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PROPORTIONALITY AND BANKS: A COMPARATIVE ANALYSIS OF TAILORED BANKING REGULATION.

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ABSTRACT

The recent surge of banking regulation complexity is associated with higher fixed costs and compliance risk to banks. In this sense, larger banks have an advantage over smaller institutions as they are more likely to mitigate such effects by applying economies of scale. A possible solution to simplify and ensure a level playing field for banking institutions is proportionate banking regulation. This dissertation studies the effectiveness and methods in which proportionality in banking regulation is applied, using a comparative analysis that examines the US, Australia, and the European Union's legal systems. The contribution of this thesis is threefold. First of all, it analyzes how proportionality is applied in the three jurisdictions. Second, it provides evidence of proportionality. Last, it analyzes the specific rules associated with its implementation. The thesis also investigates the nature of proportionality in the three jurisdictions examined, highlighting the similarities and differences present in the different legal systems. The results illustrate that proportionality is applied in the banking sector in the legal systems examined. This common result derives from a common international matrix given by the Basel accords. The results also indicate that only the US system limits the application of these standards to core banks, while the Australian and European Union systems

apply the Basel requirements to all banking institutions. Another relevant result indicates that the Australian and European Union systems consider proportionality as a principle. Conversely, in the US legal system, proportionality is defined as the activity of tailoring rules and is not considered as a principle. These differences on how the regulation is formulated are relevant not only for the legal sector, but also for the economic field.

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Introduction.

"Legum omnes servi sumus ut liberi esse possimus."
Cicero, *Pro Cluentio.*

The thesis argues the effectiveness and modalities of applying proportionality in banking regulation through comparative analysis. Before proceeding with the comparative analysis, the dissertation focuses on defining the principle of proportionality in law. The definition appears necessary, given that this concept has significant differences in the various systems examined.

Proportionality in law means to not go beyond what is necessary to achieve the stated goals. This definition has been transposed in the European Union regulation by the Treaty on European Union. However, the thesis also examines the different nuances of meaning that proportionality assumes in different contexts. The thesis focused primarily on the differences in the legal field's concept of proportionality and on the methodologies for assessing the proportionality of the measures examined by the Courts. After investigating the general concept of proportionality in law, the analysis narrows the focus on the concept of proportionality in financial regulation. For this purpose, the thesis

also considers the discipline developed internationally by the Basel Committee, headquartered at the Bank for International Settlements in Basel.[1] This institution defines proportionality as the legislator's and supervisor's action of best tailoring regulatory requirements to banks that are non-internationally active, particularly smaller and less complex institutions.[2]

Proportionality is relevant since it determines several objectives. Anecdotal evidence shows that a correct application of proportionality in law could determine the maximization of regulatory advantages. There is maximization when regulatory advantages are higher of regulatory costs (*e.g.*, compliance costs).[3] Moreover, proportionality aims to simplify banking regulation, which is becoming more and more complex. Indeed, the regulatory complexity determines the industry's costs that are fixed costs. Proportionality would also allow guaranteeing a level playing field for banking institutions. A one-size-fits-all approach would only allow larger banks to benefit from economies of scale at the expense of smaller institutions. Proportionality also has the virtue of increase the supervisor's efficiency, especially in jurisdictions with limited

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[1] *History of the Basel Committee*, THE BANK FOR INTERNATIONAL SETTLEMENTS (2014), https://www.bis.org/bcbs/history.htm (last visited Aug 30, 2020).
[2] Ana Paula Castro Carvalho et al., *Proportionality in Banking Regulation: a Cross-country Comparison* THE BANK FOR INTERNATIONAL SETTLEMENTS (2017), https://www.bis.org/fsi/publ/insights1.htm (last visited Aug 30, 2020).
[3] Vasily Pozdyshev, *Proportionality and the Basel Framework*, THE BANK FOR INTERNATIONAL SETTLEMENTS (2018), https://www.bis.org/bcbs/events/icbs20/ws3.pdf (last visited Aug 30, 2020).

resources.[4] However, the focus of this thesis is related to the laws rather than to the supervisory aspects.

The dissertation uses a comparative method to investigate proportionality. The systems studied are the United States' system, the Australian, and the European Union one. This research attempts to overcome the now obsolete comparative method based on the premise that the comparative analysis must consider State laws.[5] In this sense, the traditional comparative investigation would exclude international and supranational law, including European Union law. As a result of the growing interconnections and exchanges, not only of a commercial but also a legal nature, an increasing role of transnational, supranational, and international entities appears. For these reasons, even considering that this research focuses on the banking field, limited research on a pure state level would not be sufficient to explicate the modalities in which proportionality is implemented.

Proportionality has deep relevance in the European context. Indeed, in the European Union, it is a principle and has a Treaty *status*, being defined in article 5, paragraph 4 of the Treaty on European Union.[6] The recognition of

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[4] *Idem.*
[5] Mathias Siems, COMPARATIVE LAW 42 (2018).
[6] The Treaty on European Union is a fundamental pillar of the European Union. The Lisbon Treaty established the Treaty on European Union and the Treaty on the Functioning of the European Union. While the latter contains provisions related to EU institutions and policies, the Treaty on European Union contains general provisions. For a more detailed examination of the EU law, see, for example, Robert Schütze, EUROPEAN UNION LAW (2015).

proportionality as a principle means that it represents a necessary rule for the system's functioning.[7]

This thesis highlights how the application of the proportionality principle in the EU member states is not consistent. The elevation of proportionality as a principle has legal and economic implications. The references to the principle generated interpretative issues about how and in which areas apply a proportionality approach. These problems exist because a principle is *per se* general, and the member states have the freedom to determine how to achieve the objective.

This dissertation has the objective to examine these issues through comparative analysis. The comparative analysis is relevant because it allows us to verify how different jurisdictions apply proportionality. In this way, the comparative analysis allows us to learn different solutions to the same problem, linked to how to make proportionality effective in the banking sector, and learn from different systems' experiences. The research questions in this thesis are *in primis* related to the assessment of the application of proportionality across jurisdictions. After verifying the existence of proportionality in other jurisdictions, the thesis analyzes the main laws of different jurisdictions to demonstrate the modalities of application of proportionality through the laws.

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[7] Marcelo Kohen & Bérénice Schramm, *General Principles of Law*, OXFORD BIBLIOGRAPHIES (2017), https://www.oxfordbibliographies.com/view/document/obo-9780199796953/obo-9780199796953-0063.xml (last visited Aug 30, 2020).

The comparative analysis shows that not every jurisdiction examined considers proportionality as a principle. This consideration has strong implications, not only from the legal profile but also from the economic side. The jurisdictions examined for the comparative analysis are the United States, European Union, and Australia. Hence, the comparative analysis carried out in the following chapters goes beyond the traditional comparative approach. This comparative analysis considers the European Union as a jurisdiction, and it scrutinizes the EU member states incidentally. This choice is due to the consideration that the issues related to the application of proportionality as a principle come better to light considering the EU banking regulation in its entirety.

In this sense, the chapter that describes the EU regulation raises specific issues that have arisen in some member states and one ex member state, the United Kingdom. Besides, the EU is a member of the Basel Committee, which considers the European Union as jurisdiction.[8] The study of such issues, to which the comparative analysis aims, also involves the banking regulation inquiry in Australia and the United States. The United States is notoriously an important financial center. Hence, it seems relevant to use this regulation as a landmark. The study of the Australian banking regulation is also pertinent, given that it is generally considered a middle power. Therefore, although it cannot be defined as a superpower, it exerts sufficient influence to affect international

[8] *Basel Committee Membership*, THE BANK FOR INTERNATIONAL SETTLEMENTS (2013), https://www.bis.org/bcbs/membership.htm (last visited Jul 10, 2020).

events.[9] The study of the Australian system has relevance for the geographical position that the region has. It is a western country geographically and economically linked to Asia through commercial and cultural exchanges. Besides, Australia has deep links with the UK and its legal heritage, although the latter is recently no longer a Member State of the European Union.[10] Indeed, the UK's previous membership in the European Union profoundly impacted on UK banking and financial regulation.[11] Due to its geographical position and its role as a bridge between Asia and Europe, it is important to consider its legal experience.

In light of what has been described above, the motivation of this research is the following. *In primis*, this research has a legislative relevance given the wide application of this principle in EU directives and regulations concerning the banking sector. The research also has an economic relevance, as proportionality is a central theme on the competition and survivorship of banking institutions in the market. Indeed, the EU discipline of fair competition and the four freedoms are of fundamental importance.[12] Proportionality in banking regulation has considerable relevance, especially in the aftermath of the financial crisis,

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[9] Meltem Müftüler Baç, *Middle Power*, ENCYCLOPÆDIA BRITANNICA (2017) https://www.britannica.com/topic/middle-power (last visited Aug 30, 2020).
[10] *Brexit: All You Need to Know About the UK Leaving the EU*, BBC NEWS (2020), https://www.bbc.com/news/uk-politics-32810887 (last visited Jul 10, 2020).
[11] Alastair Holt, *Banking Regulation | United Kingdom*, GLI - GLOBAL LEGAL INSIGHTS INTERNATIONAL LEGAL BUSINESS SOLUTIONS (2020), https://www.globallegalinsights.com/practice-areas/banking-and-finance-laws-and-regulations/united-kingdom (last visited Oct 21, 2020).
[12] The four freedoms are freedom of movement of goods, persons, services and capital. See Catherine Barnard, THE SUBSTANTIVE LAW OF THE EU: THE FOUR FREEDOMS (2019).

following which copious legislative measures have been issued to remedy the crisis. The volume of law assumes relevance in connection with the issue of the modalities of implementation of proportionality. Indeed, if proportionality is not applied sufficiently or is poorly applied, it can generate negative consequences. Following the crisis, the European Union institutions enacted a reform agenda that includes more than forty legislative proposals and institutional reforms.[13]

The Australian system has also developed a complex reform plan of various related prudential standards and reporting standards.[14] In the United States, the Dodd-Frank enactment required the development of some two hundred and fifty new rules.[15] The increase in the legislative and regulatory framework in the banking sector in a scenario where proportionality is poorly implemented represents an increasing cost for banks and other financial institutions. A major concern is the risk that disproportionate regulation could cause a decrease in the competitiveness of the financial market because economies of scale would only allow larger banks to survive, while smaller banks would be forced out of the market or merged; or acquired by other banks. Thus, it is crucial to know the

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[13] Lord Boswell of Aynho et al., *The Post-crisis EU Financial Regulatory Framework: Do the Pieces Fit?* UNITED KINGDOM PARLIAMENT (2015) 19–23 https://publications.parliament.uk/pa/ld201415/ldselect/ldeucom/103/103.pdf (last visited Aug 30, 2020).

[14] *The Regulatory Response to the Global Financial Crisis: Submission to the Financial System Inquiry – March 2014: Financial Sector: Submissions*, RESERVE BANK OF AUSTRALIA (2014), https://www.rba.gov.au/publications/submissions/financial-sector/financial-system-inquiry-2014-03/regulatory-response-to-the-global-financial-crisis.html (last visited Aug 30, 2020).

[15] Douglas D. Evanoff & William F. Moeller, *Dodd–Frank: Content, Purpose, Implementation Status, and Issues,* FEDERAL RESERVE BANK OF CHICAGO 75 (2012) https://www.chicagofed.org/publications/economic-perspectives/2012/3q-evanoff-moeller (last visited Aug 18, 2020).

meaning of proportionality and the extent to which it is applied in banking regulation.

The results depict a general application of proportionality in the banking sector, deriving from an international matrix, *i.e.*, Basel agreements. Indeed, the Basel Committee on Banking Supervision developed over the years several international standards applicable to internationally-active banks.[16] The results show that in the three systems examined, only the US system limits the application of Basel requirements to the "core banks."[17] On the contrary, the European Union and Australia legislators have implemented the Basel agreements to all the banking institutions.[18]

Another result that emerged from the comparative study is that the European Union and Australian lawmakers consider proportionality a principle. The legislator of the European Union expressly refers to the principle of proportionality. Moreover, the principle is enshrined in the Treaty on European Union.[19] In Australia, academics and judges consider proportionality as a

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[16] See, for example: *Basel III: International Regulatory Framework for Banks*, THE BANK FOR INTERNATIONAL SETTLEMENTS (2017), https://www.bis.org/bcbs/basel3.htm (last visited Oct 9, 2020).

[17] *Basel III Regulatory Consistency Assessment (Level 2) Preliminary Report: United States of America*, THE BANK FOR INTERNATIONAL SETTLEMENTS (2012), 24, https://www.bis.org/bcbs/implementation/l2_us.pdf (last visited Oct 9, 2020).

[18] For the EU system see: *Capital Requirements – CRD IV/CRR – Frequently Asked Questions*, EUROPEAN COMMISSION (2013), https://ec.europa.eu/commission/presscorner/detail/en/MEMO_13_690 (last visited Aug 30, 2020). For the Australian legal system see: *Regulatory Consistency Assessment Programme (RCAP) - Assessment of Basel III LCR Regulations – Australia,* THE BANK FOR INTERNATIONAL SETTLEMENTS (2017), https://www.bis.org/bcbs/publ/d419.htm (last visited Aug 18, 2020).

[19] See *supra*, note 6.

doctrine.[20] Doctrine is defined in law as a principle established through past decisions.[21] Indeed, the thesis considers several case law (*e.g.*, *Lange*[22], *McCloy*[23] and *Kable*)[24] in which the High Court of Australia applies proportionality as a principle. This thesis also shows that references to the principle are present not only in the Australian law but also in the regulations issued by the supervisory authority. For example, the Australian Prudential Authority - APRA expressly adopts a proportionate approach in establishing the prudential framework for the institutions under its supervision.[25]

The comparative analysis also indicates that proportionality is not considered a principle in the US system but seems to have a rule's characteristics. Besides, banking regulation in the United States does not refer to the concept of proportionality, but the tailoring rules. This thesis exposes multiple examples in which the US legislator or supervisory authorities refer to tailoring rules instead of proportionality.[26] The results suggest that considering proportionality as a principle or as a rule has profound implications for the entire banking regulation

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[20] Shipra Chordia, PROPORTIONALITY IN AUSTRALIAN CONSTITUTIONAL LAW (2020).
[21] *Doctrine* MERRIAM-WEBSTER (2020), https://www.merriam-webster.com/dictionary/doctrine (last visited Aug 18, 2020)
[22] *Lange v Australian Broadcasting Corporation* (1997) 145 ALR 96.
[23] *McCloy v. New South Wales* (2015) 257 CLR 178.
[24] Roshan Chaile, *The Proportionality Principle and the Kable Doctrine: A New Test of Constitutional Invalidity*, 1 GLOBAL JOURNAL OF COMPARATIVE LAW 163 (2012).
[25] *APRA's Objectives*, CROSS-INDUSTRY (2019), https://www.apra.gov.au/apras-objectives (last visited Jul 21, 2020).
[26] For example, see: *Prudential Standards for Large Bank Holding Companies, Savings and Loan Holding Companies, and Foreign Banking Organizations*, FEDERAL REGISTER (2019), https://www.federalregister.gov/documents/2019/11/01/2019-23662/prudential-standards-for-large-bank-holding-companies-savings-and-loan-holding-companies-and-foreign (last visited Sep 10, 2020).

system. Indeed, the consideration of proportionality as a principle implies that standards are formulated as guidelines, and very often, the legislator does not indicate exactly how to implement proportionality. This approach guarantees greater flexibility, which is very useful in a context such as that of the European Union, where the member states maintain a certain level of legislative autonomy. However, this approach causes interpretative conflicts to emerge and risks an inconsistent application of the principle, as explained in the chapter relating to the European Union system. A more targeted approach to considering proportionality as a rule, however, although it is less flexible, allows a greater and more effective differentiation of the discipline based on the characteristics of the banking institutions.

The thesis contributes to the literature in several ways. First, it adds to the discussion about the modalities of application of proportionality in banking regulation. Although the economic literature recognizes the importance of proportionality in the financial field,[27] the question of how these rules are formulated in order to allow the implementation of proportionality remains open. This thesis contributes in filling this gap by providing evidence on the application of proportionality in three different jurisdictions and analyzing the rules implementing it.

[27] Marco Onado & Andrea Landi, *La funzione economica del sistema finanziario e delle banche,* LA BANCA COME IMPRESA (2004).

Apart from the economic discipline, the legal literature also depicts the principle of proportionality by showing examples of its application in financial regulation,[28] nonetheless without showing how the rules are formulated. Although examples are useful in showing the application of the principle, no studies in the legal discipline analyze the nature of proportionality as a principle, doctrine, or rule on the three jurisdictions examined. The thesis contributes to the literature by analyzing the different nuances of meaning assumed by proportionality in the legal systems examined, without starting from the imprecise assumption that proportionality has the same meaning in all jurisdictions. The study analyzes proportionality by highlighting the formal differences, *i.e.*, the different denominations that proportionality assumes in the European Union, the United States, and Australia. The thesis also examines the differences in content that proportionality has in doctrine, jurisprudence, and banking regulation.

Moreover, legal studies do not specify the rationale that is used to recognize proportionality. The literature does not present studies on the application of proportionality from the legislative perspective with the comparative analysis. This thesis contributes by considering the specific laws and regulations of the banking sector of the three legal systems, with the purpose to shed light to the

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[28] Rotondo Gennaro, *L'applicazione dei principi di proporzionalità e ragionevolezza nella regolamentazione italiana dei mercati finanziari - [The Application of the Principles of Proportionality and Reasonableness in the Italian Regulation of Financial Markets],* DIRITTO DEL MERCATO ASSICURATIVO E FINANZIARIO, 1, 81 – 117 (2017).

discussion. Last but not least, the thesis contributes by adding to the legal literature an extraction of the general methods used when proportionality is applied, considering the specific formulations of the laws.

Regarding the research design, three different perspectives can be used when analyzing foreign legal systems. In the first approach, foreign laws are analyzed from the researcher's local legal system's perspective by emphasizing the legal system to which she belongs and trying to explain foreign legal systems using her legal system's criteria.[29] Large space is left to the legal system to which she belongs, while foreign systems are treated only in a residual way. The second approach implies choosing to adopt the point of view of the foreign legal system, with the consequence that the researcher would try to present the legal materials in the same way that a jurist of the different legal system would present such materials.[30] Finally, she can have a neutral approach, *i.e.*, an impartial way to analyze how legal systems deal with certain problems. Traditionally, academics consider that the first approach is not ideal to impose one's preconceptions on other legal systems. For this reason, the thesis adopts a neutral perspective, by paying the same attention to all the legal systems examined, without trying to justify some legislative choices from the point of view of the researcher's country of origin.[31] Indeed, after the first chapter related to the conceptual

[29] Mathias Siems, *op. cit.*, 20
[30] *Idem*, 19.
[31] *Ibid.*

framework, the following three chapters carry out a neutral description of the laws of the three jurisdictions. The study also highlights and explains similarities and differences, showing the results found.

The thesis is divided into five chapters. Chapter 1 examines the concept of proportionality in law by analyzing the presence of proportionality in the jurisprudence and doctrine of the three jurisdictions examined. The second chapter focuses on the United States' legal system. The legal system description starts from the measures taken in the aftermath of the Great Financial Crisis (hereby also GFC). It analyzes examples of the application of proportionality in the Dodd-Frank Act and subsequent amendments made by the Economic Growth, Regulatory Relief, and Consumer Protection Act. The chapter also analyzes a relevant example of the application of proportionality present in the Final Tailoring Rules drawn up by the Federal Reserve and the US Banking Agencies Office of Comptroller of the Currency (OCC) and Federal Deposit Insurance Corporation (FDIC).

The third chapter focuses on the principle of proportionality in banking regulation that exists in the European Union. It analyzes the European legislator's approach considering some examples of applying the principle of proportionality in the directives and regulations issued since the aftermath of the great financial crisis. The analysis focuses in the Capital Requirements Directives and Regulations (in particular Regulation 575/2013/EU, Directive 2013/36/EU; Directive 2019/878/EU and Regulation 2019/876/EU).

The fourth chapter analyzes the Australian legal system. Following the analysis of the specificities of Australian banking regulation and the measures taken in the aftermath of the financial crisis, the chapter contemplates some examples of the application of proportionality in Australian financial regulation, including, for example, the Future of Financial Advice legislation[32] and the Banking Executive and Accountability Regime[33].

Lastly, the conclusions on the results of the thesis are in the fifth chapter. After illustrating the conceptual reference framework and describing the main features of the banking regulation of the three legal systems examined, this chapter performs a comparative analysis. The analysis involves the exposition of the results, the identification and explanation of similarities and differences, and, finally, a critical evaluation.

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[32] *Delivering Affordable and Accessible Financial Advice*, TREASURY MINISTERS (2013), https://ministers.treasury.gov.au/ministers/arthur-sinodinos-2013/media-releases/delivering-affordable-and-accessible-financial (last visited Aug 18, 2020).

[33] *Banking Executive Accountability Regime*, *Cross-industry*, AUSTRALIAN PRUDENTIAL REGULATION AUTHORITY (2018), https://www.apra.gov.au/banking-executive-accountability-regime (last visited Aug 30, 2020).

Chapter 1

The Concept of Proportionality in the Legal Dimension.

> *"Justice is therefore a sort of proportion; for proportion is not a property of numerical quantity only, but of quantity in general, proportion being equality of ratios [...]."*
> Aristotle, The Nicomachean Ethics.

Summary: 1.1 Introduction; 1.2 Defining Proportionality: the Legal Basis of the Principle of Proportionality in the European Union Law; 1.3 Proportionality According to the US Legal System; 1.4 The Concept of Proportionality in the Australian Legal Framework; 1.5 Proportionality in Banking Regulation; 1.6 Proportionality as a Core Principle in the Basel Committee Framework; 1.7 Proportionality and Consumer Protection; 1.8 Beyond the Traditional Comparative Law; 1.9 Conclusions.

1.1 Introduction.

Proportionality is a generally accepted principle by different legal systems around the world[34]. The relation between proportionality and the legal framework has ancient roots since it is envisaged by Greek philosophers as strictly related to the concept of justice.[35] The importance of proportionality derives from its function to guide legislators and interpreters of the law towards justice since this principle is inspired by the idea that the law must serve a

[34] Vicky C. Jackson, *Constitutional Law in an Age of Proportionality*, 124 YALE LAW JOURNAL 3094 (2014).
[35] Aristotle, THE NICOMACHEAN ETHICS 118 (1996). Translated with Notes by Harris Rackham.

fruitful function. Indeed, in some legal systems, proportionality is recognized by Courts through the interpretation of the general rules and local constitutions governing the territory; in this sense, proportionality is a guide adopted by judges for the interpretation of the law and its application. Sometimes the law itself envisages this principle as a guideline for the legislator and other legislative bodies. For instance, this phenomenon appears in the financial regulation of the European Union (from now on also EU), where the European legislator and, as a ripple effect, national legislators and supervisory authorities of member states use proportionality as an explicit criterion for differentiating between financial institutions with peculiar characteristics.

Proportionality embraces a variety of meanings and has different scopes. Indeed, multiple sectors of the law, such as Constitutional, Criminal, Administrative, and Financial Law, apply it. Proportionality has different definitions, and there are different ways to apply it depending on the legal system involved. In other words, examining the concept of proportionality is not a minor task, as there is not a uniform defined procedure to enforce proportionality, and different criteria of application exist. To understand the main differences of the concept of proportionality, this chapter analyzes proportionality in three different legal systems or "*supra-national"* orders: European Union, United States of America (in the future also the USA or the US), and Australia. These orders present comparable features but also idiosyncrasies that make the application of proportionality unique, noteworthy

Australia's vital financial relationships are with the EU and US, although in recent years, there has been an approaching of Australia's interests through Asia.[36] On the one hand, the European Union is a "*supra*" national entity instituted after World War II (formerly with the name of European Coal and Steel Community). It continuously develops toward an increased harmonization between States with different cultures, legal systems, and languages.[37] On the other hand, the US and Australia are both federations of states, and this implies that the impact of the Federal State is stronger than the impact of the European Union on its member states. Last but not least, in the Commonwealth of Australia, the reigning British monarch is also the Australian monarch and, therefore, Australia's head of state.[38] Hence, in Australia, it is possible to examine if and how the British influence has an impact on the legislative level. This influence is related to the UK's belonging to the EU in the period before the withdrawal of the United Kingdom from the European Union (so-called "Brexit").[39]

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[36] David Murray, *Financial System Inquiry Final Report* TREASURY.GOV.AU (2014), https://treasury.gov.au/publication/c2014-fsi-final-report (last visited Sep 1, 2020).
[37] For the history of the European Union see *ex multis* Wolfram Kaiser et al., EUROPEAN UNION HISTORY THEMES AND DEBATES (2010).
[38] Adam Vallance, *Australia* THE ROYAL FAMILY (2016), https://www.royal.uk/australia (last visited Oct 16, 2020).
[39] Murray Gleeson, *Global Influence on the Australian Judiciary* HIGH COURT OF AUSTRALIA (2002), https://www.hcourt.gov.au/assets/publications/speeches/former-justices/gleesoncj/cj_global.htm#:~:text=Australia%20now%20finds%20that%20the%20common%20law%20countries%20whose%20jurisprudence,of%20human%20rights%20and%20freedoms. (last visited Oct 6, 2020).

This investigation considers the banking regulation, which is one of the most affected sectors by this principle. Indeed, in banking regulation, proportionality can explain the important effect on the financial market and consumers. Proportionality in the banking sector is not a new concept neither for the regulatory side nor the supervisory one. Indeed, in 1996, the Basel Committee on Banking supervision already provided for market risk an option based on proportionality, adding a new simplified approach to the standardized one. However, the concept has come to the fore again after the crucial revision and reorientation of banking regulation made by legislators worldwide in response to the Great Financial Crisis. Legislators and supervisory authorities issued a myriad of new rules and regulations to face and remedy the crisis's causes.[40]

Consequently, many banks had to entirely review their standards and procedures related to their organization to be compliant with the new rules and regulations. The increased legislative and regulatory framework represents a rising cost for banks and other financial institutions. In this sense, the effects of banking regulation in the financial market became an intensely discussed topic. The main concern is related to the possibility that a disproportionate regulation could cause a decrease in market competitiveness since the economies of scale could allow larger banks to survive. In contrast, smaller banks could be forced

[40] See, for example: Leela Cejnar, *After the Global Financial Crisis: Key Competition Law Developments in Australia*, *the United States, the EU and the UK*, 5 LAW AND FINANCIAL MARKETS REVIEW 201–212 (2011).

to leave the market or be acquired. For this reason, it is decisive to understand the meaning of proportionality and to what extent it is applied in banking regulation. The comparative analysis is fundamental to assess the strengths and weaknesses of the multitude of legislative initiatives that have been developed so far in response to the Global Financial Crisis.

This chapter is divided into nine sections. Section 1.2 is about the juridical framework of proportionality in the European Union, which defined the concept in the Treaty on European Union. Section 1.3 focuses on the United States` case-law that led to a notion that is similar to the concept of proportionality developed in the EU, though with some differentiations. Section 1.4 examines the concept of proportionality in the Australian case law, considering the High Court`s latest developments on the point. Section 1.5 shifts the investigation from the general concept of proportionality towards the banking sector`s contextualized notion. Section 1.6 analyzes proportionality as a Basel Core Principle for Effective Banking Supervision. Section 1.7 focuses on consumer protection and comments on how a disproportionate regulation could, in theory, affect consumers. Section 1.8 describes the comparative method`s functions and justifies the abandonment of the traditional comparative method for this thesis's purposes; and the new challenges of the current time. Lastly, section 1.9 contains some concluding remarks.

