised, taking into account the analyses and the scores for the four above-mentioned areas. As well as a verbal assessment, a score from 1 to 4 is given.[1] In addition to this quality dimension, the institutions are placed into categories (I-IV) according to their impact on the stability of the banking system as a whole, which essentially depends on the size of their balance sheet and the type of business activities they conduct. Category I is assigned where the impact of a default on financial stability is deemed to be low, and category IV where it is deemed to be high. On the basis of these two dimensions, a final risk classification is made for each institution in a 4x4 matrix.

The overall assessment, which reflects the assessment of the quality of the institution and its impact on the stability of the banking system, then forms the basis for the annual operational supervisory plans and for deciding on supervisory actions, such as the frequency and scope of discussions with senior management.

SREP capital determination

Regulatory framework for Pillar 2 capital: …

The main change to previous supervisory practice arising from the implementation of the EBA's SREP guidelines in Germany is the mandatory setting of an institution-specific capital add-on pursuant to Section 10 (3) of the German Banking Act. The first component of this is the SREP capital add-on (Pillar 2 requirement, or P2R). This is intended, in particular, to cover those risks which are not covered, or are not sufficiently covered, by the Pillar 1 capital requirements (8% of risk-weighted assets).

… SREP capital add-on …

The institution's ICAAP figures serve as the basis for determining the SREP capital add-on, whereby the Pillar 1 requirements – as minimum requirements – form the lower bound for each risk type ("Pillar 1 plus approach"). In addition, as was previously the case, qualitative shortcomings or model weaknesses can be taken into account when determining the capital add-on. Regulatory capital must be held against the resulting capital add-on; this must comply with the Pillar 1 structural requirements. This means that at least 56% of it must be Common Equity Tier 1 capital and at least 75% Tier 1 capital.

1 This has consequences for the subsequent supervisory activities. For example, the overall score of 4 for the risk profile not only results in a significant intensification of supervision – typically by way of an initial sharp increase in requirements to provide information, which is then used as a basis for further supervisory measures – but also in the institution's classification as a problem institution in accordance with Section 2.2.4 of the Prudential Supervisory Guideline (see Guideline on the implementation of and quality assurance for the ongoing monitoring of credit institutions and financial services institutions by the Deutsche Bundesbank of 19 December 2016 (Richtlinie zur Durchführung und Qualitätssicherung der laufenden Überwachung der Kredit- und Finanzdienstleistungsinstitute durch die Deutsche Bundesbank vom 19. Dezember 2016)).

… for interest rate risk and "other material risks"…

Of the risks factored into the SREP capital add-on, the most prominent and, in quantitative terms, the greatest risk is interest rate risk in the banking book. "Other material risks" include, for example, credit spread risk in the banking book, ie the risk that the creditworthiness of a borrower worsens and thus leads to write-downs or hidden losses. In addition, funding risk, ie the risk that it will only be possible to fund assets at higher costs, is also taken into account.

… and Pillar 2 capital guidance

The second component is Pillar 2 capital guidance (P2G), which expands the concept of the capital conservation buffer. P2G is intended to ensure that the capitalisation of a given institution is so good that the entire minimum capital requirement under Pillar 1 and P2R can be met even in stress periods. P2G is determined on the basis of institution-specific stress test results. As such considerations also played a role, at least implicitly, in the calibration of the capital conservation buffer, P2G vies with the relevant Pillar 1 requirements. As a consequence, capital only need be held against the maximum of the corresponding Pillar 1 buffer and P2G. It should be noted that Common Equity Tier 1 capital always has to be held against the capital conservation buffer. By contrast, regulatory own funds and reserves pursuant to Section 340 f of the German Commercial Code *(Handelsgesetzbuch)* can be held against the portion of P2G that exceeds the capital conservation buffer.

In Germany, P2G is determined using the results of the supervisory stress test underpinning the 2015, and in future 2017, surveys on the low-interest-rate environment (for a summary of the 2017 low-interest-rate survey, see the box on pages 52 and 53).