1.2 Defining Proportionality: the Legal Basis of the Principle of Proportionality in the European Union Law.

Proportionality is one of the cornerstones of European Union law since it has a Treaty status. The extent and definition of this principle are outlined in the Treaty on European Union (from now on also TEU) in article 5 paragraph 4, which states that the EU's actions shall not go beyond what is necessary to achieve the Treaty's objectives.[41] The "Protocol on the Application of the Principles of Subsidiarity and Proportionality" attached to the Treaty of Amsterdam contains explanations. Indeed, article 5 of the Protocol specifies that: "Draft legislative acts shall be justified with regard to the principles of subsidiarity and proportionality. Any draft legislative act should contain a detailed statement making it possible to appraise compliance with the principles of subsidiarity and proportionality. This statement should contain some assessment of the proposal's financial impact and, in the case of a directive, of its implications for the rules to be put in place by member states, including, where necessary, the regional legislation. The reasons for concluding that a Union objective can be better achieved at Union level shall be substantiated by

[41] In the European Union, an early reference of proportionality is present in *Man (Sugar) v IBAP*, Case C-181/84 ECLI:EU:C:1985:359 (1985). For other references to proportionality see*: Valsabbia v Commission*, Case C-154/78 ECLI:EU:C:1980:81 (1980); *British American Tobacco (Investments) and Imperial Tobacco*, Case C-491/01 ECLI:EU:C:2002:741 (2002); *Swedish Match*, Case C- 210/03 ECLI:EU:C:2004:802 (2004); *Buitoni*, Case C-122/78 ECLI:EU:C:1979:43 (1979); *Fromançais*, Case C- 66/82 ECLI:EU:C:1983:42 (1983).

qualitative and, wherever possible, quantitative indicators. Draft legislative acts shall take account of the need for any burden, whether financial or administrative, falling upon the Union, national governments, regional or local authorities, economic operators and citizens, to be minimised and commensurate with the objective to be achieved."[42]

Hence, it seems that the definition of proportionality given by the TEU is related to the action of the European legislator and the consequences that the principle of proportionality could have on member states and EU citizens. In this sense, the article explains to what extent the EU regulation can interfere with the multitude of member states' legal systems, and it sets forth the EU's respect for every Member State's legal system. A European scholar highlighted that the principle of proportionality fulfills two basics functions.[43] The first function concerns the protection of the internal market (market integration), while the second function is related to protecting individual rights. When the proportionality principle is applied to assess if a national measure affects the four freedoms (free movement of goods, persons, services, and capital), the principle fulfills both the functions.[44] Hence, it seems that the principle has a broader scope of the one outlined in the TEU since it concerns EU measures

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[42] Article 5 of the Consolidated version of the Treaty on the Functioning of the European Union. *Protocol (No 2) on the Application of the Principles of Subsidiarity and Proportionality*, OFFICIAL JOURNAL 115 (2008), https://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:12008E/PRO/02 (last visited Oct 21, 2020).
[43] Jan H. Jans, *Proportionality Revisited*, 27 LEGAL ISSUES OF ECONOMIC INTEGRATION 239–265 (2000).
[44] *Idem*, 243.

and domestic measures.

Based on the European Court of Justice`s case-law (in the future also ECJ), scholars have developed three elements of proportionality: suitability, necessity, and proportionality "*sensu stricto"*. The first element clarifies that the means engaged by legislators must be suitable to achieve their aims.[45] As stated by the European Court of Justice in United Foods, suitability means that a "reasonable connection" must exist between the measures established by the authorities and the exercise of control concerning the suitability of measures.[46] In that respect, Jans argues that ECJ uses suitability tests to deal with national measures, considered essential to achieving a legitimate interest, but actually, they are protectionist measures.[47]

The application of this test can be seen, for instance, in *Franzén*,[48] where the Swedish regulation of alcoholic beverages production licenses and wholesale licenses were considered as a hurdle to the importation in Sweden of alcoholic beverages from the other member states. Indeed, according to evidence made by the Swedish Government itself, under the authorization regime examined by ECJ, almost all the licenses for production and wholesale of alcoholic beverages have been issued to Swedish traders. The Swedish Government maintained that

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[45] Takis Tridimas, *The Principle of Proportionality in Community Law: From the Rule of Law to Market Integration*, 31 IRISH JURIST 83–101 (1996).
[46] *United Foods*, Case C- 132/80 ECLI:EU:C:1981:87 (1981), paragraph 28.
[47] Jans, *op. cit.*, 240.
[48] *Franzén*, Case C- 189/95 ECLI:EU:C:1997:504 (1997).

its legislation was justified on the ground of health protection. However, the European Court of Justice ascertained that: "[…] the Swedish Government has not established that the licensing system set up by the Law on Alcohol, in particular as regards the conditions relating to storage capacity and the high fees and charges which license-holders are required to pay, was proportionate to the public health aim pursued or that this aim could not have been attained by measures less restrictive of intra-community trade".[49] The legal literature considers that the European Court of Justice believed that the Swedish measure was not adequate to achieve the aim of public health's protection. [50]

According to the second element of proportionality in the EU case-law and doctrine, the measure shall be necessary. The test of necessity implies that there must be no measure less restrictive but adequate to realize the objective pursued. The test of necessity considers competing interests: on the one hand, it considers the adverse consequences that the measure has on an interest worthy of legal protection; on the other hand, it must be ascertained if the consequences are justified regarding the relevance of the attained end.[51] This second test could envisage the evaluation of the presence of the "least restrictive alternative" capable of reaching the same result. Moreover, the analysis should comprehend the assessment of an eventual excessiveness of the effect on the conflicting

[49] *Idem*, paragraph 76.
[50] Jans, *op. cit.*, 244.
[51] Catherine Barnard, *op. cit.*

interest.[52] The application of this test can be observed in the *Scotch Whisky Association and Others v. Lord Advocate*,[53] which is a case in which the ECJ assessed a Scottish law fixing the minimum unit price for alcoholic beverages. In this case, the Court stated that: "[…] it is for the national authorities to demonstrate that that legislation is consistent with the principle of proportionality, that is to say, that it is necessary in order to achieve the declared objective, and that that objective could not be achieved by prohibitions or restrictions that are less extensive, or that are less disruptive of trade within the European Union".[54]

The literature calls the third element of proportionality with the term "*sensu stricto*."[55] The European Court of Justice has also defined this test as: "proportionality in the narrow sense of the term, that is to say the weighing of damage to individual rights against the benefits accruing to the general interest".[56] According to this test, a measure is not proportional when it causes an effect that reveals to be excessive regarding the objective or the result. One of the best examples of proportionality in the narrow sense of the term is *Stoke-on-Trent*.[57] This case concerns the assessment of the proportionality of a

[52] See: *Rosengren and Others*, Case C-170/04 ECLI:EU:C:2007:313 (2007), paragraph 50 and *Commission v. Germany*, Case 141/07 ECLI:EU:C:2008:492 (2008), paragraph 50.
[53] *Scotch Whisky Association and Others*, Case C- 333/14 ECLI:EU:C:2015:845 (2015).
[54] *Idem*, paragraph 53.
[55] Jans, *op. cit.*, 241.
[56] *Boehringer v Council*, Case T-125/96 ECLI:EU: T:1999:302, paragraph 102.
[57] *Council of the City of Stoke-on-Trent and Norwich City Council v. B&Q Plc*, Case C-169/91 ECLI:EU:C:1992:519 (1992).

national measure (Shops Act), which restricts commercial transactions on Sundays. In this case, the European Court of Justice balanced the two interests at stake: on the one hand, the national interest to reach the aim of employee protection; on the other hand, the interest to assure the free movement of goods. The Court considered that the restrictions made by the domestic measures were not excessive, having regard to the objective attained.[58]

Considering some case law on proportionality, Jans observed that sometimes the European Court of Justice does not apply these three elements jointly, or it does not apply strictly, the application depending on the seriousness of the interests at stake. Indeed, in his opinion, proportionality is considered as an instrument that allows the Court to evaluate domestic measures, which could represent a restriction to the four freedoms. By doing so, the European Court of Justice should consider the division between legislative and judicial powers, and the legislative competence of the European Union and the member states. [59]

In light of the above, in the European Union`s legal order, proportionality has multiple meanings. On the one hand, it is a guideline for the European legislator, since European Regulation must respect member states' legal systems, on the other hand, it can be considered as a sort of methodology used by the European Court of Justice, given its role to balance national interests and the protection

[58] *Idem.*
[59] Jans, *op. cit.*, 264.

of the four freedoms.

1.3 Proportionality According to the US Legal System.

In the United States, the concept of proportionality as conceived in the European Union is controversial. However, there is no scarcity of jurisprudential attempts to introduce the proportionality approach. An example of these efforts is present in *Heller*. [60] It is a case about the freedom to bear arms, in which the Supreme Court of the United States declared that some provisions of the District of Columbia Code violated the Second Amendment of the US Constitution. These provisions banned the transport of a handgun without a license. Moreover, the District of Columbia law required that legally owned firearms must be kept "unloaded and dissembled or bound by a trigger lock or similar device unless they are located in a place of business or are being used for lawful recreational activities." In this case, the dissenting opinion of Justice Breyer came close to the European perspective to define proportionality. Indeed, he declared that: "[…]any attempt in theory to apply strict scrutiny to gun regulations will in practice turn into an interest-balancing inquiry, with the interests protected by the Second Amendment on one side and the governmental public-safety concerns on the other, the only question being whether the regulation at issue

[60] *District of Columbia v. Heller*, 554 U.S. 570, 128 S. Ct. 2783 (2008).

impermissibly burdens the former in the course of advancing the latter. […] Contrary to the majority's unsupported suggestion that this sort of "proportionality" approach is unprecedented, […] the Court has applied it in various constitutional contexts, including election-law cases, speech cases, and due process cases. See 528 U. S., at 403 (citing examples where the Court has taken such an approach); see also, *e.g.*, *Thompson v. Western States Medical Center*, 535 U. S. 357, 388 , (2002) (BREYER, J., dissenting) (commercial speech); *Burdick v. Takushi,* 504 U. S. 428, 433 (1992) (election regulation); *Mathews v. Eldridge*, 424 U. S. 319, 339–349 (1976) (procedural due process); *Pickering v. Board of Ed. of Township High School Dist. 205*, Will Cty., 391 U. S. 563, 568 (1968) (government employee speech)".[61]

Justice Breyer referred to a multiplicity of American cases, including freedom of speech and due process, without mentioning the European Union approach. Based on Justice Breyer's thoughts, some authors consider that in his dissenting opinion, under the notion of the "proportionality approach" he implied two meanings. The first one is related to the fact that the proportionality doctrine is similar to balancing interests. The second meaning found by these authors is that proportionality is part of the American Constitutional Law.[62] However, these are extreme considerations that may not meet the opinion of those who do

[61] *Idem.*
[62]Moshe Cohen- Eliya & Iddo Porat, *The Hidden Foreign Law Debate in Heller: the Proportionality Approach in American Constitutional Law*, 46 SAN DIEGO LAW REVIEW 367 (2009).

not agree to apply an interpretation of the US constitution that invokes foreign law.[63] However, even in the presence of those opposed to the invocation of foreign law, it cannot be denied that the methodology used by the US Supreme Court to evaluate if statutes are narrowly tailored to compelling governmental interests has some similarities with proportionality tests. Indeed, some elements of the structured proportionality review used by the European Court of Justice can be found in the US judicial scrutiny, comprehensive of the inquiry about the "narrow tailoring" or "less restrictive alternatives."[64] The modern US constitutional law defines the strict judicial scrutiny as a close examination under which a measure is considered constitutional if it is "necessary" or "narrowly tailored" to assist a "compelling governmental interest."[65]

The jurisprudence has elaborated on the strict judicial scrutiny to implement constitutional values, and it is not formulated anywhere in the American Constitution. With the strict scrutiny test, the Supreme Court aimed to distinguish between ordinary rights and freedoms. The government can regulate justifying the reasons for the adoption of specific measures and fundamental rights and liberties, which necessity a higher level of judicial protection.[66] Even if "judicially crafted," this scrutiny has not a precise definition of the nature of the inquiry that courts should apply, being a generic test developed to protect

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[63] Charles Fried, *Scholars and Judges: Reason and Power*, 23 HARVARD JOURNAL OF LAW AND PUBLIC POLICY 819 (1999).
[64] Vicky C. Jackson, *op. cit.,* 3096.
[65] *Johnson v. California*, 543 U.S. 499, 505 (2005).
[66] Richard H. Fallon Jr., *Strict Judicial Scrutiny*, 54 UCLA LAW REVIEW 1285 (2006).

the fundamental rights. Hence, three different versions of the scrutiny have been adopted. The first one is called "nearly categorical prohibition," and it is the most rigorous since it allows breaches of constitutional rights only to avoid catastrophic or quasi- catastrophic harms. The second one, called "illicit motive test," aims to "smoking out" the government`s illicit purposes. The third one is similar to the European proportionality inquires, especially to the test of proportionality *sensu stricto*. Its name is "weighted balancing test" since it consists of a careful balancing of interests, and a position of favor of the protected right.[67]

According to the nearly categorical prohibition, a fundamental right can be infringed only to advert catastrophic harm, since a fundamental right is not intended in a wholly absolute way, being possible exceptions in case of catastrophe or quasi catastrophe. Examples of pressing public necessities that satisfy the strict scrutiny can be found in *Grutter v. Bollinger*[68] and the *City of Richmond v. J.A. Croson*.[69] In *Grutter v. Bollinger*, the University of Michigan Law School denied admission to a white resident of Michigan. The Law School admitted that in making admissions decisions, the race is an element of assessment. The Law School has established criteria with the justification that race is a useful measure for the compelling interest to reach racial diversity in

[67] *Idem*, 1302.
[68] *Grutter v. Bollinger*, 539 U. S. 306 (2003).
[69] *City of Richmond v. J.A. Croson Co.*, 488 U.S. 469 (1989).

the Law School. Hence, the issue at stake was related to the possibility that this admission procedure would violate the Equal Protection Clause. For the District Court, the achievement of diversity among students was not a compelling interest. However, the Court of Appeal reversed the District Court's decision, stating that diversity is a compelling governmental interest that is sufficient under judicial scrutiny review to legitimize the use of race as a criterion in university admissions. The Supreme Court, in a five to four decision given by Justice Sandra Day O'Connor, affirmed the judgment of the Court of Appeal. Indeed, the US Supreme Court held that: "The Equal Protection Clause does not prohibit the Law School's narrowly tailored use of race in admissions decisions to further a compelling interest in obtaining the educational benefits that flow from a diverse student body". For the purposes of this section, the opinion of Justice Thomas is relevant since it considered: "only those measures the State must take to provide a bulwark against anarchy, or to prevent violence" as pressing public necessities that satisfy the strict scrutiny.[70]

Another example of the nearly categorical prohibition approach is also present in the opinion of Justice Scalia in the *City of Richmond v. J.A. Croson*.[71] The case concerned a regulation adopted by the City of Richmond, Virginia, called "Minority Business Utilization Plan," which demanded the enterprises that obtained city construction contracts to subcontract the 30% of their business to

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[70] Opinion of Justice Thomas in *Grutter v. Bollinger*, 539 U.S. 306 (2003), 353.
[71] *Ibid.*

minority enterprises. Since the company J.A. Croson lost its contract because of this rule, it sued the City of Richmond.

The US Supreme Court considered that the City of Richmond regulation violated the Equal Protection Clause. In this case, it is interesting the concurrent opinion of Justice Scalia, which stated that: "only a social emergency rising to the level of imminent danger to life and limb—for example, a prison race riot, requiring temporary segregation of inmates, cf. *Lee v. Washington, supra*—can justify an exception to the principle embodied in the Fourteenth Amendment."[72] The above-mentioned opinions clarify the extent of the nearly categorical prohibition. According to this test measures that constitute a bulwark against anarchy or social emergency like prison race riots are considered pressing public necessities that satisfy the strict scrutiny.

The Illicit Motive Test guarantees that in the elaboration of a certain measure, the legislator did not aim at purpose to burden a preferred right. This test investigates the measure's motive and considers if the suspect legislation is narrowly tailored to pursue a specific compelling interest. If not, the legislation is considered unconstitutional since justified by an illicit motive. A precursor example of this test can be found in *Dean Milk Co. v. City of Madison*.[73] The case concerns an ordonnance of the City of Madison, Wisconsin, which

[72] Opinion of Justice Scalia in *City of Richmond v. J.A. Croson Co.*, 488 U.S. 469 (1989), 488.
[73] *Dean Milk Co. v. City of Madison* 340 U.S. 349 (1951).

restricted milk commerce. Indeed, to trade milk in the city, the product had to be pasteurized and bottled in an approved factory within five miles far from the city. The Court abolished this municipal regulation because it was in contrast with the commerce clause. The majority of the Court upheld that a measure that discriminates against non-territorial producers is not "narrowly tailored" to serve Madison`s interests. Hence the Court pointed out the presence of more narrowly tailored alternatives as a reason to invalidate the city's ordonnance which was clearly intended to protect health and safety interests but which affected the commerce clause (Article 1, Section 8, Clause 3 of the US Constitution) and therefore the interstate commerce. This interpretation of the strict scrutiny has some elements in common with the European test of necessity since both tests consider competing interests.[74] However, while the illicit motive test investigates the presence of narrowly tailored alternatives, the test of necessity examines the presence of the least restrictive alternative (not necessarily the most tailored) capable of reaching the same end.

The third interpretation is called the weighted balancing test[75] and considers constitutional rights on the one hand and, on the other hand, the government's interests. Hence government's interests must be particularly important in order to prevail. Examples of applying this balancing test can be found in case-law

[74] For instance, in *Dean Milk Co. v. City of Madison*, the interests at stake are health and safety versus free trade between US states.
[75] Justice Scalia referred to strict scrutiny as a balancing test in *Employment Division v. Smith*, 494 U.S. 872, 883 (1990).

concerning freedom of association. The Court has strictly evaluated if the government's interests are adequately important and decisive to justify varied effects on different groups' associational interests.[76] In *Nixon v. Administrator of General Service*, Justices Burger C.J. summarizes a passage of the constitutional analysis: "Constitutional analysis must, of course, take fully into account the nature of the Government's interests underlying challenged legislation. Once those interests are identified, we must then focus on the nature of the individual interests affected by the statute. […] Finally, we must decide whether the Government's interests are of sufficient weight to subordinate the individual's interests, and, if so, whether the Government has nonetheless employed unnecessarily broad means for achieving its purposes."[77]

As observed by Fallon, from the beginning of elaborating these interpretations, Justices never formally and decisively chose which one should prevail. It appears that judges tend to opt for different versions of the strict scrutiny based on their personal views related to the meaning and the nature of the rights involved on a case-by-case basis.[78]

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[76] *Nixon v. Administrator of General Service* 433 U.S. 425, (1977).
[77] *Idem*, 527.
[78] Richard H. Fallon Jr. *op. cit.*, 1285.

1.4 The Concept of Proportionality in the Australian Legal Framework.

While in the EU legal system, proportionality is present in a fundamental Treaty, it is not defined by the Australian law or by the Australian Constitution. Indeed, the development of this principle had its origin from case law and doctrine.[79] Australian courts apply proportionality in a variety of contexts, both constitutional and statutory.[80] The High Court of Australia adopted proportionality tests, especially in the sectors of constitutional guarantees, freedoms, and immunities. It seems that the concept of "reasonable proportionality" has been transposed in the Australian legal system from the European Court of Justice and the European Court of Human Rights.[81]

Some authors consider proportionality as a sort of ethic or doctrine. Fitzgerald defined it as an "ethic which says that the good government is government that is to the point, clear, precise and necessary and, in the context of constitutional guarantees, respectful of those guarantees."[82] He stated that the concept is theoretically vague and that the Australian system does not have a clear structure and test definition. In *Minister for Resources v Dover Fisheries*, Justice Gummow observed that proportionality is not employed as an

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[79] Gabrielle Appleby, *Proportionality and Federalism: Can Australia Learn from the European Community, the US and Canada*, 26 UNIVERSITY OF TASMANIA LAW REVIEW 1 (2007).
[80] Justice Susan Kiefel, *Proportionality: A Rule of Reason,* 23 PUBLIC LAW REVIEW 85 (2012).
[81] As stated by Justice Gummow in *Minister for Resources v Dover Fisheries*, FCA 522 1993, paragraph 40.
[82] Brian F. Fitzgerald, *Proportionality and Australian Constitutionalism*, 12 UNIVERSITY OF TASMANIA LAW REVIEW 269 (1993).

independent principle since it involves relationships between matters.[83] Hence, there must be a balance between interests or rights and the legislator's legitimate action to establish the proportionality of the measure. Differently from the approach adopted by European Courts, it appears that Australian courts sometimes questioned about proportionality and sometimes did not adopted the test of proportionality as described *supra*.[84] Generally, the proportionality test has been applied by the High Court of Australia more mildly, and *Lange v. Australian Broadcasting Corporation* is a very important illustration of this weakened application of the proportionality test. In *Lange v. Australian Broadcasting Corporation*, the former Prime Minister of New Zealand (Mr. *Lange*) alleged that the Australia Broadcasting Corporation defamed the Labor Party, the party to which he belonged when he was in government.[85]

According to *Lang*e, the defamation happened through the broadcasting of a report about his party. The High Court of Australia had to evaluate if the report broadcasted was defamatory or protected by the implied freedom of political communication. The High Court unanimously held that the report broadcasted by the Australian Broadcasting Corporation was defamatory. For the purposes of this thesis, *Lange* is relevant for the methodology with which proportionality

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[83] Gabrielle Appleby, *op. cit.,* 4; Jeremy Kirk, *Constitutional Guarantees, Characterization and the Concept of Proportionality*, 21 MELBOURNE UNIVERSITY LAW REVIEW 1 (1997).
[84] See *Nationwide News P/L v Wills* (1992) 177 CLR 1.
[85] *Lange v Australian Broadcasting Corporation* (1997) 145 ALR 96, commented by Andrew Lynch, *Unanimity in a Time of Uncertainty: The High Court Settles Its Differences in Lange v. Australian Broadcasting Corporation*, 6 GRIFFITH LAW REVIEW 211 (1997).

was applied. Indeed, the test has been split into two questions: the first one considers if the law, which in the case at issue was the law of defamation, effectively burdens the specific interest, freedom, or right at stake. In this case, the freedom of communication was at stake. If the measure effectively burdens that interest, freedom, or right, then the second step is applied. The second limb is further divided into two branches. The first one consists of verifying whether the object of the law (or regulation) is legitimate, *i.e.*, compatible with the conservation of the system prescribed by the Australian Constitution of representative and responsible government. If the object of the law is legitimate, the second sub-branch is applied. This passage consists of evaluating if the measure is "reasonably appropriate and adapted to serve a legitimate end." [86] The fulfillment of the end must be compatible with the system of law prescribed by the Constitution. If the reply to the first limb is "yes," and then the reply to the second question is "no," then the law is invalid.[87]

However, *McCloy v. New South Wales*[88] is considered the first time most of the Court opted for a European-based test of proportionality since the classic tripartite study on proportionality is undertaken.[89] In *McCloy*, the High Court

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[86] *Ibid.*
[87] For an interesting example of *Lange* test application see Elisa Arcioni, *Before the High Court: Politics, Police and Proportionality- An Opportunity to Explore the Lange Test: Coleman v. Power* UNIVERSITY OF WOLLONGONG (2003), https://ro.uow.edu.au/cgi/viewcontent.cgi?article=1021&context=lawpapers#:~:text=and assaulting police.- (last visited Oct 21, 2020).
[88] *McCloy v. New South Wales* (2015) 257 CLR 178.
[89] Anne Carter, *Proportionality in Australian Constitutional Law: Towards Transnationalism?* 76 HEIDELBERG JOURNAL OF INTERNATIONAL LAW 951 (2016).

held that the New South Wales' Act about election funding, expenditure, and disclosure (hereinafter also EFED Act) affected the implied freedom of political communication. The provisions contained in this Act prohibited indirect campaign contributions such as vehicles and office supplies. At the same time, the Election Funding, Expenditure, and Disclosure Act also prohibited for certain categories of entities (such as liquor, gambling, and tobacco business entities) from making any direct or indirect political contribution. However, the High Court stated that the aim of preventing corruption justified these measures. Therefore, the Court declared that the EFED Act was the least restrictive mean applicable and that the benefits that this Act brings in terms of fighting corruption outweigh the disadvantages of limiting political donations.[90]

McCloy approach completes and integrates the *Lange* test by replacing the second sub-branch of the second limb of the *Lange* test with the proportionality test adopted by European Union law, *i.e.*, test of suitability, the test of necessity, and proportionality "*stricto sensu"*. *McCloy* could be considered a welcome development of the concept of proportionality as intended by the European Union, given that the previous versions of the proportionality approach have been characterized by a non-homogeneous application of the test and scope of proportionality. This openness towards foreign law and especially toward European Law, is probably due to the historical roots of this country, including

[90] *McCloy, op. cit.*

the relationship between the Commonwealth of Australia and the United Kingdom. Therefore, the proximity between the two countries may have led the judges to be inspired by the European courts to delineate proportionality tests.[91]

The comparative analysis of the concept of proportionality between these three systems has brought out similar aspects, especially for the common idea that statutes and regulations shall be "reasonable" and "tailored". The comparative inquiry also highlighted contact points, primarily considering the Australian case law in *McCloy* and the European proportionality test. However, proportionality almost appears as a concept inherent human nature because, regardless of its definition and legal basis, the concept always comes to a common goal of justice. The idea constitutes not only a yardstick for High Courts but also a guideline for legislators and independent agencies with the role of regulator. It goes beyond federal states to an international level. This statement is true, especially in the financial and banking sector, where interactions between international banks and financial market participants play a crucial role. Hence, in defining the proportionality principle in banking regulation, the inquiry cannot ignore the concept as perceived by the Basel Committee on Banking Supervision (BCBS) and reported by the Bank for International Settlements (BIS), since the regulation analyzed in the present thesis are also the product of international agreement via these institutions.

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[91] Murray Gleeson, *op. cit.*

1.5 Proportionality in Banking Regulation.

The Principle of proportionality is a crucial element regarding the banking and financial services' regulation as it gives the necessary flexibility when the regulation does not seem appropriate regarding the characteristics of banks. It is commonly understood as guidance for regulation since legislative and regulatory authorities should consider the size, nature, and scope of banks' activities when regulating the matter in question. This tailored approach aims to reflect the peculiar nature of banks' cross border activity, their business model, and their relevance at a systemic perspective and the risk they are exposed.[92] In the supervisory context, proportionality has been conceived as a means to adjust the supervisory intensity based on risk profile and to avoid excessive costs for supervisors. These two concepts of proportionality in regulation and supervision are considered independent.[93]

Anecdotal evidence shows how the banking system directly or indirectly affects every aspect of many economic activities. For this reason, proportionality in banking regulation is considered a fundamental element for the economy. In

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[92] Vasily Pozdyshev, *op. cit.*
[93] Fernando Restoy, *Proportionality in Banking Regulation*, FINANCIAL STABILITY INSTITUTE (2018), https://ebi-europa.eu/wp-content/uploads/2018/01/Fernando-Restoy-Proportionality-in-banking-regulation.pdf (last visited Sep 2, 2020).

this sense, there are important reasons why proportionality is a vital part of banking regulation.[94] The importance of the application of a proportional regulation is ascribable to several benefits. First of all, proportionality is relevant for the maximization of regulation benefits. There is maximization when the benefits of the regulation are higher than the costs of compliance. However, benefits and costs can vary based on the characteristics of banks. For instance, compliance fixed costs have a higher impact on small domestic, regional banks than on larger international banks, so a regulation that reduces or simplifies compliance burdens for small domestic, regional banks reduces this typology of costs. Equally, the failure of a small bank has an impact far from the failure of a large universal international bank. Therefore, a tailored regulatory approach based on the bank typology would represent a valid instrument to ensure correct risk management regarding the systemic relevance of a bank.[95]

Proportionality also has the advantage of simplifying the regulation for some entities in some areas. Between 1988 (year of the first Basel accord known as Basel I) and now, the regulatory framework has become increasingly complex. The reasons for this complexity could be evaluated under different factors, including the innovations in the financial markets and the banks' practices of

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[94] *Proportionality in Banking Regulation*, EBA BANKING STAKEHOLDER GROUP (2018), https://eba.europa.eu/sites/default/documents/files/documents/10180/807776/de9b6372-c2c6-4be4-ac1f-49f4e80f9a66/European Banking Authority Banking Stakeholder Group- Position paper on proportionality.pdf?retry=1 (last visited Sep 2, 2020).
[95] Vasily Pozdyshev, *op. cit.*, 2.

risk management as well as the increased awareness of banking risk due to the great financial crisis. Hence, proportionality could simplify regulation where and if possible.[96]

Moreover, proportionality plays a relevant role to ensure the level playing field. In theory, larger banks take advantage of greater economies of scale than smaller banks concerning administrative fixed costs. Hence, a "tailor-made" approach could balance compliance costs (reducing costs for smaller banks) and lead to a level playing field among banking operators, increasing competition.[97] According to Vasily Pozdyshev, deputy governor of Russia's bank, proportionality would also increase supervisors' efficiency, especially in those jurisdictions with limited resources.[98] However, it seems that this advantage would be effective if proportionality would simplify regulation rather than develop a tailor-made regulation. Indeed, in this last case, it would be necessary to increase resources to study, enforce and oversee a regulation that differentiates based on banks' characteristics, thus constituting a complication for those jurisdictions with limited resources.