Hierarchy of capital requirements

The SREP capital add-on is a Pillar 2 capital requirement that must be met at all times. If the Pillar 2 capital requirement is undershot, the supervisory authorities can take measures pursuant to Section 45 of the German Banking Act to improve the institution's capital base. P2G, by contrast, is an expectation on the part of supervisors. It is a reference figure and early warning threshold, and the capital held to meet it can be used to absorb losses in times of stress. Unlike in the case of the Pillar 2 capital requirement, if P2G is undershot, this does not automatically trigger supervisory measures, but it does automatically lead to an increase in the intensity of supervision and normally to a requirement to draw up a capital plan.

National implementation

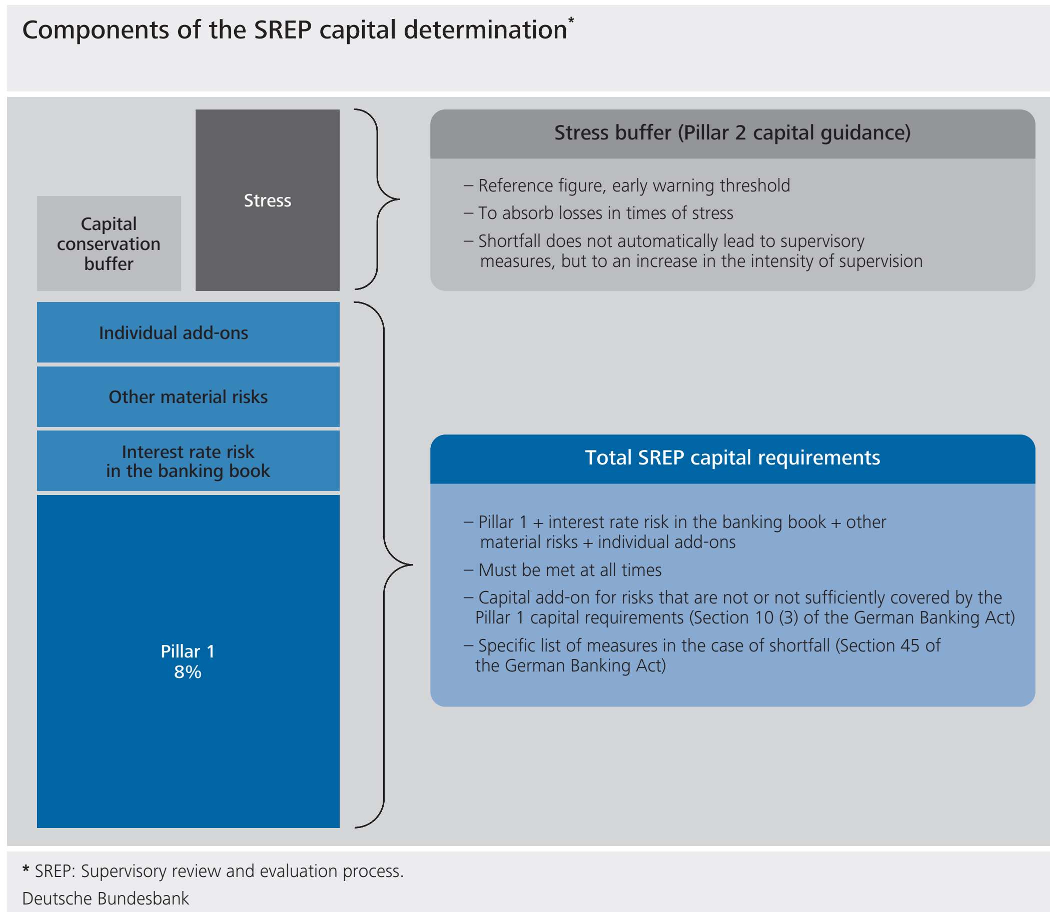
In order to implement the EBA requirements, credit institutions pursuant to Section 1 (1) of the German Banking Act, which fall under the direct supervision of the Bundesbank and BaFin, underwent (or will undergo) their first capital determination in 2016 and 2017. In 2016, an SREP capital add-on was initially determined for 303 credit institutions. A general administrative act required the remaining credit institutions to hold capital against interest rate risk in the banking book above and beyond the capital requirements set out in the Capital Requirements Regulation (CRR). These institutions, too, will now undergo an SREP capital determination in the course of 2017. The introduction of the SREP capital determination over a two-year period allows for the roughly 1,600 affected credit institutions to be properly processed. According to the EBA guidelines, the SREP capital determination must be reviewed at least every three years (for a brief description of the methodology, see the box on pages 49 and 50).

Preliminary results for 2017

Based on the provisional figures for 2017,[2] the average SREP capital add-on works out at 1.4 percentage points, which equates to a total of €18 billion. By comparison, the SREP capital add-on for significant institutions in the Single Supervisory Mechanism (SSM) averaged 2 per-

2 The process of drawing up/updating the SREP capital add-on decisions has not yet been completed. The majority of the SREP capital add-ons are currently at the consultation stage. Outstanding adjustments and/or contradictions could yet result in changes to the provisional figures.

Components of the SREP capital determination*



* SREP: Supervisory review and evaluation process.
Deutsche Bundesbank

centage points in 2016.[3] For the less significant institutions, interest rate risk in the banking book accounts for an average of 1 percentage point and other material risks account for 0.4 percentage point. The fact that interest rate risk accounts for such a large percentage of the SREP capital add-on underscores the importance of this type of risk for German credit institutions. At institution level, however, there are, in some cases, considerable differences in terms of risk exposure in these two areas. On balance, the bandwidth of the SREP capital add-ons ranges from 0 to 11 percentage points.

Size of add-on independent of capitalisation

The size of the capital add-on is determined solely on the basis of the amount of risks that are not or not sufficiently covered by Pillar 1 capital requirements. Actual capitalisation, by contrast, has no role to play in determining the capital add-on. Thus, well-capitalised credit institutions, too, may receive a high SREP capital add-on if they have a large percentage of risks that are not covered by Pillar 1. For most institutions, the size of the capital add-on therefore says little about supervisors' assessment of the overall risk profile. Only in the overall assessment is capitalisation, amongst other factors, taken into account.

Institutions are adequately capitalised

A comparison of institution-specific capital requirements and actual capital levels (see the chart on page 51) shows that the vast majority of credit institutions have sufficient regulatory own funds to satisfy the additional SREP capital add-on, with the capital ratio averaging around 20%. There is a shortfall in only a few cases.

Interestingly, individual credit institutions have taken first evasive action to reduce their capital requirements after the methodology for setting SREP capital requirements was presented and the first capital add-on decisions were sent out

3 See SSM SREP Methodology Booklet – 2016 edition. https://www.bankingsupervision.europa.eu/ecb/pub/pdf/srep_methodology_booklet_2016.en.pdf?486e2833820b13c740ffb49a0ee57672

National methodology for setting SREP capital requirements

In line with the European Banking Authority (EBA) Guidelines, the SREP capital determination consists of two components (see the chart below): the risk portion (Pillar 2 capital requirement) and the stress portion (Pillar 2 capital guidance). Both components are calculated as an add-on in relation to the institution's total risk exposure amount (TREA) pursuant to the Capital Requirements Regulation (CRR).

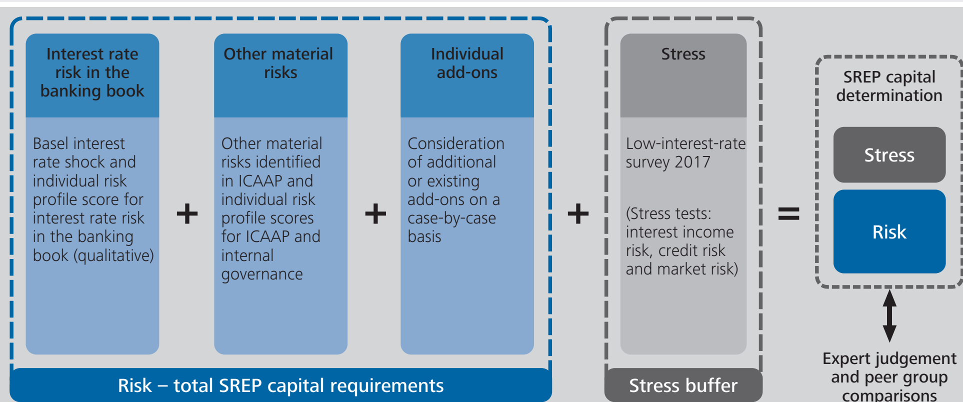
The Pillar 2 capital requirement comprises three add-ons: add-on for interest rate risk in the banking book (IRRBB), add-on for other material risks, and an individual add-on if applicable.