If not correctly applied, proportionality could also lead to some constraints.[99] The first one consists in the risk to increase arbitrage opportunities, since the

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[96] *Ibid.*
[97] Some authors consider that competition increases stability since it improves banks' profitability and asset quality, see, for example, Martin R. Goetz, *Competition and Bank Stability*, 35 JOURNAL OF FINANCIAL INTERMEDIATION 57–69 (2018).
[98] Vasily Pozdyshev, *op. cit.*, 3.
[99] *Ibid.*

presence of a less complex regulatory framework for certain types of banks which carry out certain activities or have certain characteristics, could lead banks to modify their business model or their activities in order to fit in the less complex and/or less burdensome regulation, without this leading to a reduction in risk.[100] Another relevant constraint, which could exist especially in those regulations that divide financial entities into categories based on the companies` size, consists of the potential "cliff effect." On the basis of how proportionality is implemented, banks can be subject to a "cliff effect" if they move from a requirement' set to another as a result of a change in their categorization. For instance, if a bank which is qualified as medium size increases its dimension, it becomes larger and does not fit anymore in the previous categorization. This means that this bank is now subject to different rules, thus it could bear costs that are higher than the advantage of having increased its size.[101]

Another disadvantage is related to the fact that the concept of proportionality would imply a fragmented legal framework, since if the number of approaches based on different characteristics of banks increases, it is necessary to have different approaches by regulators and supervisors. This circumstance could lead to increased complexity of the regulatory and supervisory system, and

[100] *Ibid.*
[101] *Ibid.*

therefore, this complexity could hinder the capability to oversee the resilience of the banking system.

At an international level, the regulatory framework elaborated by the Basel Committee on Banking Supervision (hereinafter also BCBS) is a useful example of the application of proportionality in the banking sector. The Basel Committee on Banking Supervision is an international institution that operates under the Bank for International Settlements (hereinafter also BIS). It is composed of representatives of central banks and bank supervisory authorities (45 members) from 28 jurisdictions from the following states: Australia, Italy, Spain, Argentina, Brazil, Luxembourg, Belgium, Switzerland, Sweden, the United Kingdom, The Netherlands, China, Canada, France, Hong Kong SAR, Germany, Indonesia, India, Korea, Singapore, Japan, Mexico, Russia, Saudi Arabia, South Africa, Turkey, and the United States.[102] Moreover, even if it is not a state, the European Union is a jurisdiction represented on the Basel Committee on Banking Supervision.[103]

BCBS was originally named "Committee on Banking Regulation and Supervisory Practices," and it was instituted in 1974 by representatives of the central banks of the Group of Ten (G-10) countries in the aftermath of the

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[102] *Core Principles for Effective Banking Supervision*, BANK FOR INTERNATIONAL SETTLEMENTS (2012), https://www.bis.org/publ/bcbs230.pdf (last visited Sep 2, 2020).
[103] *Basel Committee Membership*, BANK FOR INTERNATIONAL SETTLEMENTS (2016), https://www.bis.org/bcbs/membership.htm (last visited Sep 2, 2020).

bankruptcy of the German bank "Bankhaus Herstatt" in West Germany.[104] After having launched coordinate responses to deal with the financial crisis derived from the bankruptcy of Bankhaus Herstatt, the Committee evolved into a forum to harmonize national banking supervision and capital standards.[105]

One of the BCBS` main objectives is the enhancement of key issues related to banking supervision to improve the quality of banking supervision at a transnational level. Moreover, BCBS elaborates guidelines and standards in different areas, *e.g.*, international standards on capital adequacy, core principles for effective banking supervision, and concordat on cross-border banking supervision. Basel accords have been considered as the most successful regulatory initiatives ever experimented. Indeed, they not only are implemented in the BCBS member jurisdictions, but non-BCBS jurisdictions around the world also promulgate them.[106] Basel regulatory frameworks comprehend a set of minimum standards, and it has been developed, in principle, for internationally active banks. Hence, regulators can adopt these minimum standards, but also standards that exceed the minimum set.

In 1988, Basel I set minimum standards concerning capital requirement intended as a means to limit risks and prevent losses as well as to protect financial beneficiaries. In 1996 BCBS developed the "Basel I Required Capital

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[104]Michael S. Barr, Howell E. Jackson & Margaret E. Tahyar, *Financial regulation: law and policy*, NEW YORK: FOUNDATION PRESS 272 (2016).
[105] *Idem*,16.
[106] *Idem*, 17.

for Credit Risk and Market Risk"[107]. The innovations introduced in the part of the market risk marked the advent of proportionality in the Basel framework, offering both a standardized approach and an approach based on internal models. While the standardized approach is a methodology developed to measure credit risk and it is based on external credit assessments, the approach based on internal models is a methodology through which the calculation of the market risk capital is made through the bank's proprietary in-house models. Due to the innovation in the risk management sector, and the growing complexity of banking businesses and the relevance of cross-border activities, Basel I was no longer suited to the changed financial contest. Hence in June 2004 the second Basel Accord (Basel II) was published, which introduced the three pillars approach.

Pillar I concerns minimal capital requirements, while Pillar II is a prudential review of capital adequacy and internal assessment of an institution, and Pillar III enhances market discipline through effective use of disclosure. Pillar II accentuates a suitable review and supervisory process in order to plan every bank's capital. It envisages a principle-based approach, which requires the evaluation of national supervisors. Pillar II is an excellent example of proportionality in the Basel framework since it considers the size, complexity,

[107] The last revised version of this standard was published in January 2019, see: *Minimum capital requirements for market risk*, BANK FOR INTERNATIONAL SETTLEMENTS (2019), https://www.bis.org/bcbs/publ/d457.pdf (last visited Sep 2, 2020).

risk profile, and business model of individual banks.[108] Basel II's relevance for the present thesis relates to the variety of approaches that it offers, from the simplest to the more advanced, to calculate credit risk, market risk, and operational risk.

Basel III enhanced regulatory standards in response to the Great Financial Crisis. These standards include a wider range of risks, and they require a higher quality of capital and stricter requirements for loss absorption. These supplementary minimum standards increase the standards' complexity. For this reason, BCBS in 2017 emanated a consultative document concerning a simplified version of the standardized approach, intending to address this simplified version to banks with smaller or simpler trading books. [109] This consultative document of 2017 gave rise to MAR 40, a document containing a simplified version of the standardized approach. This document will be effective as of January 1st, 2022.[110]

Therefore, Basel standards do not adopt a one-size-fits-all approach, being necessary for national regulators to apply a different regulation based on the specific characteristics (size, complexity, risk profile, and business model) of

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[108] Ana Paula Castro Carvalho et al., *op. cit*, 4.
[109] *Ibid.*
[110] *MAR 40 - Simplified Standardized Approach*, BANK FOR INTERNATIONAL SETTLEMENTS (2019), https://www.bis.org/basel_framework/chapter/MAR/40.htm?inforce=20220101 (last visited Sep 2, 2020).

banks.

1.6 Proportionality as a Core Principle in the Basel Committee Framework.

Another relevant index of proportionality as a guideline principle for supervisor is contained in the Basel Core Principles for Effective Banking Supervision (hereinafter also BCPs), which are considered a benchmark for all jurisdictions, to develop standards and policies for banks and banking systems.[111] They are defined as "the *de facto* minimum standard for sound prudential regulation and supervision of banks and banking systems."[112] They were originally issued in 1997 by BCBS, and they were revised in 2006. In 2010, in response to the great financial crisis, the Basel Committee announced its intention to review the BCPs again as a step of its project with the main aim of enhancing effective banking supervision in all countries. The revised BCPs have been approved by banking supervisors at the International Conference of Banking Supervision held in Istanbul in 2012.[113] With the revised Principles, the Basel Committee on

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[111] Stefan Hohl et al., *The Basel Framework in 100 Jurisdictions: Implementation Status and Proportionality Practices*, BANK FOR INTERNATIONAL SETTLEMENTS (2018), https://www.bis.org/fsi/publ/insights11.pdf (last visited Sep 2, 2020).
[112] *Core Principles for Effective Banking Supervision*, BANK FOR INTERNATIONAL SETTLEMENTS (2012), https://www.bis.org/publ/bcbs230.pdf (last visited Sep 2, 2020).
[113] *Core Principles for Effective Banking Supervision*, BANK FOR INTERNATIONAL SETTLEMENTS (2012), https://www.bis.org/publ/bcbs230.htm (last visited Sep 2, 2020).

Banking Supervision tried to achieve a balance between the enhanced supervision and the flexibility of BCPs as a standard that can be applied worldwide. BCBS adopted a proportionate approach not only to apply these standards to all countries but also to allow effective compliance to the BCPs by taking into account banks' systemic importance and risk profile. In this sense, the Basel Core Principles have been developed in order to be able to be applied both by internationally active banks and non-complex and small institutions.[114]

The Basel Core Principles for Effective Banking Supervision consider proportionality in supervision in Principle 8: Supervisory approach, which states that: "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."[115] In other words, the supervisory approach for banks is expected to be proportionate if it is consistent with the risk profile and systemic importance of individual banks. Considering the prudential regulation of banks, the concept of proportionality assumes a very relevant role since it adjusts the prudential

[114] *Idem*, 5.
[115] *Idem*, 29.

requirements to encourage the stability of the financial institutions. However, at the same time, it aims to avoid an excessive regulatory burden. Moreover, proportionality has the objective to not weigh on banks in terms of compliance costs unless prudential reasons justify these costs. In this sense, proportionality as a core principle in the Basel Committee framework can be described as the action aimed to tailor Basel Core Principles or develop alternative rules to adapt them to the complexity, size, risk profile or other characteristics related to specific banks or banking systems.[116]

The Financial Stability Institute elaborated three criteria to distinguish the possible applications of the principle of proportionality in banking regulation. The first two are denominated "categorization approach" (CAP) and "specific standard approach" (SSAP) and were introduced by Castro et al. in their study on proportionality of August 2017.[117] With the Categorization Approach, banks are divided into categories based on different patterns, such as size and business. Based on this partition, banks belonging to the same category are subject to a determined regulatory regime. Hence, coherent rules are applied to banks that share comparable features. According to this study, countries like Brazil, Japan, and Switzerland adopted this approach, dividing banks into five (Brazil, Switzerland) or two (Japan) categories.[118]

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[116] *Idem*, 6
[117] Ana Paula Castro Carvalho et al., *op. cit*, 5-8.
[118] *Ibid*.

The Specific Standard Approach implies the definition of specific patterns for specific standards. In other words, if the bank meets pre-established tailored criteria, specific requirements for a subgroup of prudential standards are applied (for instance, standards related to the liquidity ratio, and disclosure requirements). According to this study of 2017, countries like the European Union, Hong Kong SAR, and the United States adopted this approach. The study specified that the European Union adopted exceptions to the general rule in trading books, disclosure, counterparty credit risk, and large exposures. Hong Kong's exception areas are only credit risk, liquidity framework and large exposures, while the US' exceptions were related to the following areas: advanced approaches, counterparty credit risk, stress tests, and capital planning, trading books, and liquidity framework.

Hohl et al. elaborated the third criterion in their study of November 2018 and defined it as the "System-Wide Approach" (SWAP). In this third approach, proportionality is applied to the entire banking system, *i.e.*, to all the banks.[119] According to Hohl et al., this approach could be used in case of a not complex financial system or when adopting a prudential standard is considered essential. However, Hohl's survey shows that an important number of jurisdictions that are not part of BCBS, adopted a proportionality strategy that embraces the three approaches. For instance, this could happen by imposing capital requirements

[119] Stefan Hohl et al., *op. cit.,* 7.

higher in comparison to the minimum standards to all banks (SWAP), while allowing banks with small trading books to calculate market risk in a simplified manner.[120]

The concept of proportionality as a Basel principle is the outset of the present study of proportionality in banking regulation. It is no coincidence that the regulations that will be analyzed in the following chapters have been emanated by states represented in the Basel Committee. The next chapters` purpose is to highlight the wide variety of the approaches related to the application of proportionality in the United States, European Union and Australia.

1.7 Proportionality and Consumer Protection.

Proportionality, both considered under the legislative, regulative, and supervisory profile, explicates its effects on small and medium banks, by enhancing of competition. Doing so, it fosters a competitive market is a fertile soil for the prosperity of consumer protection. As stated by Goodhart *et al.* "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

[120] *Idem*, 17.

which consumers can gain."[121] The regulation imposes costs on banks (*e.g.*, compliance, and IT) that, in one way or another, are sustained by users of banking services, including consumers. Indeed, the EBA Banking Stakeholders Group observed that a disproportionate regulation has negative effects not only in the sense that it compromises basic functions of banks considered as financial intermediaries, but it would also increase costs charged to bank customers.[122]

From the consumers' point of view, it has been highlighted that consumer protection should exist independently from financial institutions' typology. No one doubts that the failure of a systemic relevant institution has dramatic aftermaths, affecting consumers. Of course, these aftermaths have far more invasive and dramatic effects than the consequences deriving from the failure of a minor institution. However, it should be noted that a disproportionate regulation could contribute to removing from the market the smaller and more consumer-friendly banks. In this way, consumers would suffer a financial gap, namely, they would be deprived of important services that tend to be better offered by banks close to the consumer.[123] Therefore, a proportionate regulation should consider the risks that bank customers could face since these days (and

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[121] Charles Goodhart et al., FINANCIAL REGULATION: WHY, HOW AND WHERE NOW? 67 (2013).

[122] *Proportionality in Banking Regulation*, EBA BANKING STAKEHOLDER GROUP (2018), https://eba.europa.eu/sites/default/documents/files/documents/10180/807776/de9b6372-c2c6-4be4-ac1f-49f4e80f9a66/European Banking Authority Banking Stakeholder Group- Position paper on proportionality.pdf?retry=1 (last visited Sep 2, 2020).

[123] About this issue, De Nederlandsche Bank, the Dutch Central Bank, recommended actions to effectively implement proportional supervision. See: *Proportional and Effective Supervision*, DE NEDERLANDSCHE BANK (2018), https://www.dnb.nl/en/binaries/Proportional and effective supervision_tcm47-376254.pdf?2018112608 (last visited Sep 2, 2020).

especially right after the GFC) banks try to restore trust with their customers. For this reason, proportionality should not diminish consumer protection and, more in general, customers' rights, especially those related to the pre-contractual and contractual information. Indeed, to restore trust, adequate information must be provided to customers to prevent them from purchasing products that are not adequate to their demands and needs. This concept of adequate information is particularly relevant in the banking sector and the whole financial and insurance regulation.[124]

In conclusion, the analysis concerning consumer protection is fundamental for the present thesis in order to verify the increase in trust in institutions and regulated markets. At the same time, more attention must be given to the concept of proportionality in the search for simpler rules that the consumer can benefit from.

[124] For instance, the European Directive on Insurance Distribution (Directive 2016/97/EU of the European Parliament and of the Council of January 20th, 2016 on Insurance Distribution) at article 20 *et seq.* prescribes that the insurance distributor (previously called intermediary) shall recognize and document the demands and needs of the client. Moreover, these demands, and needs must be considered by the distributor in the product selection in the advisory phase. The adequacy of the product is considered also in the last phase of the product oversight and governance process (article 25) as a regular review that the insurance undertaking shall carry out in order to assess if the insurance product remains in accord with the needs of the identified target market.

1.8 Beyond the Traditional Comparative Law.

Comparative analysis plays a crucial role in the present thesis since it has been considered "the most fruitful way of exploring the relationship between law and society."[125] In this sense, comparative legal research expands knowledge and awareness of legal systems considered a social phenomenon. At the same time, the comparative analysis allows legal experts to reach a better understanding of the law that governs their legal system.[126]

Comparative law scholars frequently discuss the purposes of comparative law. Even though different classifications are used, it seems convenient to distinguish between three preeminent categories: knowledge and understanding, practical use of comparative law at a national level, and practical use of comparative law at an international level. The first category (*i.e.*, knowledge and understanding) has the fundamental objective to accentuate the comparative law`s role in legal research. The knowledge of foreign law plays an important role where it is relevant to the national legal system, *i.e.*, where domestic law has a legal nature composed of a variety of legal traditions or where a variety of legal systems inspires domestic law.[127]

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[125] Mauro Bussani & Ugo Mattei, THE CAMBRIDGE COMPANION TO COMPARATIVE LAW. Cambridge University Press 3 (2012).
[126] Michael Bogdan, CONCISE INTRODUCTION TO COMPARATIVE LAW 47 (2013).
[127] Mathias Siems, *op.cit.*, 4

In other cases, the knowledge of foreign law allows jurists to meditate on their laws. On this point, it could constitute a cultural and legal shock for a jurist to know that some traditional legal institutions of the legal system to which she belongs are non-existent or perceived differently in another part of the world. In addition to a better knowledge of foreign law, comparative law allows understanding how legal rules operate in the social context. For instance, considering the similarities between different legal systems, the jurist questions about the presence of any common historical roots or recent globalization trends. In cases of unexpected divergences, for example, there may be social, political, or socio-economic reasons that may be able to explain them. [128]

The second category, *i.e.,* practical use of comparative law, consists of recognizing comparative law as a valid instrument in domestic law. Comparative law very often suggests essential hints to the national legislator, offering different models on how different legal rules work to solve the same problem. Sometimes, the reasons for the practical use of comparative law could derive from a regulatory competition since states could be interested in attracting foreign companies and investors; at other times, a practical application of comparative law is due to legal modernization purposes. The legal comparison is also useful for the judges to draw inspiration from different experiences on how to deal with legal issues. An example of this practical use

[128] *Ibid.*

has been explained *supra* in section 1.4, about the concept of proportionality in the Australian legal framework.[129]

In the third category, *i.e.,* the practical use at the international level, legislators evaluate whether the unification of law can be achieved. For example, suppose legislators of different states decide to unify a field of law internationally. In that case, they can use comparative law for various purposes, such as to assess whether to apply the most common approach, the lowest common denominator, or a compromise solution. This method can be used as a foundation on which to develop international treaties. Otherwise, the comparative analysis could also lead to the solution of not unifying the law, for example, due to the insurmountable differences in legal traditions or because the costs of unification are higher than the benefits.[130]

The traditional comparative law is based on the assumption that nation-states distinguish the legal systems. Based on this premise, traditional comparative law typically excludes international, supranational, municipal, and regional laws.[131] However, some scholars consider obsolete this conception of law, which derives from the Peace of Westphalia as far back as 1648.[132] Nowadays, the world is becoming increasingly interconnected, and transnational and international legal orders play a decisive role. In this sense, there are no reasons

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[129] *Ibid.*
[130] *Idem,* 5.
[131] *Idem*, 17.
[132] *Idem*, 42.

why comparative analysis should be limited to national-states' legal systems. Indeed, it should be possible to compare the differences between international and supranational regimes, and federal states.[133]

This assumption acquires even greater relevance if we consider that the importance of international and supranational law also depends on the area of law involved. For example, in banking law, where regulation effects go far beyond the mere domestic sphere, comparative analysis acquires importance. A similar argument cannot be developed for other areas of law (*e.g.*, family law) where the focus at the national level is still justifiable.

Furthermore, for this thesis's purposes, a comparison of jurisdictions related to States belonging to the European Union would not have much value. In fact, in the member states of the European Union, proportionality assumes the same meaning. Besides, the same European supervisory authorities (*e.g.*, EBA) are present in these states and provide guidelines and technical standards. In particular, the technical standards are binding for all member states. Moreover, if the analysis were limited to the member states of the European Union, it would not be considered that this thesis's focus is to analyze through comparative analysis if other legal systems apply a more proportionate approach than the method adopted in the European Union and how this happens.

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[133] *Ibid.*

Hence, in this age of deep transformations, it seems appropriate to go beyond the traditional conception of comparative law to analyze the intersecting legal orders, which are connected with much more complex and fluid relations than before. Comparative studies are a necessary means to explain the legal orders we face in the twenty-first century. Comparative law must rethink a whole series of traditional dichotomies that have remained static for a long time. By now, it would seem that the distinction between domestic and international law, as well as the distinction between public law and private law, are increasingly losing meaning, given that such divergences do not seem to capture what is essential in our time fully.

1.9 Conclusions.

This chapter deals with the concept of proportionality, explaining its different nuances of meaning from a comparative point of view. The chapter highlights the differences in the way proportionality has been recognized in the analyzed jurisdictions. In the European Union, this principle has a Treaty status, since according to article 5(4) of the Treaty on European Union: “under the principle of proportionality, the content and form of Union action shall not exceed what is necessary to achieve the objectives of the Treaties.” However, this principle is intended to be related not only to the European Union`s action but also to EU

member states. It is also observed both at the legislative and regulatory level, as it affects the action of the European legislative body, the member states' Parliaments, and the action of the supervisory authorities when carrying out their regulatory function. Indeed, sector authorities such as the European Banking Authority frequently justify their measures and studies based on the principle of proportionality.

Differently, it seems that proportionality results from the interpretation of High Courts in Australia and the US. In these countries, the role of jurisprudence is very interesting. In the US, judges attempt to introduce proportionality through the interpretation of the US Constitution. For instance, in District of Columbia v. Heller, Justice Breyer attempted to introduce the proportionality approach, considered as unprecedented by the majority of the members of the Supreme Court, referring to the application of it in previous case law related to various constitutional contexts: election-law cases, commercial speech cases, government employee speech cases, and procedural due process cases. Hence, it seems that the US Supreme Court does not use foreign law as reasoning to justify the use of the proportionality approach, but it examines its constitutional background.[134]

The Australian experience is interesting because the High Court makes a widespread reference to foreign law. For instance, in *McCloy*, many references

[134] See *supra*, paragraph 1.3.

are made about foreign law such as Canadian and German law. References to case law from the United Kingdom and the United States of America have been made as well. Probably, the reasons of these differences between the behavior of Australian and US courts are mainly historical. On the one hand, the United States declared its independence from the United Kingdom in 1776; on the other hand, Australia is still connected to the UK and demonstrates a strong openness to foreign law, as seen in the case law at paragraph 1.4 of this chapter.

In the banking sector, which is an area with strong interconnections between states, the Basel Committee on Banking Supervision's action seems to have a harmonizing function. Indeed, BCBS is an international institution composed of 45 members from 28 jurisdictions, including the European Union, the United States and Australia. BCBS has the aim to harmonize national banking supervision and capital standards. In this sense, proportionality in banking regulation has the common meaning to adapt banking provisions to complexity, size, risk profile, or other main characteristics related to banks and banking systems. However, even if there is a harmonized concept in the banking sector, practical applications are several. Indeed, the Financial Stability Institute recognized the presence of three main possible applications of the principle of proportionality in banking regulation: Categorization Approach (CAP), specific standard approach (SSAP)[135], and system-wide approach (SWAP).[136] Even with

[135] Ana Paula Castro Carvalho, *op. cit.*
[136] Stefan Hohl et al., *op. cit.*

this categorization, banking regulation reveals its idiosyncrasies from one jurisdiction to another. These idiosyncrasies explicit their effects on banks, financial institutions, and consumers. In particular, consumers are a customer's category, which is very sensitive to banking regulation. After clarifying the shades of meaning of proportionality, the next chapters will focus on the analysis of the banking regulation of the three jurisdictions in question to understand the different approaches to the practical application of proportionality in the various legal systems and their impact on consumers.

Chapter 2

Proportionality aspects of the US Banking Regulation.

"Scire leges non hoc est verba earum tenere sed vim ac potestatem."
Justinian, Digest, Book 1, Title 3,17.

Summary: 2.1 Introduction; 2.2 Background and Outset of the 2010 Reform; 2.3 Dodd-Frank Act: an Overview; 2.4 Proportionality in the Dodd-Frank Act of 2010; 2.5 Community Banks; 2.6 Consequences and Effects of the Dodd-Frank Act on Community Banks; 2.7Economic Growth, Regulatory Relief, and Consumer Protection Act; 2.8 Proportionality in Economic Growth, Regulatory Relief, and Consumer Protection Act; 2.9 Enhanced Prudential Regulation; 2.10 Towards the Categorization Approach; 2.11 Conclusions.

2.1 Introduction.

The first chapter presented proportionality's meaning in law. The chapter analyzed the relevant case-law defining proportionality in the EU, US, and Australian jurisdictions. It also explained proportionality's main features in banking regulation, advantages and disadvantages included. The second chapter is focused on the investigation of the presence of proportionality in the US banking regulation. The banking regulation of the United States represents a fascinating example of the application of the proportionality in the Dodd-Frank Wall Street Reform and Consumer Protection Act, which has been the object of

profound criticism because of the effects it has had in terms of increased compliance costs.[137] The criticisms carry doubts about the actual application of proportionality since the measure facilitated an exacerbation of the banks' consolidation trend, specifically with the increase in mergers between banks. Because of this effect, the measure has been considered disproportionate.[138]

For this reason, on May 24th, 2018, the President of the United States, Donald Trump, signed the Economic Growth, Regulatory Relief and Consumer Protection Act, which introduces measures that bring relief not only to the community banks but also for the Systemically Important Financial Institutions (SIFIs). In this sense, although there is no direct reference to the principle of proportionality, the objective of a regulation that is "tailored" is one of the fundamental principles that the legislator intends to pursue.[139] As anticipated in the previous chapter, Castro et al. in 2017 considered that the US jurisdiction adopted the "Specific Standard Approach" to introduce proportionality. The Specific Standard Approach consists in establishing "tailored criteria for the application of specific requirements for a subset of prudential standards, such as disclosure requirements, liquidity ratios, large exposure limits and market

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[137] Aaron M. Levine & Joshua C. Macey, *Dodd-Frank Is a Pigouvian Regulation*, 127 YALE LAW JOURNAL 1360–1363 (2018).
[138] Bryce W. Newell, *The Centralization of the Banking Industry: Dodd-Frank's Impact on Community Banks and the Need for Both Regulatory Relief and an Overhaul of the Current Framework*, 15 DEPAUL BUSINESS COMMERCIAL LAW JOURNAL 23 (2016).
[139] Donald J. Trump, *Presidential Executive Order on Core Principles for Regulating the United States Financial System* THE WHITE HOUSE (2017), https://www.whitehouse.gov/presidential-actions/presidential-executive-order-core-principles-regulating-united-states-financial-system/ (last visited Sep 9, 2020).

risk (the specific standard approach for proportionality, SSAP)." According to Castro et al., this approach would make it possible to structure the regulatory requirements in more detail than those that are the banks' characteristics, taking into account the risk profile and the business model.[140]

In light of the above, the specific US system's analysis appears to be of primary importance, since it is an example of how the same approach to proportionality can lead to different results in terms of legislative choices. After a brief overview of the two main acts, this chapter will discuss the main measures in these Acts that indicate an application of proportionality without claiming to be exhaustive. This chapter aims to view the regulatory choice made by the legislator of 2010 and 2018. This analysis could help identify the different application options of proportionality.

This chapter is structured as follows: Section 2.2 describes the reform's background and the main objectives that led to the Dodd-Frank Wall Street Reform and Consumer Protection Act. Section 2.3 introduces and makes a brief overview of the Dodd-Frank Act. Section 2.4 describes the main aspects of proportionality in the Dodd-Frank Act. Section 2.5 concerns a brief overview of community banks and the advantages they bring to the territory. Section 2.6 reconnects with the previous one, and it explains the consequences and the

[140] Ana Paula Castro Carvalho et al., *op. cit*, 6.

effects of the Dodd-Frank Act on Community Banks. Section 2.7 regards the recent legislative intervention of 2018 to correct the effects of the Dodd-Frank Act and bring relief to financial institutions: the Economic Growth, Regulatory Relief, and Consumer Protection Act. Section 2.8 considers some new elements of proportionality in the Economic Growth Regulatory Relief and Consumer Protection Act. Section 2.9 continues the discussion started in section 2.8, focusing on the issue of prudential regulation. Section 2.10 considers some recent regulations issued by the Federal Reserve, the Office of Comptroller of the Currency, and the Federal Deposit Insurance Corporation, relevant for the proportionality debate. Finally, section 2.11 contains some final remarks.