The calculation of the IRRBB add-on is based on the negative change in present value as a result of the Basel interest rate shock (parallel shift of the yield curve by ±200 basis points). This is expressed as a proportion of the TREA. On the basis of the ratio calculated and the quality of risk management, which is determined using the qualitative individual risk profile score for IRRBB, IRRBB is allocated to one of 16 buckets. The relevant capital add-on can be determined from the upper add-on matrix on page 50. It should be noted that, on average, the add-on covers only about half[1] of the negative change in present value as a result of the Basel interest rate shock.

Other material risks which cannot be allocated to either Pillar 1 or IRRBB are factored in by way of a separate add-on. This is done by using data from the reports pursuant to the Financial and Internal Capital Adequacy Information Regulation *(Verordnung zur Einreichung von Finanz- und Risikotragfähigkeitsinformationen)*, which institutions have been submitting since 2015. This yields non-Pillar 1 risks expressed as the difference between total risk (excluding inter-risk diversification effects) and Pillar 1 risks (including IRRBB). The difference between total risk and Pillar 1 risks (including IRRBB)

1 The concept uses half of the negative change in present value to take into account the argument that the Basel interest rate shock framework also contains a strong stress component. The SREP merely envisages an interest rate shock of approximately 100 basis points in the Pillar 2 capital requirement.

Overview of the SREP capital determination methodology*



* SREP: Supervisory review and evaluation process.
Deutsche Bundesbank

Add-on matrix "Interest rate risk in the banking book (IRRBB)"

Percentage points

Risk profile[1]	Negative change in present value (±200 bps)/total risk (pursuant to CRR)			
	0% to 2.75%	>2.75% to 3.75%	>3.75% to 4.75%	>4.75%
1	0.00	1.00	1.50	2.00
2	0.50	1.25	1.75	2.50
3	1.00	1.50	2.00	3.00
4	1.50	2.00	2.50	3.50

1 Individual risk profile score for interest rate risk in the banking book (qualitative).
Deutsche Bundesbank

Add-on matrix "Other material risks"

Percentage points

Risk profile[1]	Non-Pillar 1 risks (excl IRRBB)/total risk			
	0% to 5%	>5% to 15%	>15% to 45%	>45% to 100%
1	0.00	0.50	1.50	3.00
2	0.25	1.00	2.00	4.00
3	0.50	1.50	2.50	5.00
4	1.00	2.00	3.00	6.00

1 Worse of the two individual risk profile scores for ICAAP and internal governance.
Deutsche Bundesbank

equates to non-Pillar 1 risks and is expressed as a proportion of total risk. By constructing the metric in this way, certain institution-specific differences in risk measurement, particularly different confidence levels or different risk definitions, can be balanced out and the ICAAP results brought to a comparable level for the SREP. As an estimator of the importance of non-Pillar 1 risks, this metric forms the material basis for the add-on for other material risks. In addition to the ratio of non-Pillar 1 risks to total risk, the calculation of the capital add-on also incorporates the quality of risk management by means of the individual risk profile scores for ICAAP and internal governance. The worse of the two individual scores is used. Depending on how the two criteria shape up (risk level and quality of risk management), the relevant institution is allocated to one of 16 buckets, from which, in turn, a specific capital add-on is derived. The institution-specific capital add-on is thus determined from the adjacent add-on matrix.