2.2 Background and Outset of the 2010 Reform.

The Great Financial Crisis of 2007- 2009, which dramatically shaken the US financial System, intensified the discussion about proportionality in banking regulation. This debate considered the impact of the regulations that attempted to remedy the consequences of the crisis. The financial crisis began with a bubble in the housing sector. The crisis has spread to subprime mortgages, leading to an interruption of the interbank lending market. As a result of the crisis, a series of tragic events happened in a short time: the collapse of Lehman Brothers, the failure of Washington Mutual, the rescue of American Insurance Group (AIG), as well as the takeover of two cornerstones of the mortgage

market, Fannie Mae (Federal National Mortgage Association) and Freddie Mac (Federal Loan Mortgage Corporation), by the government.[141]

Some authors have considered that the main contribution to the global crisis of 2007 – 2009 was due to a series of factors. The first factor is related to the development of securitizations. The financial evolution has determined the development of securitization techniques with significant complexity. Besides, the securitization has led to the creation of unrestrained chains of intermediaries placed between the originators and final investors.[142] The Over-the-Counter (from now on, also OTC) derivative market constituted another significant contribution to the crisis. The OTC derivative market rapidly increased due to the deregulation provided by the Commodity Future Modernization Act, issued in 2000, which specifically granted OTC derivatives the exemption from the regulation of the Commodity Feature and Trading Commission. This commission is an independent agency of the United States government that regulates futures and options markets. Moreover, the Commodity Future Modernization Act limited the supervision of OTC derivatives by the Securities and Exchange Commission's authority.[143]

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[141] Aigbe Akhigbe, Anna D. Martin & Ann Marie Whyte, *Dodd–Frank and Risk in the Financial Services Industry*, 47 REVIEW OF QUANTITATIVE FINANCE AND ACCOUNTING 396 (2016).
[142] James Hamilton & John Pachkowski, DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT: LAW, EXPLANATION AND ANALYSIS 30 (2010).
[143] *Ibid.*

Moreover, an essential part of the credit intermediation moved from the regulated financial sector to hedge funds and other entities included in the shadow banking system. The Financial Stability Board, an independent body that makes recommendations and monitors the financial stability system, described the shadow banking system as: "credit intermediation involving entities and activities outside the regular banking system."[144] The financial crisis demonstrated that the shadow banking system could constitute a systemic risk source, both directly and in its interconnection with the regulated banking system.[145]

Some experts considered that credit rating agencies also played a role in the crisis by underestimating the credit risk related to structured and securitized products. Finally, corporate governance's choices lead companies' executives to take high risks based on the incentives in their remuneration systems, which rewarded short term success at the expense of the long term negative consequences. Hence, when the subprime mortgage crisis came to the public's attention, it activated a national crisis that became global in a short time. [146] In June 2007, the three leading rating agencies started to downgrade their ratings on mortgage-backed securities. In the beginning, the downgrades affected the securities' lower-rated tranches, and they rapidly involved mortgage-backed

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[144] *Shadow Banking: Scoping the Issues* FINANCIAL STABILITY BOARD (2011), https://www.fsb.org/2011/04/shadow-banking-scoping-the-issues/ (last visited Oct 16, 2020).
[145] *Ibid.*
[146] James Hamilton & John Pachkowski, *op. cit.*, 31.

bonds rated AAA. Bear Stearns has been one of the first victims of the Great Financial Crisis, from the subprime crisis in 2007, due to its substantial exposure to mortgage-backed securities and derivatives. In March 2008, the massive financial loss led to the fifth-largest US investment bank's collapse and its subsequent acquisition by JPMorgan Chase.[147]

Bear Stearns' case represented the first major bank failure in the great financial crisis triggered by subprime mortgages' collapse. About six months after, the failure of Lehman Brothers led to the implementation of the TARP (Troubled Asset Relief Program) rescue plan to secure the American financial system. Although this program aimed to stop up the effects of the crisis, policymakers were aware of the necessity of comprehensive reform to promote financial stability and consumer protection and reduce the risk of future crises. On February 25th, 2009, President Obama declared the main principles concerning transparency, investor protection, and systemic risk to guide Congress to reform the previous financial regulatory regime. [148] The objectives of Obama's remarks concerned the construction of clear rules to protect consumers and investors and strengthen the financial institutions. In this sense, the Obama administration remarks, and the subsequent Dodd-Frank Act set as the primary objective not only to put an end to the effects of the Great Financial Crisis but, more generally,

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[147] *Ibid*.

[148] Barack Obama, *Remarks by the President after Regulatory Reform Meeting* NATIONAL ARCHIVES AND RECORDS ADMINISTRATION (2009), https://obamawhitehouse.archives.gov/the-press-office/remarks-president-after-regulatory-reform-meeting (last visited Sep 9, 2020).

to prevent future crises, renewing accountability, transparency, and trust in the financial markets.[149] Therefore, the predicted goals of the regulatory remarks, which led to the Dodd-Frank Act, were the following. The first one attained to the enhancement of the oversight on financial institutions. The reason for this remark is that with the financial crisis, the Federal Reserve has repeatedly acted as lender of last resort. The Federal Reserve exercised its function to the detriment of American taxpayers to avoid further negative systemic consequences. Therefore, a correct and increased oversight on financial institutions would ensure a reduction of the systemic risk that, in the long term, shows its effects on the taxpayers.[150]

The second remark aims to strengthen the markets so as they can resist to the failure of a large institution and, more in general, to extensive systemic stress. In this regard, the Obama administration proposed to modernize and rationalize the regulatory structure and monitor the extent of the risks that financial institutions assume. The third remark consists of encouraging transparency, openness, and a clear language in the financial system. The fourth remark concerns the uniform and robust oversight of financial products offered to investors and consumers. This remark considered that supervision should consider how people make decisions.[151] The fifth remark that governs financial

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[149] *Ibid.*
[150] *Ibid*.
[151] *Ibid.*

reform is accountability, starting from the top of financial institutions. The sixth remark attains the modernization of the financial regulation, to elaborate a comprehensive and free of gaps regulation. The last remark considers the real extent of the financial field: since it produces global effects, Obama's administration considers that it is necessary to coordinate the financial regulation through cooperation among states, not only inside the US.[152] Therefore, it seems that in these remarks, any direct or indirect reference to proportionality is absent. It appears that avoiding a further global financial crisis and consumer protection are the main objectives of the regulatory intervention, but no references are made to calibrate the discipline based on financial institutions' specificities.

President Obama's administration integrated the principles mentioned above in June 2009 when it first proposed the Dodd-Frank Wall Street Reform and Consumer Protection Act. Obama signed the Act into law on July 21st, 2010. The bill has been approved mostly by the Democratic party. Indeed, very few Republicans voted in favor. Many scholars considered Dodd-Frank as the broader reform of the financial system since the Great Depression and the Banking Act of 1933, which can be resumed in the following key fields: regulation of financial conglomerates that constitute a risk for the financial stability, without a distinction based on their corporate form; creation of

[152] *Ibid.*

resolution authority which aims to reduce financial conglomerates in the event of a crisis; regulation of the over-the-counter derivatives market; reduction of risky activities as well as the enhancement of the bank supervision; improvement of the investors' protection and establishment of the Consumer Financial Protection Bureau (CFPB). [153]

The reform's capacity was huge since observers underlined that the Act required the development of 398 new regulatory rules. The adopted approach has been considered much more aggressive than the past reforms, giving priority to the prudential regulation focused on intensifying financial stability and consumer protection. The Act reversed the trend of the past decades, intended to deregulate the topic. This trend started in the 1980s when the Monetary Control Act of 1980, and the Garn-St. Germain Act in 1982 and the Gramm-Leach-Bliley Act in 1999 expanded the product powers of banks and bank holding companies. Moreover, in 1994, the Interstate Banking and Branching Efficiency Act, also known as the Riegle- Neal Act, suppressed geographic limitations to banks' expansion. [154]

Observers also pointed out that another peculiarity of the Dodd-Frank Act was its flexibility. Indeed, the Act provided much discretion to regulators in implementing rules. This approach is very different from other legislative

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[153] Michael S. Barr, Howell E. Jackson & Margaret E. Tahyar, *op. cit,,* 63.
[154]Douglas D. Evanoff & William F. Moeller, *op. cit.* 76.

choices made in the past by the US Congress. For instance, the legislator issued the Federal Deposit Insurance Corporation Improvement Act in 1991 in a historical period in which the bank regulators of the time had a behavior that created discontent in the United States of America's federal legislative body. The aim of the Act consisted in hindering the savings and loan crisis and, in order to do so, the Act provided for the strengthening of the Federal Deposit Insurance Corporation, which is one of the agencies of the United States government that provides deposit insurance to depositors of commercial banks and savings institutions. In Dodd-Frank, the provisions are not as detailed as in the FDCI Improvement Act. Hence the Dodd-Frank Act gave regulators a significant discretionary authority in determining rules.[155]

In light of the above, the Dodd-Frank represented a very far-reaching reform with clear objectives, described by the Remarks by President Obama After Regulatory Reform Meeting. Having described the aims of the Dodd-Frank in this paragraph, the next one will focus on providing a general overview of the Act to give an idea of the broad scope of the reform.

[155] *Idem*, 77.

2.3 Dodd-Frank Act: an Overview.

Dodd-Frank Wall Street Reform and Consumer Protection Act was initially composed of XVI Titles and 1601 sections. The *incipit* of the Act declares its objectives. Indeed, the Act was issued: "to promote the financial stability of the United States by improving accountability and transparency in the financial system, to end the 'too big to fail', to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes". The implementation of this purpose determined a massive increase in oversight in the banking sector.[156] This paragraph describes the structure of the Dodd-Frank Act, as implemented in 2010.

Among the sixteen titles that compose the Act, the first title concerns the Financial Stability. Subtitle A establishes an independent agency, the Financial Stability Oversight Council, with the purpose to identify risks to the financial stability of the United States, deriving from financial distress or bankruptcy "of large, interconnected bank holding companies or nonbank financial companies, or that could arise outside the financial services marketplace." The second purpose of the Oversight Council is to promote market discipline by eliminating the expectation of shareholders, creditors, and other parties that the government will protect them from loss in case of failure of financial institutions. The third purpose is to respond to emerging threats to the stability of the United States.[157]

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[156] Bryce W. Newell, *op. cit.*, 1.
[157] James Hamilton & John Pachkowski, *op. cit*., 33.

Title I, Subtitle B, establishes the Office of Financial Research. According to section 153, this executive agency has the purpose of collecting data, standardizing the types of data reported and collected, performing research, developing tools for risk measurement and monitoring and support the activities of the federal financial regulators. As underlined by some jurists, the logic behind creating this authority is that it is useless to create a regulatory agency on systemic risk if the tools to measure systemic risk are not standardized.[158]

Subtitle C of Title I provides additional authority to the Board of Governors of the Federal Reserve System (Fed), to help it supervise nonbank financial enterprises. Additional authority includes the Board's power to require each nonbank financial company supervised to provide reports under oath about the enterprise's financial condition and the compliance to the provisions prescribed under Title 1. The Board also has the power to bring enforcement proceedings against enterprises in violation of Fed provisions. Moreover, the Board of directors shall prescribe more intense prudential standards for large and interconnected bank holding companies and nonbank financial institutions.[159]

Title II institutes the Orderly Liquidation Authority, which provides a process to liquidate large financial institutions close to failure. Title II provides an alternative to bankruptcy and to bail out. Indeed, the bankruptcy of large

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[158] *Ibid.*
[159] *Idem,* 35.

financial institutions causes market disruption and damage to the economy. The bailout procedure has adverse effects as well since it burdens on taxpayers and encourages market indiscipline. In the procedure described by Title II, the Federal Deposit Insurance Corporation (in the future also FDIC) is the receiver for the liquidation of the large enterprise. This title aims to ensure that the company's shareholders and creditors in distress bear the losses of the financial institution itself. The process prescribes the removal of the management that caused financial distress. With this process, it is granted to creditors a comparable result they would obtain in case of a bankruptcy liquidation.[160]

Title III subtitle D requires each federal agency to establish an Office of Minority and Women Inclusion, which is responsible for all issues related to diversity in employment, business, and management activities. Section 342 of the Dodd-Frank Wall Street Reform and Consumer Protection Act.[161]

Title IV concerned the regulation of advisers to hedge funds. It is important to note that historically, many private fund advisers had been exempted from the Security Exchange Commission (SEC) registration under certain conditions. The Dodd-Frank Act repealed this exemption and required advisers to private funds, hedge funds included, to register with the Security Exchange

[160] *Ibid.*
[161] Section 342 of the Dodd- Frank Wall Street Reform and Consumer Protection Act.

Commission if they have more than $150 million in assets under management.[162]

Title V, Subtitle B, aims to modernize the no-admitted insurance and reinsurance through state-based reforms. No-Admitted insurance is a company that is not supported by a State; this means that the insurance company does not always comply with the state insurance regulation. Hence, if policyholders believe that no-admitted insurance poorly handled their position, they cannot complain before the state insurance department. Equally, if the insurance company fails, the state does not guarantee the payment of the claim.[163] Title VI improved the prudential regulation of depository institutions, banks, and savings association holding companies. Title VI introduced new limits on the money a bank can invest in private equity funds, hedge funds, or other trading operations (so-called Volcker Rule). The Volcker Rule forbids banks from trading risky assets and forbids banks from having specifics connections with risky investment funds. For instance, banks may not acquire or retain any equity or other ownership interest with a hedge fund or an equity fund.[164]

Title VII regulates the over-the-counter (OTC) swaps market, providing for them an increased oversight. The Title gives the Commodity Feature Trading

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[162] Baird Webel, *The Dodd-Frank Wall Street Reform and Consumer Protection Act: Background and Summary* CONGRESSIONAL RESEARCH SERVICE 25 (2017), https://fas.org/sgp/crs/misc/R41350.pdf (last visited Sep 10, 2020).
[163] James Hamilton & John Pachkowski, *op. cit*., 36.
[164] *Ibid.*

Commission the oversight over swaps and the Securities and Exchange Commission supervision of the security-based swaps.[165] Title VIII concerns payment, clearing, and settlement activities on financial institutions. According to Section 803, (7), (A): "the term ''payment, clearing, or settlement activity'' means an activity carried out by one or more financial institutions to facilitate the completion of financial transactions, but shall not include any offer or sale of a security under the Securities Act of 1933 (15 U.S.C. 77a et seq.), or any quotation, order entry, negotiation, or other pre-trade activity or execution activity". Supervisory agencies with jurisdiction over a financial market utility must examine the soundness and safety of the utility at least once annually in order to determine the nature of the operations and the risks borne by the financial market utility; its financial and operational risk; its resources and capabilities to monitor such risks; the compliance of the utility with the dispositions of title VIII and the rules and orders prescribed under this title. Supervisory authorities may also enforce actions against designated financial market utilities.[166]

Title IX, indexed "investor protection and improvements to the regulation of securities," is now composed of seven subtitles. It aims to increase investor

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[165] *Idem,* 37.

[166] Financial market utilities (FMUs) are multilateral systems that provide the infrastructure for transferring, clearing, and settling payments, securities, and other financial transactions among financial institutions or between financial institutions and the system. See: *Designated Financial Market Utilities*, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM (2015), https://www.federalreserve.gov/paymentsystems/designated_fmu_about.htm (last visited Sep 10, 2020).

protection, directing the SEC to analyze the standards of conduct applicable to brokers, dealers, and investment advisers. The Title provides improvements for the regulation of credit agencies (subtitle C), for the asset-back securitization process (subtitle D), for the organization, management, and funding of the Securities and Exchange Commission (subtitle F). The Title includes measures to reform the municipal securities industry and enhance powers and tasks of the Public Company Accounting Oversight Board (from now on also PCAOB).[167] Title X institutes the Bureau of Consumer Financial Protection (in the future also Bureau or BFCP). According to section 1011, BFCP is an independent bureau established in the Federal Reserve System, "which shall regulate the offering and provision of consumer financial products or services under the Federal consumer financial laws."[168] Originally, the Consumer Financial Protection Bureau had authority in regulating consumer financial services and products. In addition to the rulemaking authority, to protect consumers from unfair practices, the Bureau was given authority to bring a civil action against who violates Federal law or CFPB regulation.[169]

Title XI considers the circumstances in which the Federal Reserve provides emergency assistance. According to section 1101, emergency lending authority can be used "for the purpose of providing liquidity to the financial system, and

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[167] James Hamilton & John Pachkowski, *op. cit*., 37.
[168] Dodd-Frank Act, Section 1011.
[169] James Hamilton & John Pachkowski, *op. cit*.,39.

not to aid a failing financial company."[170] Title XII aims to promote initiatives to support Americans who are not "fully incorporated into the financial mainstream."[171] The Title attempts to encourage low-income families and minorities to access affordable bank accounts and credit.[172] At Title XIII, the Dodd-Frank Act reduced the amount authorized of the Troubled Asset Relief Program (TARP). Formerly, the TARP's authorized amount was $700 billion, and with the Act of 2010 reduced this amount to $475 billion.[173]

Title XIV is the Mortgage Reform and Anti Predatory Lending and established a duty of care for mortgage originators, which must be qualified, licensed, and registered. A relevant element introduced by the Dodd-Frank Act was the so-called "Qualified mortgage" in Title XIV, Subtitle B. The Subtitle established minimum standards for every mortgage product. According to Section 1411, creditors could not make a home mortgage unless they determined that the borrower could repay the mortgage based on her actual income, credit history, expected income, and other factors. According to Section 1413, the failure to comply with the minimum standards provided imposed by this Title could be used as a defense by the borrower to claim damages.[174]

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[170] Dodd-Frank Act, Section 1101, (a) (6).
[171] Dodd-Frank Act, Section 1202.
[172] James Hamilton & John Pachkowski, *op. cit.,* 40.
[173] *Ibid.*
[174] *Ibid.*

Title XV and XVI provided miscellaneous provisions. For instance, Title XV contains directions according to which the American Administration must assess the loans proposed by the International Monetary finds to middle-income nations. Furthermore, this Title contains provisions about the SEC's disclosure that companies responsible for production processes or output depending on minerals originated in the Democratic Republic of Congo.[175] The legislator in 2010 focuses its attention on issues such as financial stability and consumer protection. These issues were precisely at the center of the debate because the great financial crisis had undermined citizens' and investors' trust, requiring an incisive intervention in terms of increased supervision and prudential regulation. At the regulatory level, particular emphasis is given to the Systemically Important Financial Institutions, sometimes neglecting the community banks (see *infra* at section 2.6). However, within the Dodd-Frank Act of 2010, some provisions show the application of proportionality, as will be seen more clearly in the next paragraph.

[175] *Idem*, 41.

2.4 Proportionality in the Dodd-Frank Act of 2010.

The Dodd-Frank Act granted many provisions in which an attempt to calibrate the discipline based on the financial institutions' characteristics exists. In sporadic cases, the Act referred to the fact that a measure must be "tailored," or used adjectives such as "reasonable" and "proportional." Much more often, the approach to proportionality is adopted about specific sectors (a specific standard approach for proportionality). This section lists some examples that show this approach to proportionality. In the part of the Dodd-Frank Act referred to in Titles I and VIII, the Financial Stability Oversight Council is authorized to identify Systemically Important Financial Institutions (from now on also SIFI), regardless of their "legal charter." The FSOC then subjected the SIFIs and the bank holding companies with over $ 50 billion in assets to prudential regulation and greater vigilance than other financial institutions. In this sense, even if the primary objective is that of financial stability, a differentiation is still made based on the size and characteristics of financial firms. Therefore, small banks would be exempted from the relevant legislation related to counterparty exposure limits, annual stress tests, and capital planning requirements, resolution planning, early remediation requirements, and risk management standards. [176]

[176] According to section 115 of the Dodd-Frank Act, the Financial Stability Oversight Council has the power to differentiate standards among companies subjected to heightened standards and recommend an asset threshold that is higher than $ 50,000,000,000 for the application of certain standards.

Another example of proportionality is in section 171, also known as the Collins Amendment, concerning the Capital Requirements. This section is aimed at the federal banking agencies so that they establish minimum capital requirements for bank holding companies, deposit institutions, and non-bank financial companies supervised by the federal reserve. For the investigation on the proportionality approach, it is interesting to note that section 171 provides for exemptions for small institutions, or that capital requirements apply gradually to such institutions.[177] Another example is section 1075 to title X of the Dodd-Frank Act, which is also known as the Durbin Amendment. Section 1075 amends section 920 of the Electronic Fund Transfer Act (15 U.S.C. 1693 et seq.) and provides exemptions for small issuers. This provision authorizes the Federal Reserve Board to prescribe regulations that aim to ensure that the interchange transaction fees received from a debit card issuer are reasonable and proportionate to the cost incurred. Interestingly, the Dodd-Frank Act exempts debit card issuers with less than $ 10 billion in assets from this rule.[178] Section 165 of the Dodd-Frank Act provides: "Enhanced Supervision and Prudential Standards for Non-Bank Financial Companies Supervised by the Board of Governors and Certain Bank Holding Companies." In the matter of "stress test," section 165 prescribes the execution of annual stress tests for financial companies with total consolidated assets of more than $10 billion, while non-

[177] Section 171 of the Dodd-Frank Act attains to the leverage and risk-based capital requirements.
[178] Section 1075 concerns reasonable fees and rules for payment card transactions.

bank financial companies under the supervision of the Board of Governors, as well as bank holding companies, shall carry on a semiannual stress test. Hence small banks are exempted by Dodd-Frank's stress testing requirements.[179]

Moreover, small banks are not subject to the supervision of the Bureau of Consumer Financial Protection (BCFP). However, they are only subject to the Federal Deposit Insurance Corporation's supervision, the Board of Governors of the Federal Reserve System, or the Office of the Comptroller of the Currency, which is primarily responsible for enforcing the rules issued by the BCFP.[180] Another example is section 956 of the Dodd-Frank Act, which provides enhanced compensation structure reporting. The rules contained in section 956 do not apply to financial institutions with assets less than $1 billion. Another example of the proportionality approach can is in Section 971 (c), which provides that: "The Commission may, by rule or order, exempt an issuer or class of issuers from the requirement made by this section or an amendment made by this section. In determining whether to make an exemption under this subsection, the Commission shall take into account, among other considerations, whether the requirement in the amendment made by subsection (a) disproportionately burdens small issuers."[181]

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[179] Dodd Frank Act, Section 165 (i) (2) (A).
[180] Hester Peirce, Ian Robinson & Thomas Stratmann, HOW ARE SMALL BANKS FARING UNDER DODD-FRANK? 8 (2014).
[181] Section 956 of the Dodd-Frank Act concerns the enhanced compensation structure reporting.

These examples show that the legislator of 2010 tried to diversify the regulation based on the proportionality, establishing in the different contexts a threshold within which to make exemptions from financial discipline or apply a softer discipline. Despite these efforts, it would seem that the legislator focused mainly on financial stability and has not taken into account the peculiarities of the so-called community banks. These banks, generally of small dimensions, have suffered severe consequences deriving from the implementation of Dodd-Frank. This problem and the resulting consequences will be explained in the next section.

2.5 Community Banks.

The Dodd-Frank Act had as main goals the enhancement of financial stability and consumer protection. Hence, the focus of this intervention was scarcely related to community banks. However, this paragraph will explain the importance of community banks in the US system. Community banks are peculiar institutions with an undeniable relevance for the local market. Indeed, proportionality plays a fundamental role in order to calibrate the burdens of the regulation. The term “community banks” is commonly referred to as small banks, which have the public saving collection and mortgage lending as main activities. The definition of a community bank is not univocal. The Federal

Reserve used as a threshold to define community banks 10$ billion in total assets.[182]

The Office of the Comptroller of the Currency defines community banks as "banks with less than $1 billion in total assets and may include limited- purpose chartered institutions, such as trust banks and community development banks." [183] The Federal Deposit Insurance Corporation defines community banks in a more nuanced manner and considers not only asset size but also other factors, *i.e*., if the bank takes deposits and makes loans, how geographically spread its offices are if the bank is engaged in necessary banking activities.[184] According to the Federal Deposit Insurance Corporation: "Community banks focus on providing traditional banking services in their local communities. They obtain most of their core deposits locally and make many of their loans to local businesses. For this reason, they are often considered to be "relationship" bankers as opposed to "transactional" bankers. In other words, community banks have specialized knowledge of their local community and their customers. Because of this expertise, community banks tend to base credit decisions on local knowledge and nonstandard data obtained through long-term

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[182] *Community Banking*, FEDERAL RESERVE (2020), https://www.federalreserve.gov/supervisionreg/topics/community_banking.htm (last visited Sep 10, 2020).
[183] *Community Bank Supervision,* COMPTROLLER OF THE CURRENCY ADMINISTRATOR OF NATIONAL BANKS 1 (2010), https://www.lexissecuritiesmosaic.com/gateway/OCC/Bulletin/comptrollers-handbook_pub-ch-ep-cbs.pdf (last visited Sep 10, 2020).
[184] *Ibid.*

relationships and are less likely to rely on larger banks' models-based underwriting."[185] Community bank's activities are carried out in order to satisfy the needs of a community. Although these institutions are small banks in general, it is not necessary to be small to be qualified as a community bank. Indeed, the peculiarity is related to the fact that these banks are more concentrated in the "traditional" banking activity (saving collection and mortgage lending) than in holding derivatives or security trading.[186]

Another essential feature of community banks is that they operate in a limited geographical area in which a long term and personal relationship with the bank's employees and borrowers exist. In this sense, community banks' characteristic is the direct knowledge of the small market in which they operate. Precisely for community banks' peculiar features, their supporters declare that they constitute a crucial source of income for people belonging to local communities. Indeed, larger banks may not be interested in operating within a small market, of which they have no direct knowledge. [187]

Another advantage considered by the supporters of community banks attains to the fact that community banks individually considered constituting a lower systemic risk than large banks. In this sense, regulation on financial stability might produce little benefits with high costs for community banks. Furthermore,

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[185] *FDIC Community Banking Study*, FEDERAL DEPOSIT INSURANCE CORPORATION 1-1 (2012), https://www.fdic.gov/regulations/resources/cbi/report/cbi-full.pdf (last visited Sep 10, 2020).
[186] *Ibid.*
[187] *Ibid.*

community banks have more difficulties in bearing compliance costs than larger banks, giving that they probably have fewer resources and fewer employees to dedicate to compliance with banking regulation.[188]

Indeed, another rationale on the use of proportionality is related to the fact that small banks do not benefit from economies of scale with the same extent of larger banks. Supporters of the Dodd-Frank Act declared that the legislator of 2010 understood that community banks were not the leading cause of the Great Financial Crisis. For this reason, the Act was focused on limiting the risk of the largest financial institutions and filling the regulatory gaps of activities (for instance, derivative trading) that are not carried out by community banks.[189] However, critics disapproved of this legislative intervention for the undesirable effects produced on the community banks, defining it as a "one-size-fits-all" regulatory structure. The bases of these criticisms are the presence in the Dodd-Frank Act of recordkeeping requirements and other rules that generate substantial compliance costs for community banks, which have a business model that differs enormously from larger institutions.[190]

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[188] Neal Wolin, *Financial Reform Protects and Strengthens Community Banks* U.S. DEPARTMENT OF THE TREASURY (2011), https://www.treasury.gov/connect/blog/Pages/Financial-Reform-Protects-and-Strengthens-Community-Banks.aspx (last visited Sep 10, 2020).
[189] *Idem.*
[190] See, for instance, the opinion of Senator Jerry Moran, *Moran's Memo: Three Years Later, Community Banks Bear Burden of Dodd-Frank* UNITED STATES SENATOR FOR KANSAS (2013), https://www.moran.senate.gov/public/index.cfm/editorials?ID=884C5DA1-26B2-4EEE-BB9D-471FF71C50D5 (last visited Sep 10, 2020).

It is interesting to note that the criticisms focused on the lack of proportionality of the Dodd-Frank Act, given by the fact that the same measures were applied both to larger institutions and to community banks. From the statements of those who make these criticisms, we can distinguish that the legislator applied measures to the community banks that were not necessary to achieve the purposes that the act aimed to achieve.

2.6 Consequences and Effects of the Dodd-Frank Act on Community Banks.

Various agencies, institutes, and doctrine studied the Dodd-Frank Act because of the scope of this reform. On this point, it is interesting to note that some studies have analyzed the general trend of the banking industry towards consolidation. The trend occurred in the 1980s, with the deregulation of localization requirements for banks. Indeed, in the era before the deregulation of the 1980s, banking operations were limited geographically, and it was difficult for banks to have branches in other American states.[191]

Deregulation has undoubtedly brought considerable advantages, including the development of the banking sector. Although deregulation has brought benefits,

[191] Bryce W. Newell, o*p. cit.,* 9.

it has led to unintended consequences. Indeed, deregulation has affected banks of different sizes, with negative consequences for small banks. In light of this, some authors have pointed out that the Dodd-Frank Act exacerbated the consolidation trend.[192] Although it is complicated to assess the actual impact in terms of costs of the Dodd-Frank Act, anecdotal evidence shows that this Act increased the compliance costs for banks. Compliance costs are fixed costs and affect economies of scale. In other words, the smaller a bank is, the higher the costs it has to bear. Compliance costs also imply the costs related to the hiring of qualified personnel in compliance, which of course, is easier for a more significant bank than for a smaller institution, in the light of the fact that a qualified employee is a keener to work in a more organized environment which can offer more benefits.[193]

A bank's small structure also implies that noncompliance employees are more involved in the compliance process than the past. Hence, compliance covers a large part of their time, which would be otherwise used in other strategical activities. Compliance costs have an impact on customers too. On the one hand, the increase in compliance costs represents an increase in services' costs, since banks pour compliance costs in the customers' price.[194]

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[192] *Idem.*
[193] Hester Peirce, Ian Robinson & Thomas Stratmann, o*p. cit.*, 12.
[194] *Idem*, 13.

On the other hand, the increase in compliance costs could also translate into a reduction of the services offered to customers. In this sense, the final user would have a disadvantage too. The reduction of the services offered by a small bank as well as the increase of costs could lead the customer to migrate to bigger competitors, which would not be capable of offering a service as tailored as the one offered by community banks or that would be disinclined to deal with small business or customers of rural areas.[195]

Despite the difficulties in calculating the Dodd-Frank Act's actual impact, many studies have been carried out by several organizations and institutions. According to the United States' Government Accountability Office (in the future also GAO), from 2010 to 2017, the number of community banks decreased by 24%.[196] On the one hand, GAO explained the reason for this phenomenon, with the increase of the number of mergers among US community banks, on the other hand, on the decrease of the number of new banks' formation. GAO's econometric study considered that the main reasons for this trend could be related to macroeconomic explanations and reasons related to the characteristics of the local markets or banks' peculiarities. However, the Office recognized the role played by the banking regulation.[197]

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[195] *Ibid.*
[196] Lawrance L. Evans, Jr & Oliver Richard, *Community Banks Effect of Regulations on Small Business Lending and Institutions Appears Modest, but Lending Data Could Be Improved* UNITED STATES GOVERNMENT ACCOUNTABILITY OFFICE 2 (2018), https://www.gao.gov/assets/700/693755.pdf (last visited Sep 10, 2020).
[197] *Ibid.*

In this scenario, the current US administration produced several proposals and legislative actions to roll back the Dodd-Frank Act. Among these actions, it is relevant to mention the Presidential Executive Order on Core Principles for Regulating the United States Financial System, issued on February 3rd, 2017, in which one of the declared core principles is "(f) make regulation efficient, effective and appropriately tailored."[198] Hence, even without making explicit the word proportionality, the intent to modify the regulation to achieve a more significant differentiation across banks based on their size and complexity is visible. This purpose consisted of enacting the Economic Growth, Regulatory Relief, and Consumer Protection Act, which introduces several provisions specifically focused on providing relief for community banks.

2.7 Economic Growth, Regulatory Relief and Consumer protection Act.

Given the effects produced by the Dodd-Frank, some observers considered this Act an unduly burdensome regulation with a disproportional impact on community banks' regulation.[199] Thus, the Senate passed the Economic Growth, Regulatory Relief, and Consumer Protection Act on March 14th, 2018. The House passed the Act on May 22nd, 2018, and President Donald Trump

[198] Donald Trump, *op. cit.*
[199] Bryce W. Newell, *op. cit.,* 23.

signed it into law on May 24th, 2018. The primary purposes of this Act, also called S. 2155, P.L. 115-174, are: "to promote economic growth, provide tailored regulatory relief, and enhanced consumer protections, and for other purposes."[200]

Hence the concept of making the regulation more tailored, and therefore more proportionate than the Dodd-Frank Act is evident from the purposes of the S. 2155, P.L. 115-174. This Act provides many changes to the previous discipline; for instance, it modifies the qualified mortgage criteria, the Volcker Rule, it enhances the regulation for larger banks and provides relief for smaller banks. The Economic Growth, Regulatory Relief, and Consumer Protection Act is divided into six Titles and affects mortgage lending, community banks, consumer protection, larger banks, and capital formation.

Title I, indexed "Improving Consumer Access to Mortgage Credit," loosens and provides exonerations to some rules concerning homeowners' loans. For instance, Section 101 allows banks and credit unions with assets below $10 billion to abandon particular "ability-to-pay" requirements concerning residential mortgages.[201]

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[200] Mike Crapo, *S.2155 - 115th Congress (2017-2018): Economic Growth, Regulatory Relief, and Consumer Protection Act*, CONGRESS.GOV (2018), https://www.congress.gov/bill/115th-congress/senate-bill/2155/text (last visited Sep 7, 2020).
[201] David W. Perkins et al., *Economic Growth, Regulatory Relief, and Consumer Protection Act (P.L. 115-174) and Selected Policy Issues* CONGRESSIONAL RESEARCH SERVICE (2018), https://crsreports.congress.gov/product/details?prodcode=R45073 (last visited Sep 7, 2020).

Title II grants regulatory relief for community banks. For instance, Section 203 provided the exemption from the Volcker Rule to some banks that meets two requirements. As described *supra,* the Volcker Rule restrain the speculative activity of banks. Indeed, according to this rule, banks cannot invest their capital in the stock market as derivative and shares in hedge funds above 3%. Section 203 exempts from the Volcker Rule those banks who have a total asset of less than $10 billion and trading assets and liabilities that constitute no more than 5% of total assets. Trading assets are goods held by a company for the sale or for trading purposes (to make a profit).[202]

Title III strengthens protections for veterans, consumers, and homeowners in focused sectors. For instance, Section 301 increases the length of time a consumer reporting agency must provide fraud alerts in consumer files. A consumer reporting agency regularly engages in assembling or evaluating consumer credit or other information, for monetary fees or on a nonprofit basis, to provide consumer reports to third parties, such as lenders or credit issuing entities that are examining the consumers' creditworthiness that are applying for credit.[203]

Title IV, entitled "Tailoring regulation for certain bank holding companies," modifies the previous regulation increasing the asset's threshold to which

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[202] John Raymond Wildman, PRINCIPLES OF ACCOUNTING 118 (1920).
[203] David W. Perkins et al., *op. cit.*, 20.

specific requirements are applied. Indeed, the Dodd-Frank established the first threshold is $50 billion, and the bill S. 2155 P.L. 115-174 increases the threshold to $250 billion.[204] Moreover, Section 401 allows the Federal Reserve Board to determine if a financial institution with assets equal or that exceed $100 billion shall respect the enhanced prudential requirements. Furthermore, this Section enhances the asset limit from $10 billion to $250 billion to require a company's stress test. The risk committee that was mandatory for banks with total assets equal to or greater than $10 billions, with S. 2155 P.L. 115-174 are now mandatory for banks with total assets of $50 billion.[205] Title V aims to encourage capital formation through the designing of rules that provide relief to some securities. For instance, Section 501 exempts some securities from the state registration.[206] Title VI intensifies consumer protections for student borrowers. For example, in modifying the Fair Credit Reporting Act, Section 602 prescribes that a consumer can request a financial institution to eliminate a reported default concerning a private education loan from a consumer.[207]

Who proposed the Economic Growth, Regulatory Relief, and Consumer Protection Act argued that the Acts provides the necessary regulatory relief. However, this bill's opponent asserted that it unnecessarily reduces relevant

[204] *Idem*, 29.
[205] *Idem*, 32.
[206] *Idem*, 38.
[207] *Idem*, 20.

Dodd-Frank protections to the benefit of larger financial institutions. [208]Despite the criticisms, this new discipline seems to be more focused on the idea of tailoring the regulation taking into consideration the institution size assets. Indeed, proportionality seems to be the cornerstone of the secondary regulation that implements the Growth, Regulatory Relief, and Consumer Protection Act economy.

On the point, the Fed's Vice Chairman for Supervision Randal J. Quarles declared that: "The Federal Reserve Board (Board) strongly supports the principle underlying the Act of tailoring regulation to risk, and we have embedded this principle in several aspects of our regulatory and supervisory framework. It is, however, fair to say that until recently our tailoring of regulations has been principally calibrated according to the asset size of an institution. Yet, while a useful indicator, asset size should be only one among several relevant factors in a tailoring approach. We continue to evaluate additional criteria allowing for greater regulatory and supervisory differentiation across banks of varying sizes, and the Act reflects similar goals".[209] Hence, it is clear that the concept of proportionality hinges not only

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[208] Jacob Pramuk, *Trump Signs the Biggest Rollback of Bank Rules Since the Financial Crisis* CNBC (2018), https://www.cnbc.com/2018/05/24/trump-signs-bank-bill-rolling-back-some-dodd-frank-regulations.html (last visited Sep 7, 2020).

[209] Randal K. Quarles, *Implementation of the Economic Growth, Regulatory Relief, and Consumer Protection Act* FEDERAL RESERVE (2018), https://www.federalreserve.gov/newsevents/testimony/quarles20181002a.htm (last visited Sep 10, 2020).

the primary regulation contained in the Economic Growth, Regulatory Relief, and Consumer Protection Act but also the secondary regulation.

2.8 Proportionality in Economic Growth, Regulatory Relief, and Consumer Protection Act.

One of the primary objectives of the Economic Growth, Regulatory Relief, and Consumer Protection Act consisted of having a more tailored regulation, thus avoiding the criticized one-size-fits-all approach mentioned above. Although proportionality is not expressed openly, it is still present and manifests itself repeatedly. This paragraph analyzes some examples of the tailored regulation application and mainly considers Title I, Title II, and Title IV of the Economic Growth, Regulatory Relief, and Consumer Protection Act. Title I, which contains nine sections that modify various laws, contains some provisions in which proportionality can be envisaged.

An example of the presence of proportionality in the new regulatory framework is Section 101, that deals with qualified mortgages. [210] The section conceives a new qualified mortgage compliance option. Small banks, depository

[210] The qualified mortgage has been defined by the Dodd-Frank Act, which modifies Truth in Lending Act, in section 129 (c).

institutions, or credit unions are allowed to forgo specific ability-to-pay requirements established by Title XIV of the Dodd-Frank Act if they have an asset below $10 billion. In order to forgo these ability-to-repay requirements, the bank has to evaluate and document the borrower's financial situation, that is, income, other financial resources, and debts. The Dodd-Frank Act established the ability-to-repay, which provides that "no creditor may make a residential mortgage loan unless the creditor makes a reasonable and good faith determination based on verified and documented information that, at the time the loan is consummated, the consumer has a reasonable ability to repay the loan, according to its terms, and all applicable taxes, insurance (including mortgage guarantee insurance), and assessments".[211] Policymakers established this requirement to face some market issues and policy failures that probably contributed to the speculative bubble, which led to the Great Financial Crisis. The ability-to-repay constitutes a warning to banks, which must verify if the borrower can repay the debt. The violation of the ability-to-repay requirements constitutes legal liability, with the payment of statutory damages.[212]

Section 1412 of the Dodd-Frank Act defines qualified mortgages and states that: "The Board may prescribe regulations that revise, add to, or subtract from the criteria that define a qualified mortgage upon a finding that such regulations are

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[211] 15 USC 1639c.

[212] *Ability-to-Repay and Qualified Mortgage Standards under the Truth in Lending Act*, BUREAU OF CONSUMER FINANCIAL PROTECTION 29 (2013), https://files.consumerfinance.gov/f/201301_cfpb_final-rule_ability-to-repay.pdf (last visited Sep 10, 2020).

necessary or proper to ensure that responsible, affordable mortgage credit remains available to consumers in a manner consistent with the purposes of this section, necessary and appropriate to effectuate the purposes of this section and section 129B, to prevent circumvention or evasion thereof, or to facilitate compliance with such sections".[213] CFPB issued the qualitative mortgage regulation, which is in addition to the standard discipline. The Bureau provided for additional categories, including the Small Creditor Portfolio Qualitative Mortgage. The Small Creditor Portfolio Qualitative Mortgage has less strict underwriting requirements than the Standard Qualitative Mortgage. A mortgage must satisfy three different criteria in order to be defined as a Small Creditor Portfolio Qualified Mortgage. Firstly, the bank must hold in its portfolio that mortgage for at least three years, with some exceptions. Secondly, the lender must be a small creditor, which means that the institution has less than $2 billion in assets, and during the previous year, it originated 2,000 or fewer mortgages. Third, the mortgage must meet all the Standard Qualified Mortgage requirements with the debt-to-income ratio's exemption.[214]

Some observers criticized the measure, stating that not all the requirements are essential to verify the ability-to-repay of the borrower and that it would be sufficient to retain the loan in the institution's portfolio to encourage an accurate

[213] Section 1412 of the Dodd-Frank Act, indexed: "Safe harbor and rebuttable presumption".
[214] David W. Perkins et al., *op. cit.*, 6.

underwriting.[215] According to this argument, keeping the loan in the portfolio means that the creditor maintains the default risk, so it is exposed if the borrower does not repay the mortgage. Hence, bearing the default risk, the creditor will proceed with further verifications even if it does not require this. Therefore, the new regulation P.L. 115-174 provides an alternative to the Small Credit Portfolio Qualified Mortgage for lenders who retain their portfolio. First of all, section 101 of P.L. 115-174 extends the number of lenders that can take advantage of the new compliance option, increasing the previous asset limit from $2 billion to $10 billion and removing the origination limits. Moreover, this portfolio option created by the new regulation P.L. 115-174 prescribes that the lender must keep the loan in its portfolio, instead of only three years, for the entire life of the loan, providing some exceptions to this general rule. Apart from this requirement, the option provided by P.L. 115-174 has less stringent restrictions than the other compliance option.[216]

Hence the new option provided by the Economic Growth, Regulatory Relief, and Consumer Protection Act at section 101 extends the number of banks and credit unions that can opt for the new option, passing from the original asset requirement of $ 2 billion and less than 2000 mortgage in a year to the only capital limit of $10 billion. Simultaneously, the new regulation reduces the

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[215] Andy Barr, *Barr Introduces Legislation to Help Homebuyers, Prevent Bailouts U.S. Congressman* ANDY BARR (2015), https://barr.house.gov/2015/2/barr-introduces-legislation-to-help-homebuyers-prevent-bailouts (last visited Sep 10, 2020).
[216] David W. Perkins et al., *op. cit.*, 6.

compliance requirements, providing more relaxed criteria then the CFPB's Small Creditor Portfolio Qualified Mortgage.[217]

In Section 104, there are some proportionality elements, since the provision exempts specific financial institutions that originated less than a determined number of mortgages from specific public disclosure requirements. This Section makes changes to the Dodd-Frank Act. Indeed, the Dodd-Frank revised the Home Mortgage and Disclosure Act, enacted in 1975. The adjustments concerned the addition of further requirements, among which the collection of additional data such as payable fees, mortgage terms, and interest rate information. Currently, lenders must meet the Home Mortgage and Disclosure Act requirements if they meet specific criteria, including having assets greater or equal to $45 million and originated at least 25 mortgages during each year the previous two years. Hence the new regulation acted intending to reduce the disclosure requirements provided by the Dodd-Frank.[218]

Section 108 provides an exemption of residential mortgage loans from some escrows requirements if a depository institution or a credit union with assets equal or less of $10 billion issued the mortgage; originated 1000 or fewer loans during the previous year; and meets certain requirements.

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[217] *Idem*, 7.
[218] *Idem*, 8.

According to the Consumer Financial Protection Bureau, the bank creates an escrow account, also called an impound account, in order to pay some expenses concerning the property, such as property taxes and homeowner insurances.[219] Maintaining escrow accounts represents a potential cost, especially for small institutions. The Dodd-Frank Act modified the previously existing discipline, which provided that for high-price loans, an escrow account had to be maintained for at least one year. The Dodd-Frank extended this limit for five years, with additional requirements. However, Dodd-Frank guaranteed the Consumer Financial Protection Bureau the discretion to change these requirements for banks operating in rural or disadvantaged areas. Hence the Consumer Financial Protection Bureau provided the exemption from the escrow requirements for financial institutions with a particular feature, among which the geographical area (the bank is in a rural or disadvantaged area); the activity (the bank extends 2000 mortgage or fewer); and the size (total assets equal or less than $2 billion). [220]

These criteria have been amended by Section 108 of P.L. 115-174; hence a bank is exempted from maintaining an escrow account if it has assets of $10 billion or less and originated less than 1,000 mortgages in the previous year. In this sense, the new regulation extends the exemptions with particular consideration

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[219] *What is an Escrow or Impound Account?* CONSUMER FINANCIAL PROTECTION BUREAU, (2017), https://www.consumerfinance.gov/ask-cfpb/what-is-an-escrow-or-impound-account-en-140/ (last visited Sep 10, 2020).
[220] David W. Perkins et al., *op. cit.*, 11.

of the size ($10 billion instead of the previous $2 billion) than the number of mortgages extended (from 2,000 to 1,000).[221]

The Economic Growth, Regulatory Relief, and Consumer Protection Act provides specific provisions to support community banks. Also, the previous regulation provided exemptions for small banks for specific requirements and rules. However, the Act of 2018 provides, at Title II, an increase of asset thresholds and reduces regulatory burden for small banks. In Title II, several examples of proportionality are visible. For example, Title II introduced a provision to decrease the frequency of tests and reports to be produced. Changes to prudential regulation have also been made, including Volcker Rule and minimum capital requirements.[222]

A relevant rule is section 201. This article requires the Federal Banking Agencies to adopt a Community Bank Leverage Ratio, a leverage ratio for banks with less than $ 10 billion in assets. In particular, this is one of the indicators that is used to measure a company's debt. Therefore, the Agencies must establish a ratio between 8% and 10% of capital on unweighted assets to be considered well-capitalized.[223]

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[221] *Ibid.*
[222] *Idem*, 12.
[223] *Idem*, 14.

This requirement is more favorable for small banks if one considers that the requirement to generate is more restricted, 5%. In other words, a bank with assets under 10 billion, if it maintains a leverage ratio below the established threshold, may be exempted from other requirements relating to leverage and risk-based capital requirement. Precisely in order to make this regulation proportionate and adequate to the specific case as much as possible, the Federal Banking Agencies can provide that, even if a single bank has assets that do not exceed $ 10 billion but have a specific risk profile it is not suitable for being exempted.[224] It is also interesting to recall section 203, which changes the Bank Holding Company Act of 1956. This section aims to exempt the "Volcker Rule" banks that have specific requirements. As said *supra*, the Volcker Rule, envisaged by section 619 of the Dodd-Frank Act, prohibits bank agencies from engaging in proprietary negotiations or having relations with hedge funds or private equity funds. Banks that are exempt from this rule must possess the following requirements: i) they must have less than $ 10 billion in assets and ii) trading assets and liabilities that do not exceed 5% of total assets.[225]

An essential step of the new act that reduces excessive burdens for small banks concerns reporting requirements. Section 205 provides that regulators must provide that some small banking institutions can satisfy the reporting requirements with a simplified document. In general, at the end of each financial

[224] *Ibid.*
[225] *Idem*, 16.

quarter of the year, the banks must present the federal banking agencies with a "report of condition and income," also termed "call report." This document aims to provide the federal banking agencies with detailed information on various aspects concerning the bank's income, expenses, and balance sheet. Thus, section 205 aims to reduce this burden for banks that have an asset below $ 5 billion. Regulators will therefore have to prescribe for the small banking institutions new reports that are shorter or simplified.[226]

Another measure undertaken by the Economic Growth, Regulatory Relief, and Consumer Protection Act in favor of small community banks is related to the frequency of the banks' examination (Section 210). Indeed, bank regulators carry out on-site examinations of banks with a frequency that can be 12 months or 18 months, depending on the bank's size. This Act raised the threshold for an 18-month examination. Currently, banks with an asset of $ 3 billion are now subject to examination every 18 months. Before this reform, the threshold was only $ 1 billion. The result is that many more banks will now be able to take advantage of this 18-month cycle examination. The Act extends the relief to a more significant number of banking institutions.[227] The examples highlighted above mostly concern the regulatory intervention of the Economic Growth, Regulatory Relief, and Consumer Protection Act on small banks. However, the

[226] *Idem,*18.
[227] *Idem,* 19.

legislative intervention of 2018 was not limited to providing relief to small banks, as there was also a relief for larger institutions.

2.9 Enhanced Prudential Regulation.

The proportionality in the regulatory choices cannot be deduced exclusively from the application of a relief to small banks, understood as the reduction of the burdens and exemptions. Proportionate regulation could also imply a more rigorous approach for large companies rather than small and medium-sized enterprises.[228] In this sense, proportionality means to tailor enhanced regulation, which inevitably intersects with the theme of economic stability and with the too-big-to-fail problem. Concerning the issue of economic stability, both Basel III and Dodd-Frank have envisaged three categories of systemically relevant banking institutions, to which enhanced regulation applies:

1) Banking holdings that have more than $ 50 billion in assets;
2) Institutions that present $ 250 billion or more in assets or $ 10 billion or more in foreign exposures;

[228] *Idem*, 32.

3) The so-called "Globally Systemically Important Banks" is defined based on their characteristics, complexity, interconnections, and dimensions.[229]

The Dodd-Frank Act treated enhanced regulation in Title I. This title envisaged a new regulatory regime about various issues such as stress tests and capital planning, liquidity requirements; risk management standards; financial stability requirements, and so on. This regulation applied to all banks with more than $ 50 billion in assets. The Economic Growth, Regulatory Relief, and Consumer Protection Act changed that threshold, which was initially set by the Dodd-Frank Act at $ 50 billion. For instance, section 401 of Economic Growth, Regulatory Relief, and Consumer Protection Act determines an increase in the threshold within which specific prudential standards should be applied, going from $50 billion to $250 billion.[230]

At the same time, the Fed has the option to determine at its discretion whether a banking institution with assets equal to or greater than $ 100 billion may be subject to such prudential standards. The attribution of this discretion to the Fed could perhaps help to carry out greater customization for the bank of the specific case. In this sense, at least at a theoretical level, it could be considered a forecast

[229] *Idem*, 29- 30.
[230] *Idem*, 32.

of greater proportionality precisely because the Fed would consider the specific case.[231]

Section 401 also provides for specific and differentiated thresholds in the event of stress tests and mandatory risk committees. The Federal Reserve defines the Dodd-Frank Act Stress Test (DFAST) as: "a forward-looking quantitative evaluation of the impact of stressful economic and financial market conditions on firms' capital. […] The supervisory stress test serves to inform the Federal Reserve, firms, and the general public of how firms' capital ratios might change under a hypothetical set of stressful economic conditions developed by the Federal Reserve." [232]

Regarding the mandatory risk committee, the Dodd-Frank Act required the presence of a separate risk committee constituted by independent directors for publicly traded bank holding companies and publicly traded nonbank financial companies subject to the Federal Reserve's oversight. If initially the stress test and the mandatory risk committee applied to banks with assets higher than or equal to $ 10 billion, the Economic Growth Act extended this threshold to $ 250 billion for the applicability of the stress test and $ 50 billion for the mandatory risk committee.[233]

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[231] *Ibid.*
[232] *Dodd-Frank Act Stress Test 2019: Supervisory Stress Test Methodology*, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM 3 (2019), https://www.federalreserve.gov/publications/files/2019-march-supervisory-stress-test-methodology.pdf (last visited Sep 10, 2020).
[233] *Ibid.*

In this case, therefore, the new act introduced new and relevant elements of differentiation based on the size of the banking institutions. This legislative choice was inspired by the criticisms concerning the fact that the threshold identified by the Dodd-Frank Act was too low. Critics of the $50 billion threshold criticized that the Dodd-Frank Act has been inserted in the same group different types of banks: from the so-called Regional banks to the "Wall Street banks."[234] The difference concerns not only the size of banks' assets but also the typology of activities carried out. The Regional Banks are medium and small institutions that mostly carry out traditional banking activities. On the other hand, the latter, in addition to having a larger size, provides derivatives, prime brokerage, and asset management. Considering the compliance costs related to regulatory compliance, putting different banks' typologies through the same regulation would seem disproportionate.[235]

Those banks that the 50 billion threshold would be the most affected (so-called cliff effect, described in chapter 1). The Economic Growth Regulatory Relief, and Consumer Protection Act found a compromise solution, choosing to attribute the discretion to the Fed to evaluate case-by-case if a bank that has an asset between $100 billion and $ 250 billion is a systemically important financial institution. This choice, although the criticism due to the possible

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[234] Deron Smithy, *Testimony Before the Senate Banking Committee* REGIONAL BANK (2015), http://regionalbanks.org/wp-content/uploads/2015/03/Regions-Bank-Testimony-Senate-Banking.pdf (last visited Sep 10, 2020).
[235] *Idem.*

increase in systemic risk,[236] constitutes an attempt to overcome an approach to proportionality exclusively based on thresholds. The result would be more tailored banking regulation in the United States compared to the past.

2.10 Towards the Categorization Approach.

Continuing the argument concerning the proportionality approach in the U.S. banking regulation, it is essential to mention the recent Final Tailoring Rules drawn up by the Federal Reserve and the U.S. Banking Agencies Office of Comptroller of the Currency (OCC) and Federal Deposit Insurance Corporation (FDIC).[237] The Federal Reserve developed the Final Enhanced Prudential Standards Tailoring Rules intending to adapt U.S. banks' standards. The other two agencies updated the regulation that aims to tailor the rules on capital and liquidity. These rules were effective on December 31, 2019. The importance of these rules for the purposes of this chapter is linked to the fact that the Authorities mentioned above develop four categories of banks, determined on the basis of a combination of the following risk indicators: U.S. GSIB

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[236] See, for example, Thomas W. Joo, *Lehman 10 Years Later: The Dodd-Frank Rollback*, 50 LOYOLA UNIVERSITY CHICAGO LAW JOURNAL 597 (2019).

[237] *Prudential Standards for Large Bank Holding Companies, Savings and Loan Holding Companies, and Foreign Banking Organizations*, FEDERAL REGISTER (2019), https://www.federalregister.gov/documents/2019/11/01/2019-23662/prudential-standards-for-large-bank-holding-companies-savings-and-loan-holding-companies-and-foreign (last visited Sep 10, 2020).

assessment methodology; size; cross-jurisdictional activity; weighted short-term wholesale funding (STWF); non-bank assets; and off-balance sheet exposure.[238]

The Federal Reserve explicitly stated that its rules apply to domestic and foreign banks for the purpose of correlating regulation more closely with the risk profile of banks. These rules would therefore have the effect of reducing compliance requirements for companies with less risk while maintaining stringent requirements for larger banks.[239] These requirements have been developed in accordance with Section 165 of the Dodd-Frank Act. Section 165 asks the Federal Reserve System's Board of Governors to establish prudential standards for banking institutions. The division into four bank's categories provides that the first category includes the largest and most complex banks and, therefore, subject to stricter regulation. The following categories include banks of gradually smaller size, up to category IV. Therefore, the most stringent capital and liquidity requirements apply to Category I, which applies to U.S. GSIBs, given that these can potentially pose a greater risk to the United States' financial stability. The Federal Reserve capital rules determine the existence of a GSIB. Category I standards reflect the Basel Accords and include additional

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[238] *Federal Reserve Board Finalizes Rules that Tailor its Regulations for Domestic and Foreign Banks to More Closely Match Their Risk Profiles*, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM (2019), https://www.federalreserve.gov/newsevents/pressreleases/bcreg20191010a.htm (last visited Oct 16, 2020).
[239] *Ibid.*

requirements set by the Federal Reserve System's Board of Governors. The standards envisaged in Category I remain unchanged with respect to the pre-existing requirements.[240]

Category II includes banking entities that are not included in the definition of GSIB and have an amount equal to or greater than $ 700 billions in total consolidated assets; or an amount equal to or greater than $ 100 billion in total consolidated assets and an amount equal to or greater than $ 75 billion in cross-jurisdictional activities. The Federal Reserve justified cross-jurisdictional activity as a risk indicator, declaring that "significant cross-border activity can indicate heightened interconnectivity and operational complexity."[241] Category II entities are subject to the application of all Enhanced Prudential Standards and Capital and Liquidity Requirements, except for the rules that apply exclusively to GSIB.[242]

The banking entities in Category III are those firms that do not fall into Categories I and II and which have an amount equal to or greater than $ 250

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[240] *Prudential Standards for Large Bank Holding Companies, Savings and Loan Holding Companies, and Foreign Banking Organizations*, FEDERAL REGISTER (2019), p. 4. https://www.federalregister.gov/documents/2019/11/01/2019-23662/prudential-standards-for-large-bank-holding-companies-savings-and-loan-holding-companies-and-foreign (last visited May 26, 2020).

[241] *Changes to Applicability Thresholds for Regulatory Capital and Liquidity Requirements*, FEDERAL REGISTER (2019), https://www.federalregister.gov/documents/2019/11/01/2019-23800/changes-to-applicability-thresholds-for-regulatory-capital-and-liquidity-requirements (last visited May 26, 2020).

[242] Davis Polk, *Final Tailoring Rules for U.S. Banking Organizations*, DAVIS POLK & WARDWELL LLP (2019), https://www.davispolk.com/publications/final-tailoring-rules-us-banking-organizations (last visited Oct 16, 2020).

billion in total consolidated assets, or an amount equal to or greater to $ 100 billion in total consolidated assets and an amount equal to or greater than $ 75 billion in any of these three specific risk indicators: weighted short-term wholesale fund; non-bank assets or off-balance sheet exposure. Significant changes are expected for this category of banks. For example, the calculation of advanced approaches to calculate the risk-weighted assets (RWAs) for counterparty credit risk is no longer required. Besides, this category has reduced Liquidity Coverage Ratio requirements for certain bank institutions.[243]

Finally, Category IV includes companies that do not belong to Categories I, II and III and have an amount greater than or equal to $ 100 billion in total consolidated assets. There is a significant change for these firms, given that the frequency of liquidity stress tests is reduced. The frequency of company-run stress tests is also reduced.[244]

These four categories represent a significant evolution in the methods of applying proportionality since they create a further distinction between banks, whose regulation is no longer distinguished using a single threshold. These measures were then followed by others, more aimed at providing temporary relief to the banks affected by the crisis brought by the coronavirus in 2020.[245]

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[243] *Ibid.*
[244] *Ibid.*
[245] *Regulatory Capital Rule: Temporary Changes to the Community Bank Leverage Ratio Framework*, FEDERAL REGISTER (2020), https://www.federalregister.gov/documents/2020/04/23/2020-07449/regulatory-capital-rule-temporary-changes-to-the-community-bank-leverage-ratio-framework (last visited Oct 16, 2020).