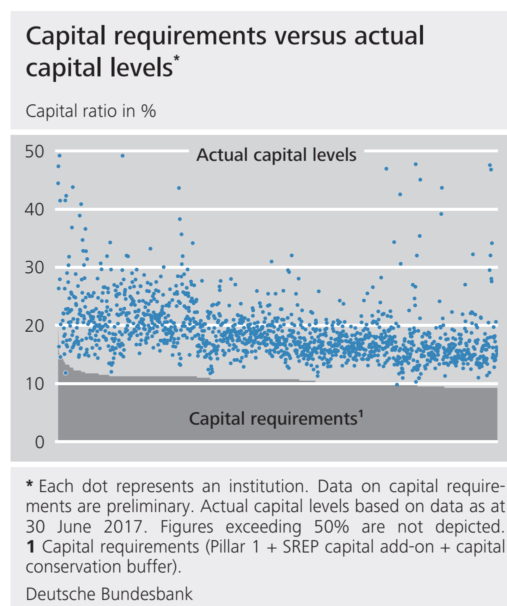
In addition, an individual capital add-on can be considered on a case-by-case basis in order to address aspects not covered by the two other components. These include, for example, deficiencies in internal governance.

Pillar 2 capital guidance is derived from the result of the supervisory stress test for the 2017 survey on the low-interest-rate environment. As for the Pillar 2 capital requirement, the approach taken here entails using different buckets to determine the institution-specific requirement. The allocation to the relevant bucket is based on the institution-specific stress effect.

last year. For instance, the change in present value as a result of the Basel interest rate shock (parallel shift of the yield curve by ± 200 basis points) has declined considerably since 2016 at a significant number of institutions. To what extent this can be attributed to an optimised methodology, for example targeted parameter adjustments for positions with indefinite capital tie-up or the recognition of pension liabilities, or to a genuine change in financial circumstances, for example through hedging transactions or restructuring of proprietary investments, will have to be examined on a case-by-case basis. In addition, a number of institutions have, for internal capital adequacy reporting, started to report their risks in aggregate form only or not to recognise certain risks at all. Such adjustments raise questions about the quality of internal risk management procedures. The Bundesbank and BaFin will, therefore, keep a critical eye on any adjustments that result in a material change in risk exposure and thus the level of capital add-ons.

Capital requirements versus actual capital levels*

Capital ratio in %



* Each dot represents an institution. Data on capital requirements are preliminary. Actual capital levels based on data as at 30 June 2017. Figures exceeding 50% are not depicted. **1** Capital requirements (Pillar 1 + SREP capital add-on + capital conservation buffer).

Deutsche Bundesbank

Foreseeable developments

Procedure for calculating Pillar 2 capital guidance in 2017

Based on the results of the 2017 low-interest-rate survey and the phasing-in of the capital conservation buffer, the procedure for determining Pillar 2 capital guidance will be adjusted slightly. First, buckets will be redefined. In particular, this will take into account the fact that, by 2019, the capital conservation buffer of 2.5 percentage points will have been introduced in full, eliminating the need for a differentiated analysis of Pillar 2 capital guidance below this rate. Second, the size of the respective Pillar 2 capital guidance will now be linked more directly to the level of stress effects. This is possible because banks were informed ahead of the stress test that the results would be used to determine Pillar 2 capital guidance. This transparent approach also allowed data quality to be improved. In the case of an institution with nominally comparable stress effects in the 2015 and 2017 low-interest-rate surveys, the modified procedure will tend to result in higher Pillar 2 capital guidance. Overall, the institutions will – with just a few exceptions – have enough capital to cover this additional stress buffer. This will represent a challenge for only a small number of institutions.

New guidelines on capital adequacy in response to new realities

In addition, German banks' capital adequacy concepts need adjusting because capital add-ons will be set regularly going forward. This is most relevant for institutions where governance is primarily designed to meet regulatory own funds requirements (known as "going concern" approaches).[4] Under these approaches, the only capital available as risk coverage potential is capital that is not needed to meet regulatory capital requirements. As capital add-ons increase regulatory capital requirements, their room for manoeuvre in terms of available risk coverage potential narrows so much, in some cases, as to render meaningful governance impossible. The institutions in particular were therefore keen that the supervisory framework for the ICAAP be adapted to the new realities. As the aim is for significant institutions (which are supervised directly by the ECB) and less significant institutions to be roughly in line with one another, the SSM re-

4 See Deutsche Bundesbank, Banks' internal methods for assessing and maintaining internal capital adequacy and their relevance to supervision, Monthly Report, March 2013, pp 29-41.

Stress tests as part of the 2017 low-interest-rate survey

Content of the survey

Following two surveys in 2013 and 2015, the Bundesbank and the Federal Financial Supervisory Authority this year conducted a third survey among 1,555 small and medium-sized German credit institutions that are directly overseen by national supervisors on their profitability and resilience in the low-interest-rate environment. The aim of the survey is to gain a comprehensive insight into the profit outlook of German credit institutions and to identify at an early stage potential risks that might arise, above all, in a scenario of persistently low interest rates. The survey results will be taken into account in future supervisory activities.

Supervisory stress tests were again part of the survey, which covered interest rate risks, credit risks, and market risks. The aim here was to test the credit institutions' resilience in a status quo scenario, taking into account additional stress factors such as an abrupt hike in interest rates, an increase in the number of defaults in the credit portfolio, as well as a sudden rise in credit spreads or falling asset prices (see the chart below). The individual results from the stress tests are used to determine supervisory Pillar 2 capital guidance and thereby help to improve the stability of the German banking market even further.

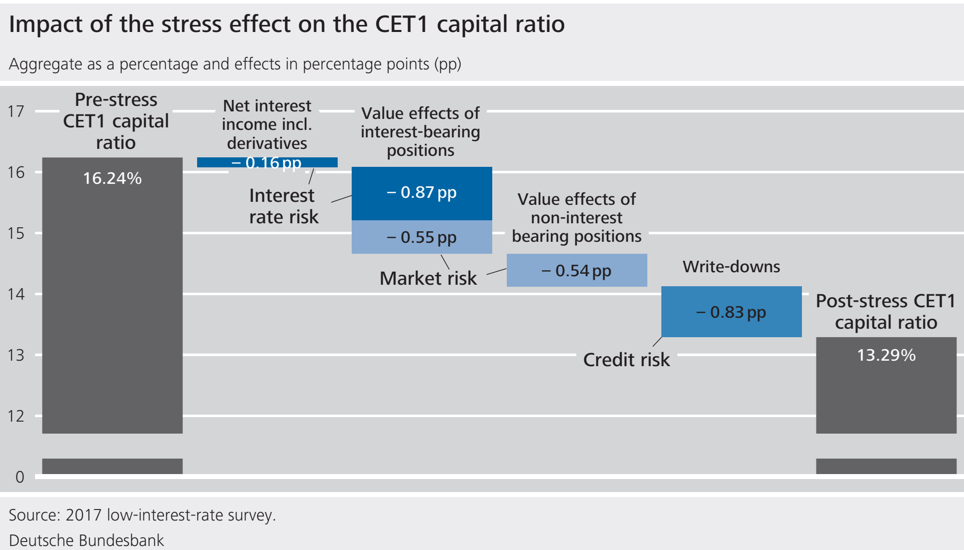
Results

Over a one-year stress horizon, the aggregate Common Equity Tier 1 capital ratio falls by just under 3 percentage points, from the most recent value of 16.24% to 13.29% at the end of 2017. The main drivers are value effects of interest-bearing positions resulting from rising interest rates and/or credit spreads. In a stress scenario, any available hidden reserves could also be liquidated to increase earnings and thereby mitigate the stress effect. Particularly vulnerable institutions are now subject to even more intensive supervision.

The stress test on interest rate risk shows that an abrupt interest rate hike of 2 percentage points would be passed on mainly on the assets side – ie in the form of rising

Impact of the stress effect on the CET1 capital ratio

Aggregate as a percentage and effects in percentage points (pp)



Source: 2017 low-interest-rate survey.
Deutsche Bundesbank

interest rates in lending – whereas interest on the liabilities side would increase to a much lesser extent. Nevertheless, due to the higher volume of interest-bearing liabilities, there is a slight fall in interest income in the short term. The stress effect is, however, largely driven by valuation effects, especially from securities in the liquidity reserve. These valuation effects account for around 60% of the stress effect arising from interest rate risk.

In the market risk stress test, approximately half of the stress effect was caused by value changes in interest-bearing positions. However, the valuation effects of non-interest-bearing positions make a disproportionately large contribution to the stress effect relative to their portfolio share of around 20%. Substantial losses from special funds and real estate funds are especially noteworthy in this regard.