From the examples cited above, therefore, the United States legislator's profound effort and the various supervisors to apply proportionality in banking regulation is evident. It is not defined with the term proportionality, but with the concept of "tailoring rules," and represents an interesting application of the methodology based on the application of banking regulation based on the division of banking entities into categories.

2.11 Conclusions.

Various aspects of proportionality in banking regulation emerged from this overview of the US system. Although the legislator does not refer to the concept of proportionality, in the banking regulation after 2017, there is specific attention to making the regulation more tailored. Indeed, there are substantial differences in the application of the proportionality before and after the implementation of the Economic Growth, Regulatory Relief, and Consumer Protection Act. In the Presidential Executive Order 13772, titled "Core Principles for Regulating the United States Financial System" signed by U.S. President Donald Trump on February 3rd, 2017, one of the declared core principle was to “(f) make regulation efficient, effective and appropriately tailored.” On the contrary a reference of the tailored regulation is absent in the Remarks made by President Obama in 2009. However, the principle defined in Executive Order 13772 is not comparable to a principle found in a treaty or

constitution. While the latter has a wider impact, the principle defined in the Executive Order governs the specific regulation to which the Executive Order refers. Therefore, it does not have a broad value and is easily subject to changes by the law or acts having law force issued subsequently.

The Dodd-Frank Act's intentions and the Economic Growth, Regulatory Relief, and Consumer Protection Act are different. One of the Economic Growth, Regulatory Relief, and Consumer Protection Act's objectives is to "provide tailored regulatory relief." Therefore, this Act has the intention to intervene in a targeted manner and considering the specificities of financial institutions operating in the market. On the contrary, the Dodd-Frank Act aimed at promoting financial stability, ending the "too big to fail," protecting American taxpayers and consumers. Hence, proportionate regulation did not seem to be at the center of the legislator's concerns in the Great Financial Crisis's aftermath. The greater proportionate approach of the Economic Growth, Regulatory Relief, and Consumer Protection Act is also visible in the different rules. For example, it is interesting to recall the approach adopted in section 401, in which the enhanced prudential regulation is generally applied to institutions with assets of more than $250 billion, and on a discretionary basis to institutions that have assets greater than or equal to $100 billion, on a case by case analysis of the Federal Reserve. This measure is more detailed than the previous framework established by the DFA, which provided an enhanced prudential regulation for banks with more than 50 billion in assets. Section 401 may require a more

significant effort by the Federal Reserve in determining which banks are subject to such regulation, but in any case, this seems to be an approach that guarantees more significant tailoring.

Criticism is also not lacking for the Economic Growth, Regulatory Relief, and Consumer Protection Act; however, while the criticisms of the Dodd-Frank Act focused mainly on the fact that this is a disproportionate measure, the criticisms of the Economic Growth, Regulatory Relief, and Consumer Protection Act concern issues relating to financial stability rather than the disproportionality of the measures adopted. Finally, further examples of proportionality are present in the Federal Reserve's regulations and the Office of Comptroller of the Currency and the Federal Deposit Insurance Corporation. In these examples, the larger banks are divided into four categories. In this sense, the American legal experience reflects an interesting evolution of the application of proportionality in banks. Over the years, there has been a notable increase in the regulatory tailor's level, starting from the provisions of the Executive Order 13772 in 2017.

Chapter 3

The principle of proportionality in the EU Banking Regulation.

"*Europe will not be made all at once, or according to a single plan. It will be built through concrete achievements which first create a de facto solidarity.*"
Robert Schuman, Declaration of May 9th, 1950.

Summary: 3.1 Introduction; 3.2 A Necessary Premise; 3.3 The European Regulatory Response to the Great Financial Crisis; 3.4 The European Discipline on Capital Requirements; 3.5 Overview of the Capital Requirements Directive IV and Regulation; 3.6 Proportionality in the Capital Requirements Directive IV and Regulation 3.7 The New Capital Requirements Package: Directive 2019/878/EU (CRD V) and Regulation 2019/876/EU (CRR II); 3.8 Proportionality Elements in the New CRD IV and CRR II; 3.9 Case Study: Banker's Remuneration Provisions, and the Discordance Between the European Union and the United Kingdom; 3.10 Conclusions.

3.1 Introduction.

The previous chapter analyzed the banking regulation in the US legal system. Even if the concept of proportionality is not expressly recognized in the US banking regulation, the second chapter showed several examples of applying a tailored regulation depending on financial institutions' characteristics. This chapter analyzes the jurisdiction in which proportionality is considered as a

principle. Indeed, in the European Union, proportionality is an expressed principle; unlike in the United States, it forms part of a treaty. The application of the principle in the European Union is different from the application in the United States, in which the primary law defines the applicability thresholds of the discipline. Besides, the U.S. legislator recently provided for a set of measures with the Economic Growth, Regulatory Relief, and Consumer Protection Act of 2018 that give regulatory relief to community banks present throughout the United States and in particular in rural areas.[246]

In the European Union, the landscape appears different; in fact, there is not the same integration level in the United States, given that the European Union has a recent story. If the United States declared its independence from the British Empire on July 4th, 1776, the European Union has only become so in the past few decades. The path of integration began through the establishment of international organizations starting in 1948. European citizens started talking about the European Union replacing the European Communities only with the Lisbon Treaty in 2009.[247] Hence, the European Union's historical background must necessarily be taken into account when talking about financial regulation in the European Union. In light of the specific features that characterize the European Union, chapter three considers some examples of how the European

[246] David W. Perkins et al., *op. cit.*, 12.
[247] For an overview of the path towards the establishment of the European Union, see, *ex multis*, Damian Chalmers, Garet Davies & Giorgio Monti, EUROPEAN UNION LAW 23-56 (2014).

Union's banking discipline has implemented the principle of proportionality. The Capital Requirements regulation, which transposed the Basel agreements into the European Union, will be analyzed. This regulation has received severe criticism because it does not guarantee the effectiveness of the principle of proportionality. With the new regulatory package on Capital Requirements (Regulation 2019/876/EU CRR II, and Directive 2019/878/EU CRR V), there seems to be an attempt by the European legislator to make the principle of proportionality more effective. However, special consideration is reserved for supervisors in setting technical standards and the member states to achieve the objectives set by the European legislator.

The chapter is structured as follows. Following the introduction, the second section introduces the European Union's specificities, starting from its story and describing the legislative instruments available to the European legislator. Section 3.3 describes the effects of the great financial crisis within the European Union and the reform of the financial sector adopted by the European legislator in response to the crisis. The fourth section focuses on the regulation on Capital Requirements, analyzing the different packages of reforms on Capital Requirements that the European legislator adopted from 2000 until today. The fifth section describes the regulation's key points on the Capital Requirements (Regulation 2013/575/EU CRR and Directive 2013/36/EU CRD). The sixth section highlights some examples of the application of the proportionality principle in CRR and CRD IV. The seventh section deals with the new Capital

Requirements of 2019. The eighth section contemplates the aspects present in the new legislation that apply proportionality. The ninth section analyzes a specific case of proportionality in the remunerations sector. The tenth section contains the final remarks.

3.2 A Necessary Premise.

The analysis of the concept of proportionality in the context of the European Union law requires some clarifications. This elucidation is necessary in order to understand the intrinsic to the nature of this organization. Indeed, the nature of the European Union is currently the subject of several theories.[248] The European Union was initially conceived as an international organization, given that an international treaty established it. However, over time this organization has evolved, and the European treaties gained the constitutional status.[249]

The European Union is the result of cooperative efforts that started after the Second World War. Initially, this cooperation resulted in three international organizations: the Organization for European Economic Cooperation, the Western European Union, and the Council of Europe. The Organization for

[248] Robert Schütze, *op. cit.* 50–72.
[249] *Idem*, 75.

European Economic Cooperation was created in 1948 by 16 European states to manage the Unites States' international aid for European reconstruction. The Western European Union was an alliance formed with the Brussels Treaty in 1948.[250] The terms of the Brussel Treaty were modified in 1954. This international organization aimed to use military security and political cooperation in order to prevent another war in Europe. The Council of Europe was established in 1949 to protect human rights and fundamental freedoms in Europe. None of these organizations aimed to lead to the European Union. With the 1951 Treaty of Paris, the European Coal and Steel Community (ECSC) was founded. As can be seen from the name of the ECSC itself, the Community has been set up to integrate a specific sector, *i.e.*, coal and steel production. Six European States founded the European Coal and Steel Community: Italy, France, Luxembourg, Germany, Belgium, and the Netherlands. With the ECSC, these six States intended to move away from the ordinary forms of international treaties and organizations to further favor states' integration.[251]

Subsequently, in 1957 the Treaty of Rome was stipulated and created the European Atomic Energy Community and the European Economic Community. The Treaty of 1965 partially merged these three communities and established the Single Council and the Single Commission of the European Communities. The Maastricht Treaty of 1992, which entered into force a year later, integrated

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[250] Anthony Arnull et al., EUROPEAN UNION LAW 4 (2006).
[251] Robert Schütze, *op. cit.*, 3-5.

the three European Communities into the (old) European Union. The first article of the Treaty on European Union defined the constitutional structure of the old European Union: "By this Treaty, the High Contracting Parties establish among themselves a European Union, hereinafter called "the Union." This Treaty marks a new stage in creating an ever-closer union among the people of Europe, in which decisions are taken as closely as possible to the citizens. The Union shall be founded on the European Communities, supplemented by the policies and forms of cooperation established by this Treaty. Its tasks shall be to organize, in a manner demonstrating consistency and solidarity, relations between the member states and between their peoples".[252]

This article established the European Union, *i.e.*, an international organization other than the European Communities already existing. The Maastricht Treaty indeed provided common provisions that established that a single institutional framework should serve the Union. The Maastricht Treaty organized the European Union in three pillars, which were the European communities (First Pillar), Common Foreign and Security Policy (Second Pillar), and Justice and Home Affairs (Third Pillar). Several changes to the treaty characterized the decade following the Maastricht Treaty. The reasons were mainly because with the collapse of the Berlin Wall in 1989, Eastern Europe wanted to join Western Europe through the European Union. The European Union has started not only

[252] Art. A EU (old).

an essential process of expansion but also evolution towards a political union, through institutions that were democratic and transparent. In order to respond to these needs, the Amsterdam Treaty was signed in 1997 and the Nice Treaty in 2001. On this point, Prof. Schütze observed that both Treaties have proved to be fragmented reforms resulting from pragmatic and temporary political compromises.[253]

The Lisbon Treaty, signed in 2007 and entered into force in 2009, marks a turning point. This Treaty differs significantly from its predecessors. It announces that the European Union replaces the European Community. Although the Lisbon Treaty merged the European Community established by the Treaty of Rome and the old European Union established by the Maastricht Treaty into a single new European Union, the Treaty of Lisbon maintained the treaties' dual structure. Indeed, before the Lisbon Treaty, there was the Treaty of the European Union (old TEU) and the Treaty of the European Community (TEC). With the Lisbon Treaty, there is now the Treaty on European Union (new TEU), which contains the general provisions on the European Union and the Treaty on the Functioning of the European Union (TFEU), which contains specific provisions on institutions and policies of European Union.[254]

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[253] Robert Schütze, *op. cit.,* 28.
[254] *Idem,* 38.

The European Union has evolved profoundly over the years. It was initially an organization limited to specific economic sectors and progressively has expanded its scope at a jurisdictional and geographical level. Moreover, the European Union has also deepened its supranational feature, especially considering the normative level. Indeed, a characteristic of the European Union is its law. The European Union divides its legal acts into different types. At the top are the treaties, also known as primary law. The law that derives from the principles and objectives of the treaties is also known as secondary law. Secondary law stands out in regulations, directives, decisions, recommendations, and opinions.[255]

According to paragraph 2 of article 288 of the Treaty on the Functioning of the European Union, a regulation has general application, and it is binding in its entirety. A characteristic of the regulation is that it is directly applicable in all member states. In other words, the member states do not need to adopt an internal act to ensure that the regulation can be applied internally. This feature is typical of directives. Directives are binding on the Member State to which is addressed, regarding the objective to achieve. However, they leave the Member State the discretion to determine the form and method to achieve the directive's objective. Paragraph 4 of article 288 TFEU describes decisions as binding in its entirety and specifies that applicability is limited to those to whom it is

[255] Damian Chalmers, Garet Davies, Giorgio Monti, *op. cit.*, 106 – 153.

addressed if specified. Decisions share a common aspect with regulations as they apply in their entirety and are directly applicable. However, decisions were initially not designed to be generally applicable, despite the European practice developed a non-addressed decision. Finally, paragraph 5 of art. 288 specifies that recommendations and opinions are not binding, having the aim of declaring the positions of the European institutions (recommendations) or of making declarations (opinions) without imposing legal obligations. Other legal acts characterized the European regulatory framework, including delegated acts, which allow the European Commission to integrate or modify non-essential parts of other legislative acts and the implementing acts that allow the Commission to adopt conditions aimed at ensuring the uniform application European Union law.[256]

Hence, it is evident that European Union law has a complex structure, in which legislative acts sometimes have a direct effect on the citizens of the European Union (such as in the case of regulations) and sometimes require the legislative intervention of the member states in order to be effective (for example in the case of directives). In light of the above, it is clear that the European Union appears to be continually evolving. It was born as an international organization, but it took on different connotations over the years than the typical concept of an international organization. This process also emerged from the Court of

[256] *Idem*, 77-115.

Justice's caselaw, which insisted on the non-contractual nature of European Union law, unlike the regulatory regime that characterizes international treaties.[257]

Moreover, the Maastricht Treaty introduced the concept of citizenship of the European Union. European citizenship is closely related to the citizenship of a Member State, according to Article 9 of the Treaty on European Union (TEU).[258] The institutions of the European Union also have particular characteristics. For example, the European Union citizens elect the European Parliament, and this aspect brings the European Union closer to a "federal" perspective. Instead, the European Council is composed of the heads of state or government of the member states, the European Council President, and the European Commission President. In this sense, the Council would have connotations that bring it closer to an international organization. This hybrid nature has led to several theories about the nature of the European Union.

On the one hand, there is the thought of those who consider state sovereignty as indivisible. In this sense, they see the European Union merely as an international organization. On the contrary, the federal theory openly maintains that the

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[257] *Commission v. Luxembourg and Belgium,* Case 90-91/63 [1963] ECR 625. ECLI:EU:C:1964:80. In this case the European Court of Justice stated that: "[…] the Treaty is not limited to creating reciprocal obligations between the different natural and legal persons to whom it is applicable, but establishes a new legal order which governs the powers, rights and obligations of the said persons, as well as the necessary procedures for taking cognizance of and penalizing any breach of it."

[258] Damian Chalmers, Garet Davies, Giorgio Monti, *op. cit.*, 26.

European Union is a federation of States. Moreover, the "*Sui Generis* Theory" considers the European Union as an incomparable legal phenomenon. [259] Although the European Union cannot incontrovertibly be defined as a federal State, the characteristics of the European Union described above allow for an interesting comparative analysis with the United States legal system. Having clarified the specific features that characterize the European Union, as well as its ever-changing nature, the next paragraph provides an overview of the financial regulations adopted in the aftermath of the Great Financial Crisis in 2008. The analysis is conducted in light of the European Union's particularities, which differentiate it from the path adopted overseas in the United States.

3.3. The European Regulatory Response to the Great Financial Crisis.

The European Union regulates the financial sector, with the specific objective of building a single and integrated financial system. Indeed, one of the European Union's objectives consists precisely in creating an internal market through the elimination of internal restrictions. The European Union's internal market concept is based on four principles: free movement of goods, services, capital, and services. Besides, European banking supervision is based on principles

[259] For an examination of the different theories see Robert Schütze, *op. cit.,* 43 – 75.

aimed at achieving market integration; these principles are home country control, mutual recognition, and minimum harmonization of laws. Another fundamental element of European integration is the discipline of competition. Indeed, the European Union aims at the level playing field in the market of all member states for the companies that operate within the European Union borders. The level playing field for all the companies guarantees the competitiveness of goods and services as well as better protection of the European consumers.[260]

Financial regulation in the European Union was designed on the "Lamfalussy procedure," initially developed in 2001. This procedure is structured on four levels of legislation. The first level of the Lamfalussy procedure concerns the adoption of directives and regulations adopted through the co-decision procedure by the Parliament and the European Council, in order to establish the basic principles in a specific sector. In the second level, specialist committees and representatives of authorities suggest the technical details. In the third level, national authorities work to coordinate the European Union's law with the law of the member states. The fourth level relates to a conformity assessment and implementation of the legislative initiative.[261]

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[260] Articles 101 (previously Article 81 TEC) and 102 (previously Article 82 TEC) of the Treaty on the Functioning of European Union concern rules applying to undertakings in the matter of competition.

[261] Duncan Alford, *The Lamfalussy Process and EU Bank Regulation: Another Step on the Road to Pan-European Regulation*, 25 ANNUAL REVIEW OF BANKING AND FINANCIAL LAW 397–403 (2006).

The Lamfalussy procedure is adopted in all areas of competence of the European Union and acquires a specific financial regulation role. The latter has undergone profound changes, especially following the Great Financial Crisis, which gave input for a significant reform process. Indeed, the financial crisis affected Europe in July 2007, when European banks first suffered from the subprime-related losses and in August 2007, when banks stopped lending money to each other. The crisis led to financial instability, which jeopardized European banks' soundness and forced some domestic banks to demand recapitalization measures. The financial collapse of Iceland, albeit this state is not a member of the European Union, affected the rest of Europe; and preceded the sovereign debt crisis, which started in Greece in 2010; and expanded in the other EU member states.[262]

Given the global importance of the financial system, the G20 and the Financial Stability Board have internationally coordinated the reforms to be undertaken. Therefore, the reform program of the European Union has reflected the reform agenda of the G20, initially granted in 2008 in Washington. At the November 2008 summit, the G20 leader analyzed the causes of the crisis and dealt with the issues of the financial market and the global economy for the first time at a

[262] Pedro Gustavo Teixeira, *Regulation of the European Financial Market After the Crisis,* EUROPE AND THE FINANCIAL CRISIS 9 (2011).

global level. Further summits followed the summit held in Washington.[263]

Dabrowski argued that the European response to the crisis intervened late and was not sufficiently coordinated. The danger of a financial crisis was underestimated, and the reduction in liquidity was initially considered a temporary effect deriving from what occurred in the United States. However, the bankruptcy of Lehman Brothers in September 2008 dramatically infected global financial markets, causing anomalies in the functioning of various segments of the global financial system. According to Dabrowski, this phase would, therefore, have revealed the systemic weaknesses of European financial institutions.[264] Also, Moloney stated that if on the one hand, the regulatory structure of the European Union meant that cross-border activities carried out by European large banking groups were facilitated, on the other hand, this structure did not adequately address the issue of cross-border supervision, deposit protection, and crisis resolution.[265]

In order to remedy the delicate situation, in November 2008, the European Commission commissioned the de Larosière Group to analyze the European Union crisis. On February 25th, 2009, the group chaired by Jacques de Larosière

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[263] London and Pittsburgh in 2009, Toronto and Seoul in 2010, Cannes in 2011, San José del Cabo, Los Cabos in 2012, St. Petersburg in 2013, Brisbane in 2014, Serik, Antalya in 2015, Hangzhou in 2016, Hamburg in 2017, Buenos Aires in 2018 and Osaka in 2019.
[264] Marek Dabrowski, *The Global Financial Crisis: Lessons for European Integration*, 34 ECONOMIC SYSTEMS 42 (2010).
[265] Niamh Moloney, *EU Financial Market Regulation After the Global Financial Crisis: "More Europe" or More Risks?* 47 COMMON MARKET LAW REVIEW 1319 (2010).

produced a report that analyzed the complex causes of the financial crisis, the regulatory and supervisory remedies. The report also provided recommendations to promote financial stability at the global level. This report highlighted several regulatory weaknesses and supervisory errors, and the absence of a macro-prudential supervision system.[266]

This report was received very positively by the European authorities. Indeed, the European Commission, in its communication of May 27th, 2009, considered that the final report of the Larosière Group, presented on February 25th, 2009, delineated a "balanced and pragmatic vision for a new system of European Financial Supervision. At the core of this vision are proposals to strengthen cooperation and coordination between national supervisors including through the creation of new European Supervisory Authorities, and, for the first time, a European level body charged with overseeing risk in the financial system as a whole. "[267]

Based on the recommendations made by the High-Level Expert Group, chaired by Jacques de Larosière, the European Commission on March 4th, 2009, drew up an action plan called "Driving European Recovery." This plan contained a

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[266] Jacques De Larosière, *Report of the High-level Group on Financial Supervision in the EU* EUROPEAN COMMISSION (2009), https://ec.europa.eu/economy_finance/publications/pages/publication14527_en.pdf (last visited Sep 16, 2020).

[267] *Communication, European Financial Supervision of May 27th, 2009* EUROPEAN COMMISSION (2009), https://ec.europa.eu/transparency/regdoc/rep/1/2009/EN/1-2009-252-EN-F1-1.Pdf (last visited Sep 16, 2020).

reform program with five primary objectives. The first objective aspired to provide the European Union with a supervisory framework capable of identifying potential risks in time and being able to address them before they can have a negative impact. The second objective consisted of filling the regulatory gaps, where European and national regulation is insufficient or incomplete. The third objective was to ensure that investors, consumers, and small and medium-sized businesses are confident about access to credit, their deposits, and the rights relating to financial products. The fourth objective consisted in improving risk management in financial companies and align remunerative incentives with sustainable performance. Finally, the fifth objective aspired to ensure effective penalties.[268]

In 2009 the European Council recommended the adoption of a Single Rulebook,[269] which currently consists of the most important legal acts for the Banking Union. The legal acts that the Single Rulebook includes are the discipline on capital requirements, on the deposit guarantee system, and the recovery and resolution of banks. The Single Rulebook aims to eliminate differences in legislation between the member states, ensure a level playing field

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[268] *Communication for the Spring European Council of 4 March 2009–Driving European Recovery*, EUROPEAN COMMISSION (2009), https://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2009:0114:FIN:EN:PDF (last visited Sep 16, 2020).

[269] *Brussels European Council 18/19 June 2009 Presidency Conclusions* COUNCIL OF THE EUROPEAN UNION (2009), https://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/108622.pdf (last visited Sep 16, 2020).

for banks, and protect consumers.[270] Subsequently, a package of legislative measures for the financial sector was presented in June 2010. This package has the form of communication and is called "Regulating financial services for sustainable growth."[271] The intent of the measures adopted by the European Union is to safeguard financial stability, protect investors, and protect the European single market. At the same time, the European Union tried to prevent individual member states from adopting protectionist measures in response to the crisis. The financial crisis has endangered the fundamental assumptions on the Single Market's functioning, given that the member states first tried to introduce domestic measures to protect their domestic market, thus isolating themselves from the Single Market.[272]

In light of the above, the European Union developed a new regulatory structure for the Single Market, aimed at strengthening the supervision system: the European System of Financial Supervision. The system is based on two pillars. On the one hand, the micro-prudential supervision by three European sectoral authorities. On the other hand, the macro-prudential supervision by the European Systemic Risk Board. Regarding the micro-prudential supervision,

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[270] *The Single Rulebook*, EUROPEAN BANKING AUTHORITY (2018), https://eba.europa.eu/regulation-and-policy/single-rulebook (last visited Sep 16, 2020).
[271] *Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the European Central Bank - Regulating financial services for sustainable growth* EUROPEAN COMMISSION (2010), https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52010DC0301&from=IT (last visited Sep 16, 2020).
[272] Pedro Gustavo Teixeira, *op. cit.*, 10.

the European Union established the European Supervision System in 2010 through a series of regulations to overcome the gaps in financial supervision that emerged following the great financial crisis. Directive 2010/78/EU defined the powers of the European Supervisory Authorities (ESAs).[273] The three sectoral authorities established are the European Banking Authority (EBA)[274], the European Securities and Markets Authority (ESMA)[275] and the European Insurance and Occupational Pensions Authority (EIOPA).[276] The European Systemic Risk Board is responsible for the macro-prudential supervision of the European Union's financial system, intending to prevent or mitigate systemic risk.[277]

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[273] *Directive 2010/78/EU of the European Parliament and of the Council of 24 November 2010 amending Directives 98/26/EC, 2002/87/EC, 2003/6/EC, 2003/41/EC, 2003/71/EC, 2004/39/EC, 2004/109/EC, 2005/60/EC, 2006/48/EC, 2006/49/EC and 2009/65/EC in respect of the powers of the European Supervisory Authority (European Banking Authority), the European Supervisory Authority (European Insurance and Occupational Pensions Authority) and the European Supervisory Authority (European Securities and Markets Authority),* EUR-LEX 120 (2010), https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32010L0078 (last visited Oct 21, 2020).

[274] *Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC*, EUR-LEX (2010), https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32010R1093 (last visited Oct 21, 2020).

[275] *Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC*, EUR-LEX (2010), https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32010R1095 (last visited Oct 21, 2020).

[276] *Regulation (EU) No 1094/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Insurance and Occupational Pensions Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/79/EC*, EUR-LEX (2010), https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32010R1094 (last visited Oct 21, 2020).

[277] *Regulation (EU) No 1092/2010 of the European Parliament and of the Council of 24 November 2010 on European Union macro-prudential oversight of the financial system and*

Among the competences of the ESAs, there is the drafting of technical regulatory standards in their area of responsibility. ESAs carry out this competence within the delegated powers' limits following article 290 of the Treaty on the Functioning of the European Union (TFEU). These authorities submit a draft of standards to the European Commission, which can adopt them as delegated acts. Once the European Commission approves them, so they become delegated acts, they have a binding effect across the European Union. The Commission cannot change the content of the drafts without first coordinating with the supervisory authority.[278]

ESAs can also issue guidelines and recommendations to financial institutions to ensure the application of European Union law and develop coherent practices. The guidelines are not binding; however, the "comply or explain" procedure is applied. In other words, national authorities that do not comply with the guidelines have to declare why they were not compliant. ESAs can also transmit recommendations to a specific supervisory authority, particularly if they believe that this authority is keeping itself away from the application of European Union law.[279]

Moreover, ESAs have a coordinating role in financial crisis; in fact, they ask national authorities to take specific actions in order to be compliant with

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establishing a European Systemic Risk Board, EUR-LEX (2010), https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32010R1092 (last visited Oct 21, 2020).
[278] Pedro Gustavo Teixeira, *op. cit.*, 14.
[279] *Ibid.*

European regulation. ESAs also have a crucial role in the colleges of supervisors, with the aim that these colleges are efficient and function adequately. Indeed, ESAs can participate in colleges as observers.[280] ESAs also receive all relevant information that has been shared by the members of the colleges and manage a central database to make the information available to national supervisors. ESAs also make decisions in cases where there are disagreements between national authorities regarding the coordination of activities. Also, ESAs have a significant role in the consumer protection sector, being able to communicate warnings if the financial activity may pose risks to the stability of the financial system.[281] Finally, ESAs manage systemic risk, collaborating with the European Systemic Risk Board to develop indicators aimed at measuring the systemic risk of financial institutions.[282]

The European Systemic Risk Board, established in 2011, also implements the greater integration of European financial supervision proposed by the Group led by de Larosière. The European Systemic Risk Board is a member-driven organization. Its governance structure includes the Chair, which is the president of the European Central Bank; two Vice-Chairs; a General Board; a Steering Committee; a Secretariat: an Advisory Scientific Committee; and an Advisory Technical Committee. The European Systemic Risk Board can request

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[280] *Ibid.*
[281] Maria Lucia Passador, *European Supervisory Authorities tra mercati e vigilanza: il caso dell'EIOPA*, CONTRATTO E IMPRESA EUROPA 411 (2017).
[282] Pedro Gustavo Teixeira, *op. cit.*, 15.

information from the ESAs. Suppose the ESAs do not give the information because it is not available or not available at an appropriate time. In that case, the European Systemic Risk Board can request this information directly from the relevant national institutions, including, for example, national supervisors or national central banks. Another important task of the European Systemic Risk Board is to issue warnings and recommendations to the European Union, the member states, or national and European supervisory authorities.[283]

The description of the European Union framework allows understanding the context in which the principle of proportionality operates. It also allows in understanding its methods of application. The first chapter of this thesis indicated that the principle of proportionality is established by art. 5 of the Treaty on European Union, which stands at a general level as an instrument limiting the exercise of the powers of the European Union, to frame the actions of the European institutions within specified limits. The actions of the European institutions must be limited to achieving the objectives set by the Treaties. At the same time, the European Union cannot ignore the definition of proportionality provided in the financial context by the Basel Committee (see *supra* at chapter 1). From the brief overview made in this paragraph, however, it is also evident that the legislative solutions introduced in the European Union as a response to the financial crisis have strongly reflected the

[283] Luigi Chiarella, *The Single Supervisory Mechanism: The Building Pillar of the European Banking Union*, 34 UNIVERSITY OF BOLOGNA LAW REVIEW 43 (2016).

G20 agenda. Hence, the factors that influenced European financial regulation are manifold. Copious legislative acts have been issued in order to remedy the devastating effects produced by the Great Financial Crisis.

Concerning the Basel agreements' implementation, in particular, Basel 3, the European Union has proceeded to adopt a new regulation on the Capital Requirements. The analysis of a specific package of reforms allows understanding the application methods of the principle of proportionality adopted by the European legislator. The next paragraph will, therefore, proceed to analyze the Capital Requirements regulation, with a brief reconstruction of the legislative interventions that have taken place over the years.

3.4 The European Discipline on Capital Requirements.

In the aftermath of the Great Financial Crisis, the European Union faced and is still facing a large project of reforms. This project involves the implementation of more than forty legislative measures for the reform agenda. The measures introduced in response to the global financial crisis constitute the Single Rulebook applicable to all the financial actors operating in the European member states. As early as October 2008, the Commission had proposed to reform the Capital Requirement Directive (CRD II), which came into force in 2009. This directive intervened in many areas, reforming the previous extensive exposures regime, adopting management principles of the risk based on the

quality of liquidity available to the bank and quality of capital. The directive also introduced the obligation for banks to establish supervisory colleges for cross-border groups, in addition to establishing rules on their operation.[284]

Before getting to the heart of the description of the Capital Requirements Directive and Regulation, which has been issued following the Great Financial Crisis to implement Basel 3, it seems appropriate to make an *excursus* on the evolution of this discipline over the years. The regulation concerning Capital Requirements refers to a set of disciplines aimed at implementing the Basel II and Basel III agreements in the European Union. The Capital Requirements Directives have replaced the previous 1993 Capital Adequacy Directive.

The first Capital Requirements Directive was issued in 2000, with which various banking directives and subsequent amendments have been replaced by a single directive, the Directive 2000/12/EC, "relating to the taking of business. "Under article 2 of the directive mentioned above, it applied "to all credit institutions." This directive is no longer in force, having ceased its validity on July 19th, 2006. The European Union subsequently adapted its banking regulation following the issuing in 2004 of Basel II, emanating on the one hand Directive 2006/48/EC (which is a recast of the previous directive 2000/12/EC concerning the directive 2006/49/EC, *i.e.*, a recast of the previous directive the capital adequacy of investment firms and credit institutions (Council Directive

[284] Moloney, *op. cit*., 1326.

93/6/EEC of March 15th, 1993). Also, this directive is no longer in force, having ceased its validity on December 21st, 2013.[285]

The CRD II therefore arises in a temporal context following these directives. The European Parliament and the Council have in fact adopted this directive, 2009/111/EC, on September 16th, 2009, intending to ensure the financial stability of banks and investment companies. This directive is still in force and has amended "Directives 2006/48/EC, 2006/49/EC, and 2007/64/EC regarding banks affiliated to central institutions, certain own funds items, large exposures, supervisory arrangements, and crisis management ".[286] CRD II is followed a year later by the CRD III. The council and the European parliament have adopted Directive 2010/76/EU, which has amended Directives 2006/48/EC and 2006/49/EC as regards capital requirements for re-securitization and the trading book as well as the supervisory review of remuneration policies. The implementation of this directive has followed two phases. As provided by article 3 of Directive 2010/76/EU, the first phase related to remuneration and some pre-existing capital requirements was completed on January 1st, 2011. The Directive then provided for the implementation of the remaining provisions by

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[285] *Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions*, EUR-LEX (2006), https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32006L0048 (last visited Oct 21, 2020).

[286] *Directive 2009/111/EC of the European Parliament and of the Council of 16 September 2009 Amending Directives 2006/48/EC, 2006/49/EC and 2007/64/EC as Regards Banks Affiliated to Central Institutions, Certain own Funds Items, Large Exposures, Supervisory Arrangements, and Crisis Management*, EUR-LEX (2009), https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32009L0111 (last visited Sep 17, 2020).

December 31st, 2011. This Directive is no longer in force, and the date of the end of validity was December 31st, 2013.[287]

Following the new capital standards set by the Basel Committee (Basel III), the European legislator has issued a new regulatory package, composed of Regulation 575/2013/EU (CRR I)[288] on the prudential requirements for the credit institutions and investment companies and Directive 2013/36/EU[289] on access to the activity for credit institutions and prudential supervision.[290]

The European legislator modified these acts and published on June 7th, 2019, in the Official Journal of the European Union Directive 2019/878/EU and Regulation 2019/876/EU. Directive 2019/878/EU of May 20th, 2019 amends the Capital Requirements Directive IV as regards exempted entities, financial holding companies, mixed financial holding companies, remuneration,

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[287] *Directive 2010/76/EU of the European Parliament and of the Council of 24 November 2010 Amending Directives 2006/48/EC and 2006/49/EC as Regards Capital Requirements for the Trading Book and for Re-securitisations, and the Supervisory Review of Remuneration Policies*, EUR-LEX (2013), https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32010L0076 (last visited Sep 17, 2020).

[288] *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*, EUR-LEX (2013), https://eur-lex.europa.eu/legal-content/en/ALL/?uri=celex:32013R0575 (last visited Oct 21, 2020).

[289] *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*, EUR-LEX (2013), https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32013L0036 (last visited Oct 21, 2020).

[290] The Capital Requirements Directive IV (CRD IV) is an EU legislative package that contains prudential rules for banks, building societies and investment firms, see: *CRD IV* FINANCIAL CONDUCT AUTHORITY (2015), https://www.fca.org.uk/firms/crd-iv (last visited Oct 16, 2020).

supervisory measures, and powers and capital conservation measures (CRD V).[291]

Regulation 2019/876/EU, which has been issued the same day of Directive 2019/878/EU, amends the Capital Requirements Regulation as a leverage ratio, the net stable funding ratio, requirements for own funds and eligible liabilities, counterparty credit risk, market risk, exposures to central counterparties, exposures to collective investment undertakings, large exposures, reporting and disclosure requirements (CRR II).[292]

3.5 Overview of the Capital Requirements Directive IV and Regulation.

Before considering some examples in which the European banking regulation applies the principle of proportionality, it seems appropriate to briefly outline the key points of the discipline on Capital Requirements. First, it is interesting to consider the scope of the directive and the regulation. In the aftermath of the

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[291] *Directive (EU) 2019/878 of the European Parliament and of the Council of 20 May 2019 Amending Directive 2013/36/EU as Regards Exempted Entities, Financial Holding Companies, Mixed Financial Holding Companies, Remuneration, Supervisory Measures and Powers and Capital Conservation Measures,* EUR-LEX (2019), https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32019L0878 (last visited Sep 17, 2020).

[292] *Regulation (EU) 2019/876 of the European Parliament and of the Council of 20 May 2019 Amending Regulation (EU) No 575/2013 as Regards the Leverage Ratio, the Net Stable Funding Ratio, Requirements for own Funds and Eligible Liabilities, Counterparty Credit Risk, Market Risk, Exposures to Central Counterparties, Exposures to Collective Investment Undertakings, Large Exposures, Reporting and Disclosure Requirements, and Regulation (EU) No 648/2012*, EUR-LEX (2019), https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32019R0876 (last visited Sep 17, 2020).

financial crisis, the European Union based its substantial financial regulatory reform on the G20 agenda. The reform was based explicitly on the standards set by the Basel Committee on Banking Supervision (Basel III). Since 1988,[293] the Basel Committee on Banking Supervision considered that Basel's standards on capital requirements provide for their application for "internationally active banks."[294] Hence, the main objective consisted in providing at the international level, uniform conditions in order to allow internationally active banks to exercise their activities. However, the European legislator had always applied the regulation that implements Basel agreements to all banks and investment firms; and it confirmed this approach also for the CRR/CRD package. In other words, Basel standards are applied to more than 8,300 European banks.[295]

The European Commission explained that this choice would be necessary for the European Union due to its peculiarities. Indeed, the European Single Market allows banks authorized in one Member State to provide services in another member states. Hence, according to the European Commission, these banks are more expected to be involved in cross-border activities. Moreover, the European Commission explained that the application of Basel's agreements

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[293] As explained *supra* at chapter 1, 1988 is the year of the first Basel agreement.
[294] The scope of application of Basel III follows the existing scope of the Basel II Framework ("International Convergence of Capital Measurement and Capital Standards"). Part. 1, I, 20 of the Basel II framework specifies that: "This framework will be applied on a consolidated basis to internationally active banks". *International Convergence of Capital Measurement and Capital Standards*, BANK FOR INTERNATIONAL SETTLEMENTS (2006), https://www.bis.org/publ/bcbs128.pdf (last visited Sep 16, 2020).
[295] *CRD IV Frequently Asked Questions*, EUROPEAN COMMISSION (2011), https://ec.europa.eu/commission/presscorner/detail/fr/MEMO_11_527 (last visited Sep 16, 2020).

only to a subgroup of banks would create competitive distortions and potential regulatory arbitrage.[296]

The following paragraphs will consider the questionability of this choice in terms of proportionality. However, after defining the scope, this paragraph will provide an overview of the CRR/ CRD IV package. As this is a large-scale intervention, the paragraph will address the main features of the legislation. The CRR/ CRD IV regulation, composed of the 2013/575/EU regulation and the 2013/36/EU directive, entered into force on January 1st, 2014.

It can be divided mainly into capital requirements, liquidity requirements, and corporate governance requirements and remuneration. The European legislator requires banks that possess specific capital requirements so that they can deal with unexpected losses, thus avoiding financial instability. The more the asset carries a risk, the higher the bank's capital will have to set aside to face the risk of loss. The regulation considers two typologies of assets based on their quality and risk: Tier 1 (T1) and Tier 2 (T2). Tier 1 and Tier 2 together constitute the total asset. Tier 1 is capital that allows the bank to continue its business and be solvent, while Tier 2 operates when the bank has become insolvent and needs capital to pay off its creditors and depositors. The main innovation of CRR/CRD IV consisted of increasing the quantity and quality of the capital. Regulation

[296] *Idem.*

2013/575/EU contains the capital requirements of Pillar I (*i.e.,* minimum capital requirement). Per the agreements undertaken following the G-20 summit of September 2009, CRR introduces the leverage ratio at part seven, art. 429 et seq.[297]

One of the most significant aspects of the CRR/ CRD IV regulation is represented by the Counterparty Credit Risk (CCR- Article 271 et seq.) and Credit Valuation Adjustment (CVA- Article 381 et seq.), which have been drawn up to correct the previous regulation. One of the disadvantages of the CRD III directive was that it did not deal adequately with risk in derivatives transactions. Subsequently, the Regulation 2012/648/EU on OTC derivatives, central counterparties, and trade repositories (EMIR) has improved the standards to derivative transactions carried out by banking institutions. The financial crisis revealed that the most severe risk concerns over-the-counter derivatives. Therefore, the CVA capital regime applies a capital charge to these instruments and aims to capture credit losses. The CVA capital regime also provides incentives for financial institutions to reduce the counterparty credit risk by clearing over-the-counter derivatives through central counterparties (CCPs).[298]

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[297]Rainer Masera, SFIDE E OPPORTUNITÀ DELLA REGOLAMENTAZIONE BANCARIA: DIVERSITÀ, PROPORZIONALITÀ E STABILITÀ 61 (2016).
[298]Niamh Moloney, *op. cit.* 385–423 (2016).

The CRD IV disciplines capital buffers: the capital conservation buffer, the counter-cyclical buffer, the global systemic institution risk buffer, the other systemic institutions' buffer, and the systemic risk buffer. Hence, CRD IV provides Basel III-required buffers (capital conservation buffer and counter-cyclical buffer), and EU specific buffers (global systemic institution risk buffer, other systemic institutions buffer, and systemic risk buffer).[299]

The capital conservation buffer aims to ensure that in periods when there are no market tensions, the banks set aside additional capital that can be used in the periods in which the institution suffers losses. If a bank violates certain thresholds, the Directive prescribes the adoption of measures that limit the distribution of dividends and bonuses. A counter-cyclical buffer is a tool that serves to mitigate procyclicality, *i.e.*, that set of mechanisms that contributes to amplifying cyclical fluctuations, improving the expansive phases but aggravating the recessionary phases. Therefore, a counter-cyclical reserve requires that a percentage of capital be set aside during the expansionary phases, to avoid excessive credit growth and draw on the reserve in case of recession.[300]

The global systemic institution risk buffer aims to cover systemic and structural risks. As an EU Member State, it is optional to introduce it to prevent and reduce long-term non-cyclical or macro-prudential risks. This buffer meets the need to

[299] *Ibid.*
[300] Masera, *op. cit.*, 63.

manage the separation of commercial banking activities within complex banking groups. The Basel agreements do not envisage this buffer; in fact, the United States managed the interactions between commercial banking and investment banking through the Volcker Rule (see *supra*, chapter 2). The other systemic institutions' buffer and the systemic risk buffer aim to reduce the moral hazard that could result from implicit state aid and external bailouts with the taxpayers' detriment. The CRR/ CRD IV framework requires the Commission and the member states to be able to establish more stringent capital requirements.[301]

Moreover, CRR/ CRD IV introduced two liquidity requirements: the liquidity coverage requirement (LCR) and the net stable funding requirement. The liquidity coverage requirement aims to reduce short-term liquidity risks and provides that banks must have high-quality liquidity reserves capable of covering cash flows in times of stress. The net stable funding requirement aims at guaranteeing stable financing. Based on this coefficient, long-term financial obligations must be guaranteed by stable financing. Furthermore, the CRR/ CRD IV regulation introduces provisions on governance, intending to prevent banking organizations from taking excessive risk, providing for a diversified composition of the boards of directors, and specifying the directors' quality and professional skills. The regulation on remuneration also aims to prevent banks

[301] *Idem*, 64.

from taking excessive risks. The compliance, audit and risk management offices carry out adequate checks in order to verify and correct the assumption of risk.[302]

The above overview is functional to the analysis that will be performed in the next paragraph. The next paragraph considers some examples of the application of the principle of proportionality in the discipline of Capital Requirements.

3.6 Proportionality in the Capital Requirements Directive IV and Regulation.

The CRR/ CRD IV discipline represents an essential reference to the principle of proportionality in the European Union. The reference to the principle of proportionality is present five times, both in the Capital Requirement Directive and in the Capital Requirement Regulation, while the adjective "proportionate" is present 26 times in the CRR and 21 times in the CRD IV. Indeed, there are references to this principle already in the introductory part, *i.e.*, the recitals. Furthermore, the principle is also referred to in the regulatory areas, including, for example, leverage, liquidity, public disclosure, corporate governance,

[302] *Idem*, 68.

prudential review process, and capital adequacy assessment.[303]

The examples of the application of the principle of proportionality are several. In some cases, an explicit reference is made to the concept of proportionality, as set out in article 5 of the Treaty on European Union. For instance, recital 104 of CRD IV states that, since the single member states cannot achieve the objective of the Directive, but they are better achieved at the EU level, the European Union may adopt measures following the principle of proportionality set out in article 5 of the Treaty on European Union and the CRD IV "does not go beyond what is necessary in order to achieve those objectives."[304]

Therefore, the European legislator, in legislating on the banking sector, uses the exact words of the Treaty on European Union in defining proportionality. In other cases, the European legislator has mentioned the principle of proportionality at an abstract level, leaving the application to the competent authorities. Sometimes, these authorities carry out a case-by-case assessment based on the provisions of the EBA's delegated acts and technical standards. For example, in art. 74 of CRD IV, relating to internal governance and recovery and resolution plans, the fourth paragraph provides for a reduction in the

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[303] Ignace Gustave Bikoula et al., *Dalla proporzionalità caso per caso alla proporzionalità strutturata*, SFIDE E OPPORTUNITÀ DELLA REGOLAMENTAZIONE BANCARIA: DIVERSITÀ, PROPORZIONALITÀ E STABILITÀ 118 (2016).

[304] Recital 104 of Directive EU/36/2013 (CRD IV) specifies that its objectives are "the introduction of rules concerning access to the activity of institutions, and the prudential supervision of institutions". These objectives cannot be sufficiently achieved by the member states.

obligations of an institution concerning recovery and resolution plans if, after consulting the competent authority, the competent authorities consider that the failure of a specific institution does not will have repercussions on financial markets, due to its size, business model and interconnectedness. [305]

In other cases, the European legislator asks the member states, when transposing the Directive, to establish more specific criteria in compliance with the principle of proportionality. This is, for example, what happens in section 3 of art. 76 CRD IV, about the treatment of risks, which the European legislator states that the member states ensure that the institutions that are "significant in terms of their size, internal organization and the nature, scope, and complexity of their activities establish a risk committee composed of members of the management body who do not perform any executive function in the institution concerned." Therefore, in this case, it is the member states that determine the criteria according to which a financial institution must establish the Risk Committee.[306]

The Capital Requirement Regulation contains many references to the proportionality approach of the legislation. For example, recital 128 declares that the European Commission and the European Banking Authority should ensure that technical standards developed by EBA in some issues should be applied to all institutions in a manner that is proportionate to their nature, scale,

[305] Article 74 was further modified by article 1 (19) of Directive EU/2019/878 (CRD V).
[306] Article 76 (3) of Directive EU/36/2013 (CRD IV).

and complexity.[307] Moreover, article 8 envisages the possibility for competent authorities to derogate in full or in part the application on liquidity requirements to an institution.[308] Also, article 10 considers the possibility to partially or fully waive the requirements to own funds, capital requirements, large exposures, exposures to transferred credit risk, liquidity, leverage, and disclosure. Competent authorities have the option to not apply these requirements to one or more credit institutions situated in the same Member State, which are permanently affiliated to a central body, which supervises them.[309]

References to proportionality are also made in article 99, where reporting requirements developed by EBA shall be proportionate to the nature, scale, and complexity of the institutions' activity.[310] Also, the frequency of disclosure at art. 433, is a matter that involves proportionality. Indeed, art. 433 prescribes that institutions shall publish the disclosure at least at annual basis. However, based on EBA's guidelines, institutions shall assess the need to publish the disclosure more frequently.[311] The issue of the Global Systemically Important Institutions (from now on also G-SIIs) is also vital for outlining the European legislator's proportional approach. Directive 2013/36/EU does not define the concept of G-

[307] Recital 128 of Regulation EU/575/2013 (CRR).
[308] Article 8 of Regulation EU/575/2013 (CRR), indexed: "Derogation to the application of liquidity requirements on an individual basis."
[309] Article 10 of Regulation EU/575/2013 (CRR), indexed: "Waiver for credit institutions permanently affiliated to a central body."
[310] Article 99 of Regulation EU/575/2013 (CRR), indexed: "Reporting on own funds requirements and financial information."
[311] Article 433 of Regulation EU/575/2013 (CRR), indexed: "Frequency of disclosure."

SIIs but allows the member states to outline this definition based on the criteria established by the Directive itself. Indeed, article 131 in the first two paragraphs establishes that the member states of the European Union must designate the competent authority that identifies the G-SIIIs and the Other Systemically Important Institutions (from now on also O-SIIs).[312]

The second paragraph of article 131 indicates the methodology aimed at identifying these systemically important institutions. The methodology is based on five categories related to size, interconnectedness with the financial system, substitutability of the services or the financial structure, complexity, and cross border activity between the member states and between a member state and a third country.[313] The methodology for identifying and classifying the Global Systemically Important Institutions is defined in the delegated regulation 2014/1222/EU.[314]

On this point, the European Banking Authority produced its guidelines on disclosure of indicators of global systemic importance,[315] which were last

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[312] Article 131 of Directive 2013/36/EU (CRD IV), paragraphs 1 and 2.
[313] Article 131 paragraph 2 of Directive 2013/36/EU.
[314] *Commission Delegated Regulation (EU) No 1222/2014 of 8 October 2014 supplementing Directive 2013/36/EU of the European Parliament and of the Council with regard to regulatory technical standards for the specification of the methodology for the identification of global systemically important institutions and for the definition of subcategories of global systemically important institutions*, EUR-LEX 27- 36 (2014), https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32014R1222 (last visited Oct 21, 2020).
[315] *Guidelines on Disclosure of Indicators of Global Systemic Importance*, EUROPEAN BANKING AUTHORITY (2014), https://eba.europa.eu/sites/default/documents/files/documents/10180/717755/a017aea5-ceba-4d74-a1ee-fe513f7dbbdf/EBA-GL-2014-

modified in 2017.[316] For example, in the Italian legal system, the Bank of Italy is responsible for identifying systematically important institutions. The Bank of Italy transposed the provisions of the EU/2013/36 directive with the Circular 2013/285, which sets out the criteria on which the methodology for identifying systemically relevant institutions is based.[317]

According to the methodology identified at the European level and with the G-SII's list published annually by the Financial Stability Board, the Bank of Italy assigns a score to each bank. Based on each institution's score, the Bank of Italy places the G-SII in one of the five categories identified. Each category is assigned a level of capital that must be held.[318] The authority that identifies the systemically relevant institutions in France is the Autorité de contrôle prudentiel et de resolution (ACPR). The ACPR calculates a score that indicates each bank's systemic importance, and that allows it to draw up a list of systemically relevant institutions. Subsequently, the judgment of the supervisory authority allows it to complete this list based on optional indicators.[319]

02%20(Guidelines%20on%20disclosure%20of%20indicators%20of%20systemic%20importance).pdf (last visited Sep 16, 2020).

[316] *Guidelines for the Identification of Global Systemically Important Institutions* (G-SIIs)., EUROPEAN BANKING AUTHORITY (2018), https://eba.europa.eu/regulation-and-policy/own-funds/guidelines-for-the-identification-of-global-systemically-important-institutions-g-siis- (last visited Sep 16, 2020).

[317] Mariakatia Di Staso, *Disposizioni in tema di vigilanza, Circolare n. 285 del 17 dicembre 2013* BANCA D'ITALIA (2013), https://www.bancaditalia.it/compiti/vigilanza/normativa/archivio-norme/circolari/c285/aggiornamenti/Testo-int-30-agg.pdf (last visited Sep 16, 2020).

[318] *Idem.*

[319] *Methodology for Identifying "Other Systemically Important Institutions" (O-SIIs) and determining associated buffer rates*, AUTORITÉ DE CONTRÔLE PRUDENTIEL ET DE RESOLUTION

Another fundamental part of the CRD IV is the one concerning remuneration policies, provided by art. 92 and seq. in which is specified that: "Competent authorities shall ensure that, when establishing and applying the total remuneration policies, inclusive of salaries and discretionary pension benefits, for categories of staff including senior management, risk takers, staff engaged in control functions and any employee receiving total remuneration that takes them into the same remuneration bracket as senior management and risk takers, whose professional activities have a material impact on their risk profile, institutions comply with the following principles in a manner and to the extent that is appropriate to their size, internal organization and the nature, scope and complexity of their activities."

In light of what above, the references to the principle of proportionality are numerous in the European Union's banking regulation, which, as we have said above, operates at various levels. At the highest level, after the Treaties, the Regulations are present, which are directly applicable in all their elements throughout the European Union, and the Directives, which merely establish the objectives that all member states must achieve, defining how European objectives must be achieved through national provisions. In a step below, there is the legislation delegated to the European Commission or defined according

(2019), https://acpr.banque-france.fr/sites/default/files/20161213_o-sii_methodology.pdf (last visited Sep 16, 2020).

to the standards and professional opinions of the European Banking Authority - EBA, the legislation transposing the member states, second-level national legislation (for example, regulations of the competent Authorities) and, finally, the interpretative guidelines. The problem underlying this organization is represented by the fact that, since there are no specific indications regarding the methods by which to implement proportionality, there is a risk that its content will be weakened. There does not seem to be a standard methodology on how to implement this principle. The absence of a standard methodology creates numerous problems also at the interpretative level within the member states, which must transpose the European directives into the domestic system.[320]

A practical example is the interpretation of the discipline relating to variable element remuneration and, in particular, the bonus cap, according to article 94 of the Directive 2013/36/EU (CRD IV).[321] On this point, there was a debate on the application of the principle of proportionality. Indeed, the EBA considered that the bonus cap regulation should apply to all institutions, even the smallest ones.[322] However, the Bank of England and Financial Conduct Authority (hereinafter also FCA) declared they did not agree with the interpretation

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[320] *Idem*, 119.
[321] The criticisms that arose regarding the bonus cap discipline will be discussed in greater detail in this chapter in paragraph 3.9.
[322] *Guidelines on Sound Remuneration Policies Under Articles 74(3) and 75(2) of Directive 2013/36/EU and Disclosures Under Article 450 of Regulation (EU) No 575/2013*, EUROPEAN BANKING AUTHORITY (2016), https://eba.europa.eu/sites/default/documents/files/documents/10180/1314839/5057ed7d-8bf1-41b4-ad74-70474d6c3158/EBA-GL-2015-22%20Guidelines%20on%20Sound%20Remuneration%20Policies_EN.pdf (last visited Sep 16, 2020).

provided by EBA, as, in their opinion, such an approach would not be proportionate. In particular, the Prudential Regulation Authority (hereinafter also PRA) and the Financial Conduct Authority have highlighted how the extension of the bonus cap, even to smaller financial firms, has had the effect of increasing the fixed segment of the pay, leaving the total pay unchanged. According to the PRA and FCA, this transition to a higher share of fixed remuneration has meant a greater difficulty for small financial institutions to adjust the variable remuneration to reflect the institution's real state of health. Hence, there was a disagreement on whether to apply a proportionate approach and how to apply it.[323]

The criticisms made to the principle of proportionality within the European Union are not related to the fact that the principle is not present within the regulatory framework. As already pointed out, what appears doubtful is the effectiveness of the proportionality approach used in the European Union. It would seem that the directives and regulations are devoid of concrete elements that can be followed by the competent authorities and the member states. As stated by Bikoula et al., the result would be that even the technical standards of the European Banking Authority and the delegated acts of the Commission fail to give substance to the principle of proportionality and, in turn, provide for

[323] Caroline Binham & Mark Odell, *UK Declines to Extend Bonus Cap Rules* FINANCIAL TIMES (2016), https://www.ft.com/content/e67a0630-dee8-11e5-b072-006d8d362ba3 (last visited Sep 16, 2020).

broad and labile rules, with the result that the member states and the competent national authorities are responsible for identifying sectors and methods of applying proportionality.[324]

As mentioned above, sometimes proportionality is implemented through a case-by-case approach, such as the reference to art. 74 CRD IV, and the method of determining GSII in the French model. Bikoula et al. pointed out that a case-by-case approach would determine the use of broad discretion, which is not always in line with the European Authorities' guidelines. Bikoula et al. pointed out that the reason for this result lies in the fact that European legislation (mainly directives and regulations) does not give the competent authorities a sufficiently precise mandate for the development of the delegated regulation, with the consequence that these authorities are not in a position to affect sufficiently in order to avoid the risk of exceeding the delegation that has been conferred on them.[325]

Therefore, the member states identify areas and measures on which to apply the principle of proportionality with discretion since the principles conferred are ample and unclear. The European Banking Authority conducted some studies, showing the different approaches adopted by each Member State. For example, in its report on the application of the principle of proportionality, the European

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[324] Ignace Gustave Bikoula et al., *op. cit.,* 119.
[325] *Ibid.*

Banking Authority stated that all but five member states contemplate waivers in their regulation in the area of remuneration. Some states established waivers based on the institution's size and the level of remuneration that identified staff receives. The other States established exemptions on a case by case basis. For instance, as regards the specific provisions on deferral and payout in instruments, the EBA has highlighted how some member states, including Belgium, Portugal, and Greece, adopted a case-by-case approach, also considering the size, nature, scope, and complexity of the financial institution.[326] Moreover, the EBA's report stated that the States that adopt a threshold-based approach are, for example, Italy, Germany, Austria, and France. According to this report, some states like Spain, Finland, and Bulgaria do not provide for waivers.[327]

Even the European Banking Institute recognized the problem of the effectiveness of the principle of proportionality, stating that: "the banking regulatory framework adopted by the European Union is both stern and unidimensional. Hard requirements are in place, with no distinction depending on the situation. Proportionality is only a theoretical reference, with little or no

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[326] *Review of the Application of the Principle of Proportionality to the Remuneration Provisions in Directive 2013/36/EU. The EBA's Response to the European Commission's Letter*, EUROPEAN BANKING AUTHORITY (2016), https://eba.europa.eu/sites/default/documents/files/documents/10180/1667706/f60bdec5-9377-47c5-ab0c-8fb39f6c29a2/EBA%20Opinion%20on%20the%20application%20of%20the%20principle%20of%20proportionality%20to%20the%20remuneration%20provisions%20in%20Dir%202013%2036%20EU%20%28EBA-2016-Op-20%29.pdf?retry=1 (last visited Sep 18, 2020).
[327] *Ibid.*

practical implementation."[328] This aspect was also underlined by Masera, which underlined the cooperative banks' role in Europe. These banks do not have the immediate goal of making a profit and creating value in the short term for shareholders. As is the case for community banks in the United States, these types of banks let that small and medium-sized businesses have advantages in accessing credit. Therefore, their role within the European Union is fundamental, despite Masera stressed that there is a common tendency for the decrease in small banks in the European Union, as has happened in the United States. According to Masera, the phenomenon of bank concentration would be caused precisely by the high compliance costs and many supervisors' orientation to push towards concentration processes.[329]

One of the European Commission's prerogatives is to ensure the level playing field in competition policies between banks. Differently from the American legal experience, the formulation of the principle of proportionality in the European Union is attributable to the Treaties' general objectives. Also, the Basel Committee envisages the proportionality principle as a core principle in financial regulation. However, while the Basel Committee designed the Basel agreements to be applied to internationally active banks, the European Union decided to apply these standards to all the banks that carry out their activity in

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[328] Bart Joosen et al., *Stability, Flexibility and Proportionality: Towards a Two-Tiered European Banking Law?* 20 EUROPEAN BANKING INSTITUTE WORKING PAPER SERIES 28 (2018).
[329] Rainer Masera, COMMUNITY BANKS E BANCHE DEL TERRITORIO: SI PUÒ COLMARE LO IATO SUI DUE LATI DELL'ATLANTICO? 23 (2019).

the European member states. The European Commission has explained the reasons for this choice because banks authorized to operate in a Member State are authorized to operate in the whole European single market and are more likely to engage in cross border activities.[330]

Moreover, according to the European Commission, the Basel agreements' application only to a subset of banks could create distortions in competition and potential regulatory arbitrage.[331] Masera criticized this one-size-fits-all approach to financial firms regulation, as it would cause significant competitive distortions, mainly because it penalizes smaller firms with high fixed costs. Besides, Masera stated that even the regulation aimed to handle the *too big to fail* problem favored larger banks, with evident distortionary effects of competition, to the detriment of small and medium-sized banks. Indeed, he underlined a point of fundamental importance, *i.e*., the fact that the big banks are familiar with the use of derivatives and have been better able to exploit the Basel agreements' complexity and loopholes, without actually decreasing the overall risk.[332]

The Bundesbank, which is the German Central Bank, also underlined the issue of proportionality. The Bundesbank stressed the need to define a so-called Small

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[330] *Capital Requirements – CRD IV/CRR – Frequently Asked Questions* EUROPEAN COMMISSION (2013), https://ec.europa.eu/commission/presscorner/detail/en/MEMO_13_690 (last visited Sep 16, 2020).
[331] *Ibid.*
[332] *Idem*, 43.