The credit risk stress test leads to a fall in the Common Equity Tier 1 capital ratio of 0.83 percentage points. The main risk drivers in the credit risk stress test are loans to enterprises. These account for more than 30% of the total stress effect. Although loans secured by residential property constitute a similarly high proportion of the portfolio, they lead to considerably lower write-downs due to higher collateralisation ratios.

More information is available at:

https://www.bundesbank.de/Redaktion/EN/Pressemitteilungen/BBK/2017/2017_08_30_joint_press_release.html

quirements in terms of the ICAAP for significant institutions must also be incorporated.[5] New guidelines on the supervisory assessment of banks' internal capital adequacy concepts are therefore currently being developed.[6] This involves regular consultations with representatives of the banking associations. The guidelines are to be finalised at the end of this year.

The draft guidelines are based on principles, with particular emphasis on observing the principle of proportionality. As before, responsibility for designing and implementing the ICAAP lies with the institutions themselves. The ICAAP is to retain its central role in banks' internal processes and in supervision, as ICAAP results are to remain the starting point for determining capital add-ons in the SREP.

SREP well designed, but changes possible

Overall, the German supervisory authorities are well equipped with the current design of the SREP for less significant institutions. The provisions of the EBA guidelines have been implemented. A uniform methodology is used to determine prudential capital requirements for all institutions, ensuring a comparable and consistent approach and involving no additional operational burden for banks. At the same time, adequate account is taken of banks' particularities. Thanks to the now well-established internal capital adequacy reporting, the Bundesbank and BaFin have a systematically collected, high-quality data base, which means that additional data collection is generally not necessary. As a result, the processes that have been developed are efficient, easy to standardise and can be implemented in a risk-based manner. For the institutions, the method used to determine capital add-ons is clear and transparent in BaFin's decisions.

5 See multi-year plan for SSM Guides on ICAAP and ILAAP. https://www.bankingsupervision.europa.eu/ecb/pub/pdf/170220letter_nouy.en.pdf
6 https://www.bundesbank.de/Redaktion/EN/Standardartikel/Tasks/Banking_supervision/risk_management_marisk_risk_bearing_capacity.html?https=1

Currently, the SSM is working on a harmonised SREP methodology for less significant institutions.[7] The Supervisory Board is scheduled to take a decision at the end of 2017.

Proportionality from a regulatory perspective

In banking regulation, the principle of proportionality means that the prudential requirements and their application must be proportionate to the nature, scale and complexity of the risks associated with an institution's business model and activities.

Banking regulation already takes the principle of proportionality into account through the above-described gradations under Pillar 2. For instance, the CRR[8] contains size-dependent gradations in reporting requirements and, when determining capital charges for market risk, differentiates between trading book and non-trading book institutions in terms of the level of requirements to be met. The principle of proportionality is also implicitly recognised in the fact that small institutions generally apply only the CRR's simple standardised approaches, while entry barriers mean that model-based approaches are usually reserved for large institutions.

Single rulebook is regulatory mainstay in the EU

European banking regulation is based on the concept of the "single rulebook", in other words one binding regulatory framework for all Member States. It follows the regulatory standards agreed at the international level by the Basel Committee on Banking Supervision (hereinafter referred to as the Basel Committee). At the European level, the Basel rules were implemented in the CRR and CRD.[9] They are thus directly applicable (CRR) or must be applied after national transposition (CRD) by all institutions resident in the EU, irrespective of their size. This is intended to ensure a level playing field.

The Basel Committee provisions were recently fundamentally revised in response to the financial crisis.[10] This made the framework increasingly complex. Since small and medium-sized institutions do not enjoy the same economies of scale as large institutions in terms of meeting the heightened regulatory requirements, the increased complexity of the rules may be detrimental to the level playing field and create incentives for uniformity and size in the banking sector. Against this backdrop, there is increasing debate on whether and how banking regulation could be made more "proportionate" for small and less complex institutions, in particular.

Proportionality in the revision of the CRR

On 23 November 2016, the European Commission presented a legislative proposal for the revision of the CRR and CRD. This was motivated by the implementation of the provisions of the Basel Committee (particularly in relation to liquidity, the trading book and the leverage ratio). However, the Commission's proposal also contains suggestions on how to render individual requirements in terms of reporting, disclosure and remuneration more proportionate. Under the Commission proposal, institutions whose average total assets over the last four years do not exceed an absolute threshold are to be granted relief in the above-mentioned areas. For reporting and disclosure requirements, it is proposing a threshold of €1.5 billion and for remuneration rules €5 billion (in combination with a criterion that depends on remuneration payments). As regards reporting requirements, the proposals aim primarily at reducing reporting frequency. According to the

7 See Deutsche Bundesbank, The supervision of less significant institutions in the Single Supervisory Mechanism, Monthly Report, January 2016, pp 51-62.
8 Regulation (EU) No 575/2013 of 26 June 2013.
9 Directive 2013/36/EU of 26 June 2013.
10 See Basel Committee on Banking Supervision, Basel III, A global regulatory framework for more resilient banks and banking systems, December 2010 (rev June 2011).

Commission's proposal, institutions with limited trading book activities (less than 10% of total assets, subject to a maximum of €300 million) would, moreover, be eligible to use a simplified standardised approach to calculate regulatory own funds requirements for trading book transactions.

Initiative for a three-step approach with a "small banking box"

A German initiative for simpler rules for small banks

In addition to the European Commission's proposals for specific relief in the context of the review of the CRR and CRD, there is also a German initiative for even more proportionality in banking regulation. To this end, an expert working group has been created, including representatives of the German Ministry of Finance, BaFin, the Bundesbank and five associations representing the German banking sector. After the working group was set up and consultations had taken place, a working paper was drawn up, which the Federal Ministry of Finance put before the competent expert group of the European Commission in June of this year. It is being used there as the basis for further discussion at the European level. Specifically, the proposal is as follows.

- The full Basel III requirements will continue to apply to institutions that are systemically important or potentially pose a systemic risk – in terms of numbers, this is the smallest group, but it is very significant in terms of risk and therefore the most closely regulated. This group will receive no relief under the CRR and CRD.

- A second group of institutions which are neither large nor systemically important, but equally neither small nor low-risk, will receive some targeted relief, which can be achieved by adjusting individual points of the current rules.

- The third group constitutes small and non-complex institutions. This group, which is numerically the largest, is to receive the most relief. The idea is to create a separate set of rules: the "small banking box".

Contents of the "small banking box"

Creating a separate regulatory framework for small institutions is based on the idea that this can relieve such institutions of having to meet requirements that are not relevant to them more than can adjustments to the details of the existing regulatory framework. There is, moreover, the danger that a lot of detailed exemptions could ultimately make the rules less clear and more difficult to interpret. Creating a separate regulatory framework for small institutions would, by contrast, increase the clarity of the framework.

In the future discussions on route to establishing a "small banking box", care must equally be taken to ensure that the reduced reporting and disclosure requirements do not lead to a reduction in overall regulatory requirements, in particular with regard to the relevant institutions' capital and liquidity levels. In addition, when considering lowering reporting requirements, policymakers should not forget the information needed by other policy areas, such as monetary policy or macroprudential regulation. Ultimately, creating a "small banking box" is intended to achieve greater proportionality by eliminating requirements in terms of remuneration rules, Pillar 3 disclosure requirements and recovery and resolution planning that are not necessary from a supervisory perspective and by rendering the supervisory reporting regime noticeably less onerous.

Exactly where the threshold for banks within the "small banking box" should be has yet to be established in discussions at the European level; in this process, the circle of institutions involved and the planned reporting relief cannot be regarded in isolation. The German working paper proposes, by way of example, an absolute threshold of total assets of €3 billion and an, as yet unspecified, relative threshold which

would be tied to the gross domestic product of the Member State in question or the size of its banking sector, whichever is the lower. The quantitative threshold is flanked by qualitative criteria to ensure that only small institutions with a simple business model can fall within the scope of the "small banking box". Exemplary calculations show that even if the "small banking box" were to apply to a large number of banks, the vast majority of the German banking system's total assets would be supervised according to the general rules.