Banking Box, *i.e.*, a regulatory area in which simplified requirements are explicitly defined for small and medium-sized financial institutions dimensions.[333] According to Andreas Dombret, a member of the Deutsche Bundesbank board of directors from 2010 to 2018, the Small Banking Box is the best approach to simplify the burdens borne by small banks. In Germany, the Bundesbank worked concretely in collaboration with BaFin, *i.e.*, the Federal Financial Supervisory Authority and the German Finance Minister, in order to draw up a draft. The project's importance has meant that the German Minister of Finance is promoting the Small Banking Box to extend the initiative to the whole European Union. The goal is to create a complex of rules aimed at small banks that do not have unnecessary burdens. An easy-to-understand set of rules that would require less time and resources to comply. It is no coincidence that this initiative started with the German Central Bank. Germany is characterized by the presence of numerous small banks, which, with the implementation of the copious European regulation issued in the aftermath of the financial crisis, have registered a significant decrease in number due to acquisitions.[334]

The criticisms highlighted the problem of the effectiveness of the principle of proportionality. If, on a theoretical level, this principle is abundantly present in European Union law, in practice, there are many doubts. The European

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[333] Andreas Dombret, *Heading Towards a "Small Banking Box" – Which Business Model Needs What Kind of Regulation?* DEUTSCHE BUNDESBANK (2017), https://www.bundesbank.de/en/press/speeches/heading-towards-a-small-banking-box-which-business-model-needs-what-kind-of-regulation--711536 (last visited Sep 16, 2020).
[334] *Ibid.*

legislator does not provide clear criteria of application, with the consequence that the twenty-eight member states of the European Union apply the principle in different ways. In this context, the European supervisory authorities' role appears fundamental to provide clarifications, albeit with the limits highlighted above.

3.7 The New Capital Requirements Package: Directive 2019/878/EU (CRD V) and Regulation 2019/876/EU (CRRII).

In light of the criticism expressed above, on September 30th, 2015, the European Commission launched a Call for Evidence to understand whether the more than forty legislative acts issued following the financial crisis were functioning as intended. The European Commission said that more than three hundred interested parties reported to the Call for Evidence, sharing their experience in implementing EU financial regulations. The European Commission has examined the Call for Evidence as to the first example of an exercise to verify the financial sector' functioning at an international level following the response to the financial crisis.[335]

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[335] *Call for Evidence EU Regulatory Framework for Financial Services*, EUROPEAN COMMISSION (2015), https://ec.europa.eu/finance/consultations/2015/financial-regulatory-framework-review/docs/consultation-document_en.pdf (last visited Sep 16, 2020).

In this context, Her Majesty's Treasury of the United Kingdom underlined its doubts about the fact that the European legislator gave no precise meaning to the principle of proportionality, which is supposed to apply. The criticisms have been raised precisely regarding the Capital Requirement regulation, hoping that the European Commission will consider proposals aimed at achieving a more proportionate regulation for smaller and less complex banks and financial institutions.[336]

In November 2016, following the responses to the call for evidence, the European Commission adopted a communication on follow-up and published staff working documents to accompany the communication mentioned above. The Commission declared the need for targeted measures. Such measures would be justified to reduce regulatory burdens that are not justified or undue, increase the proportionality of the rules, while maintaining a prudential approach, and make regulation more accurate. These measures considered a revision of the Capital Requirement Package. The Commission said that the Call for Evidence had the advantage of making individual proposals highlighted and considered in a broader context. Another advantage of the Call for Evidence would also be to allow an adjustment of the financial discipline to technological changes and

[336] *Response to the EU Commission: Call for Evidence on EU Regulatory Framework for Financial Services*, HER MAJESTY TREASURY 29 (2016), https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/496887/PU1903_HMT_response_to_EU_consultation.pdf (last visited Sep 16, 2020).

developments in the financial and economic sectors.[337]

Following the Call of Evidence, the European Commission undertook an initiative on proportionality as part of the new Capital Requirement Regulation 2019/876/EU (hereinafter also CRR II) and the Directive 2019/878/EU (hereinafter also CRD V). The European Parliament- Committee on Economic and Monetary Affairs on this point published a Draft Report.[338] The European Council has also published its proposals to amend the Capital Requirement Regulation.[339]

The European Commission underlined that this bank reform package proposal represents a milestone towards the completion of the reform process undertaken following the 2008 financial crisis. The Directive 2019/878/EU of the European Parliament and Council, May 20th, 2019 and Regulation 2019/876/EU of the

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[337] *Report from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions*, EUROPEAN COMMISSION 3 (2017), https://ec.europa.eu/info/sites/info/files/171201-report-call-for-evidence_en.pdf (last visited Sep 16, 2020).

[338] *Draft Report on the Proposal for a Regulation of the European Parliament and of the Council Amending Regulation (EU) No 575/2013 as Regards the Leverage Ratio, the Net Stable Funding Ratio, Requirements for Own Funds and Eligible Liabilities, Counterparty Credit Risk, Market Risk, Exposures to Central Counterparties, Exposures to Collective Investment Undertakings, Large Exposures, Reporting and Disclosure Requirements and Amending Regulation (EU) No 648/2012 (COM(2016)0850 – C8-0480/2016 – 2016/0360A(COD))*, EUROPEAN PARLIAMENT (2017), https://www.europarl.europa.eu/doceo/document/ECON-PR-613409_EN.pdf (last visited Sep 16, 2020).

[339] *Proposal for a Regulation of the European Parliament and of the Council Amending Regulation (EU) No 575/2013 as Regards the Leverage Ratio, the Net Stable Funding Ratio, Requirements for Own Funds and Eligible Liabilities, Counterparty Credit Risk, Market Risk, Exposures to Central Counterparties, Exposures to Collective Investment Undertakings, Large Exposures, Reporting and Disclosure Requirements and Amending Regulation (EU) No 648/2012*, COUNCIL OF THE EUROPEAN UNION (2018), https://data.consilium.europa.eu/doc/document/ST-6614-2018-INIT/en/pdf (last visited Sep 16, 2020).

European Parliament and the Council, May 20th, 2019 introduce measures that reduce risk and make considerable progress in completing the Banking Union.[340]

The European Commission declared that the reform package also aims to reduce risks in the banking sector, further strengthening banks' ability to resist possible shocks. The reform also updates the Single Rulebook, *i.e.*, the set of harmonized rules established in the aftermath of the financial crisis. The European Parliament approved the reform package on April 16th, 2019, which consist of the Capital Requirement Regulation II (CRR II), Capital Requirement Directive V (CRD V), but also the Bank Recovery and Resolution Directive (BRRD II) and the Single Resolution Mechanism Regulation (SRMR II).[341]

This prudential regulatory framework concludes the long process undertaken to modify the regulatory framework supported by the European Commission. According to art. 3 of CRR II, the regulation entered into force on June 27th,

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[340] For this thesis's purpose, it is important to say that the Banking Union, which began in 2012 in response to the 2008 financial crisis, has become necessary for the countries of the euro area due to the profound interconnection existing between these States. The Banking Union consists of transferring supervisory responsibilities from national authorities to European authorities. Consob, the authority that superintends the Italian financial market, recognized the Banking Union's merit to allow to protect the real economy and financial stability in the entire euro area, thanks to the unified banking supervision (the so-called Single Supervision Mechanism - SSM) - operational since November 2014, relating to all countries belonging to the eurozone and those not belonging to the eurozone that decides to join it through a mechanism of close cooperation. See: *L'Unione Bancaria*, CONSOB (2014), http://www.consob.it/web/investor-education/l-unione-bancaria (last visited Sep 16, 2020).

[341] Dorota Kolinska, *Parliament Approves Rules to Reduce Risk to EU Banks and Protect Taxpayers*, EUROPEAN PARLIAMENT (2019), https://www.europarl.europa.eu/news/en/press-room/20190410IPR37556/parliament-approves-rules-to-reduce-risks-to-eu-banks-and-protect-taxpayers (last visited Sep 16, 2020).

2019 ("the twentieth day following that of its publication in the Official Journal of the European Union"). However, the last deadline for the application of some rules will be 2023.[342]

Among the main innovations introduced by the Regulation 2019/876/EU and the Directive 2019/878/EU, there are *ex multis*, the discipline on own funds, Total Loss Absorbing Capacity (TLAC), credit risk, leverage, and Net Stable Funding Ratio (NSFR). The new CRR II in article 1 amends the title of part two of Regulation 575/2013/EU, which is now called "Own Funds and Eligible Liabilities". The reform excludes certain investments in software from the intangible assets of its funds, which will be considered not subject to economic deterioration in the event of resolution, insolvency, or liquidation. This rule was introduced in order to encourage investments for the digitalization of the banking sector. Also, the new article 92 *bis* provides, only for global systemically important institutions (G-SIIs), specific requirements for own funds and eligible liabilities, aimed at guaranteeing a high loss absorption capacity (Total Loss Absorbing Capacity - TLAC). In this way, efforts are made to ensure adequate loss absorption mechanisms in the event of resolution. The

[342] The new article 504a of Regulation 2013/575/EU concerning holding of eligible liabilities instruments introduced by article 1 of Regulation 2019/876/EU; paragraph 2 of the new article 507 of Regulation 2013/575/E about large exposures replaced by article 1 of Regulation 2019/876/EU; the new paragraphs 6, 9 and 10 of art. 510 added by article 1 of Regulation 2019/876/EU, paragraph 1 of article 514 replaced by article 1 of Regulation 2019/876/EU. Moreover, article 3 of the Regulation 2019/876/EU states that: “Point (53), as regards Article 104a of Regulation (EU) No 575/2013, and points (55) and (69) of Article 1 of this Regulation, containing the provisions on the introduction of the new own funds requirements for market risk, shall apply from 28 June 2023”.

reform also introduces a more favorable regulatory regime for exposures deriving from loans to small and medium-sized enterprises, for credit aimed at creating infrastructures classified in the "corporate" or "specialized lending" portfolios and loans guaranteed by the sale of a portion of the salary or pension. Moreover, the reform modifies art. 92 of Regulation (EU) no. 575/2013 by introducing a minimum leverage requirement of 3%, to be complied with in addition to the risk-based capital requirement. An additional leverage ratio buffer is then added only for G-SIIs. A minimum level of Net Stable Funding Ratio is introduced to ensure that the banking institution can have sufficient stable financing to meet its financing needs both under normal conditions and stress conditions.[343]

The new reform package requires the use of multiple resources by banking institutions in order to understand and implement the new rules on their corporate organization. Hence, the reform constitutes an additional burden for all credit institutions, because of the necessary compliance costs. However, it would seem that this reform contains attempts to minimize the regulatory burden towards smaller credit institutions, in particular regarding reporting requirements. Moreover, the new discipline introduces new prudential standards for smaller banks concerning market risk, net stable funding ratio, interest rate risk in the banking gook, and counterparty credit risk. The new

[343] Article 1, (46) of Regulation 2019/876/EU.

discipline also prescribes simplified obligations in the issue of remuneration.[344] After this overview of the new Capital Requirements package, the next paragraph examines some examples of the proportionality approach in this legal framework.

3.8 Proportionality Elements in the New CRD V and CRR II.

A significant innovation emerging from the new discipline is the presence of explicit definitions of small and non-complex institutions. The Regulation in recital Seven specifies that this description is functional to the realization of the proportionality principle: "A precise definition of small and non-complex institutions is necessary for targeted simplifications of requirements with respect to the application of the principle of proportionality. By itself, a single absolute threshold does not take into account the specificities of the national banking markets. It is therefore necessary for member states to be able to use their discretion to bring the threshold in line with domestic circumstances and adjust it downwards, as appropriate. Since the size of an institution is not in itself the defining factor for its risk profile, it is also necessary to apply

[344] *Adoption of the Banking Package: Revised Rules on Capital Requirements (CRRII/CRDV) and Resolution (BRRD/SRM)*, EUROPEAN COMMISSION (2019), https://ec.europa.eu/commission/presscorner/detail/en/MEMO_19_2129 (last visited Sep 16, 2020).

additional qualitative criteria to ensure that an institution is only considered to be a small and non-complex institution and able to benefit from more proportionate rules where the institution fulfils all the relevant criteria".[345]

In light of the above, art. 4 paragraph 1 of Regulation 2013/575/EU has been amended by Regulation 2019/876/EU to include the category of small and non-complex institutions. Following this definition, small and non-complex institution means: "an institution that meets all the following conditions:

(a) it is not a large institution;

(b) the total value of its assets on an individual basis or, where applicable, on a consolidated basis in accordance with this Regulation and Directive 2013/36/EU is on average equal to or less than the threshold of EUR 5 billion over the four-year period immediately preceding the current annual reporting period; member states may lower that threshold;

(c) it is not subject to any obligations, or is subject to simplified obligations, in relation to recovery and resolution planning in accordance with Article 4 of Directive 2014/59/EU;

(d) its trading book business is classified as small within the meaning of Article 94(1);

(e) the total value of its derivative positions held with trading intent does not exceed 2% of its total on- and off-balance-sheet assets and the total value of its

[345] Recital 7, Regulation 2019/876/EU of the European Parliament and the Council, May 20th, 2019.

overall derivative positions does not exceed 5%, both calculated in accordance with Article 273a(3);

(f) more than 75 % of both the institution's consolidated total assets and liabilities, excluding in both cases the intragroup exposures, relate to activities with counterparties located in the European Economic Area;

(g) the institution does not use internal models to meet the prudential requirements in accordance with this Regulation except for subsidiaries using internal models developed at the group level, provided that the group is subject to the disclosure requirements laid down in Article 433a or 433c on a consolidated basis;

(h) the institution has not communicated to the competent authority an objection to being classified as a small and non-complex institution;

(i) the competent authority has not decided that the institution is not to be considered a small and non-complex institution on the basis of an analysis of its size, interconnectedness, complexity or risk profile." [346]

The last two points, h) and i), define the so-called opt-out clause. In other words, supervisors and the banking institution have the option to decide that the institution should not be classified as a small and non-complex institution.[347] It is clear from the opt-out clause that a specific institution can be excluded from

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[346] Article 1, paragraph 2 (a) (xv) (145) of Regulation 2019/876/EU.

[347] *The European Banking Package – Revised Rules in EU Banking Regulation*, DEUTSCHE BUNDESBANK (2019), https://www.bundesbank.de/resource/blob/800764/d87f4df7102744e5b52f284fc03d186d/mL/2019-06-bankenpaket-data.pdf (last visited Sep 16, 2020).

the definition of a small and non-complex institution on a case-by-case basis. Although the European legislator finally identifies certain thresholds in Regulation 2019/876/ EU to define small and non-complex institutions, it always leaves space theoretically for supervisory authorities and the member states to exclude specific institutions from this definition.

In the application of the principle of proportionality, in the new regulation on Capital Requirements, there is a facilitated regulation and exemptions for small and non-complex institutions in various areas, among which there is the discipline on supervisory reporting requirements, disclosure, trading books, and Net Stable Funding Ratio Requirements. For example, CRR II introduces, after art. 429 g of Regulation 2013/575/EU (CRR), part Seven A relating to reporting requirements, within which there is art. 430 called "reporting on prudential requirements and financial information." Section 8 of this article provides that the European Banking Authority makes recommendations in order to reduce reporting obligations for small institutions. The European Banking Authority also assesses whether it is possible to waive the imposition of reporting obligations and to reduce the reporting frequency.[348]

CRR II also introduces a new article 433 b indexed "Disclosures by small and non-complex institutions." It provides disclosure obligations annually for specific risk management objectives and policies, including strategies and

[348] Article 1 (118) of Regulation EU/876/2019 (CRR II).

processes for managing risk categories, a declaration on the adequacy of risk management arrangements, and a brief risk statement approved by the management body. The new discipline also prescribes disclosure on an annual basis on own funds requirements and risk-weighted exposure amounts (article 438) and remuneration policies (article 450). In these cases, small and non-complex institutions have a simplified disclosure. The disclosure on the critical metrics referred to in art. 447 (the composition of own funds, total risk exposure amount, leverage ratio) usually occurs on a half-yearly basis. Article 433 b, however, makes a further distinction in the context of small and non-complex institutions. Indeed, if these institutions are not listed, the frequency of the information is annual.[349] Even for trading books, art. 94 provides exceptions if transactions relating to the trading portfolio are small, or equal to or less than € 50 million and 5% of the entity's total assets.[350]

Furthermore, Regulation 2019/876/EU provides in recital n. 53 the possibility of applying a simplified version of the Net Stable Funding Ratio NSFR requirement in the case of small and non-complex institutions. As said by the European legislator: “A simplified, less granular version of the NSFR should involve collecting a limited number of data points, which would reduce the complexity of the calculation for those institutions in accordance with the

[349] Article 1 (119) of Regulation EU/876/2019 (CRR II).
[350] Article 94 of Regulation EU/575/2013 (CRR) as replaced by article 1 (48) of Regulation EU/876/2019 (CRR II).

principle of proportionality, while ensuring that those institutions still maintain a sufficient stable funding factor by means of a calibration that should be at least as conservative as the one of the fully-fledged NSFR requirement." In other words, small and non-complex institutions will be subject to a simplified version of the NSFR to reduce their burden related to data collection. However, this simplified version should remain at least as cautious as the regular NSFR.[351]

Another interesting aspect is related to the stress test, *i.e.*, an assessment carried out by the European Banking Authority on banks operating within the European Union in order to observe how these institutions would react in the event of disastrous economic and financial events. The stress test in the European Union is conducted on banks with a net asset of at least 30 billion euros. In other words, smaller banks, *i.e.*, financial institutions with less than € 30 billion in assets, are exempted from the stress test. The European Banking Authority said that this sample of banks covers 70% of the banking sector within the euro area, *i.e.*, all the member states that adopt the euro as their official currency. According to the special report no. 10 2019 of the European Court of Auditors, the number of participants fell compared to the first stress test of 2011, in which 90 banks participated, while in 2018 the number of banks fell to 48.[352] Comparing the

[351] Recital 53 of Regulation 2019/876/EU.
[352] *EU-wide Stress Test for Banks: Unparalleled Amount of Information on Banks Provided but Greater Coordination and Focus on Risk Needed*, EUROPEAN COURT OF AUDITORS (2019), https://op.europa.eu/webpub/eca/special-reports/eba-stress-test-10-2019/en/ (last visited Sep 16, 2020).

data of the Board of Governors of the Federal Reserve System, the number of banks would still be higher than the banks subjected to stress tests based on the Dodd-Frank Act, which corresponds to 18 banks in 2018.[353] This result is because in the United States, with the Economic Growth, Regulatory Relief and Consumer Protection Act, the stress test applies to banks with more than $ 250 billion in consolidated assets, while before the 2018 reform the stress test applied to banks with consolidated assets greater than or equal to $ 10 billion.

3.9 Case Study: Banker's Remuneration Provisions, and the Discordance Between the European Union and the United Kingdom.

The provisions of the Capital Requirements Package concerning remuneration's policies represent an interesting example that highlights the difficulties due to the absence of a common methodology regarding the application of the principle of proportionality. It is generally believed that variable remuneration can lead to excessive risk-taking in the short term.[354] Even the de Larosière Report pointed out that: "Remuneration and incentive schemes within financial

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[353] *Dodd-Frank Act Stress Test 2019: Supervisory Stress Test Results*, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM (2019), https://www.federalreserve.gov/publications/files/2019-dfast-results-20190621.pdf (last visited Sep 16, 2020).

[354] See: Lucian A. Bebchuk & Holger Spamann, *Regulating Bankers' Pay*, 98 GEORGETOWN LAW JOURNAL 247 (2010); Emilios Avgouleas & Jay Cullen, *Excessive Leverage and Bankers' Pay: Governance and Financial Stability Costs of a Symbiotic Relationship*, 21 COLUMBIA JOURNAL OF EUROPEAN LAW (2014).

institutions contributed to excessive risk-taking by rewarding short-term expansion of the volume of (risky) trades rather than the long-term profitability of investments. Furthermore, shareholders' pressure on management to deliver higher share prices and dividends for investors meant that exceeding expected quarterly earnings became the benchmark for many companies' performance".[355]

Therefore, in the reform project undertaken in the aftermath of the financial crisis, the remuneration discipline acquired a fundamental role. In particular, the Capital Requirements Directive (CRD IV) considered four dimensions of bankers' remuneration. The first dimension concerns the reform of performance measurement systems. Articles 92 and 94 of CRD IV require financial institutions to make sure that the remuneration policies are in line with sound risk management, to avoid excessive risk-taking and be short-sighted, not counting the medium and long term. The second dimension relates to the structure and level of remuneration, such as the so-called bonus cap, deferral, and clawback contemplated in article 94.[356]

The third dimension concerns the internal governance mechanisms of remuneration. For example, in this sense, article 95 CRD IV provided that the remuneration committee can render an independent opinion on the

[355]Jacques De Larosière et al., *op. cit.*, 10.
[356] Art. 94 Capital Requirement Directive (CRD IV) 2013/36/EU.

remuneration policies. Independence is guaranteed because the chairman and members of the remuneration committee are members of the management body who do not perform executive functions within the financial institution. Besides, if employee representation is provided within the management body under the member states' domestic law, one or more employee representatives must be included in the management body. In this way, the CRD IV ensures greater independence of the remuneration committee.[357]

The fourth dimension relates to the duty of disclosure, as CRD IV provides that financial institutions with a website must disclose how they are compliant with the rules relating to governance arrangements and the risk committee.[358] Among the measures adopted with the CRD IV by the European Union legislator, the bonus cap is the most debated measure. The bonus cap sets limits on variable remuneration. On the one hand, the European legislator and the supervisory authorities believe that the bonus cap regulation positively affects curbing speculative risk and preventing future financial crises. On the other hand, the doctrine complains that this rule has the unintended consequence of undermining bank corporate governance's integrity and efficiency and bringing negative consequences to the financial market[359] The United Kingdom

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[357] Art. 95, paragraph 2 Capital Requirement Directive (CRD IV) 2013/36/EU.
[358] Art. 96 Capital Requirement Directive (CRD IV) 2013/36/EU.
[359] Kevin J. Murphy, *Regulating Banking Bonuses in the European Union: A Case Study in Unintended Consequences*, 19 EUROPEAN FINANCIAL MANAGEMENT (2013); Anya Kleymenova & Irem Tuna, *Regulation of Compensation and Systemic Risk: Evidence from the UK* SSRN (2016), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2755621 (last visited Sep 16, 2020).

government and its supervisory authorities, including the Bank of England and the Financial Conduct Authority, are also of this opinion.[360]

The UK legislator has implemented the remuneration discipline set out in CRD IV through the Remuneration Codes. CRD IV entered into force in 2014, the year in which the United Kingdom was still part of the European Union. Indeed, UK citizens voted on the Brexit referendum in 2016, and the United Kingdom officially exited from the EU on January 31st, 2020.[361] Despite the full implementation of CRD IV, the UK legislature has always made clear its position on the bonus cap. On this point, the United Kingdom has brought a case before the Court of Justice in order to request the annulment of Articles 94, paragraph 1, letter g), 94 paragraph 2 and paragraphs 1 and 3 of article 162 of Directive 2013/36/EU and articles 450 paragraph 1, letter d), points i) and j) and of art. 521 paragraph 2 of Regulation 2013/575/EU.[362]

The United Kingdom contested the provisions of the CRD IV directive, which adjust the variable remuneration of individuals whose professional activities impact the risk profile of the credit institutions in which they work. These provisions set a maximum fixed ceiling for the variable remuneration of these subjects. The United Kingdom has submitted six pleas to the Court of Justice of the European Union. Among the six reasons, it is essential to underline for the

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[360] Caroline Binham & Mark Odell, *op.cit.*
[361] Tom Edgington, *Brexit: All You Need to Know About the UK Leaving the EU* BBC (2020), https://www.bbc.com/news/uk-politics-32810887 (last visited Sep 18, 2020).
[362] *United Kingdom v. Parliament and Council,* Case C-507/13.

purposes of this dissertation, the second reason presented by the United Kingdom, which, in a certain sense, revealed the substance of the challenge to the Court of Justice. In this plea, the United Kingdom complained that the bonus cap governed by directive 2013/36/EU and Regulation 2013/575/EU does not respect the principle of proportionality, as it is not appropriate to achieve the objectives of banking stability and supervision prudential. The Advocate General rejected all six grounds filed by the United Kingdom.[363] However, the Advocate General's conclusions have provided arguments in favor of the bonus cap and, although not legally binding, they have an important influence on the decisions of the Court of Justice. Hence, on November 20th, 2014, the UK government announced to abandon the challenge because the chances of success were minimal.[364]

Subsequently, in light of articles 74 paragraph 3, and 75 paragraph 2 of the Capital Requirement Directive IV, the European Banking Authority issued the Guidelines on Sound Remuneration Policies.[365] The guidelines specify that: "These guidelines set out requirements regarding remuneration policies

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[363] *United Kingdom v. Parliament and Council, Opinion of Advocate General Jääskinen,* Case C-507/2013, paragraph 126.
[364] Alex Barker, *Osborne Gives Up on Challenge to Bank Bonus Cap Financial Times* (2020), https://www.ft.com/content/12d1ba3a-7094-11e4-9129-00144feabdc0 (last visited Sep 16, 2020).
[365] *Guidelines on Sound Remuneration Policies Under Articles 74(3) and 75(2) of Directive 2013/36/EU and Disclosures Under Article 450 of Regulation (EU) No 575/2013*, EUROPEAN BANKING AUTHORITY (2016), https://eba.europa.eu/sites/default/documents/files/documents/10180/1314839/5057ed7d-8bf1-41b4-ad74-70474d6c3158/EBA-GL-2015-22%20Guidelines%20on%20Sound%20Remuneration%20Policies_EN.pdf (last visited Sep 17, 2020).

applicable to all staff of institutions and specific requirements that institutions have to apply to the remuneration policies and variable elements of remuneration of identified staff."[366] Therefore the European Banking Authority's guidelines should be applied to all financial institutions that fall within the scope of the Capital Requirements package.[367] In interpreting these guidelines in conjunction with the Capital Requirements Directive and Regulation provisions, UK supervisors have considered the principle of proportionality. In particular, the Financial Conduct Authority divided the financial institutions into three categories based on their assets and establishing the exemption from the application of the bonus cap discipline for the firms belonging to the category with the lowest assets.[368]

On December 21st, 2015, the European Banking Authority published the Final Guidelines on Sound Remuneration Policies.[369] The European Banking Authority has also issued its opinion on the application of the principle of proportionality.[370] In this document, although the European Banking Authority

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[366] *Idem*, 7, section 6.
[367] Article 4 paragraph 1 (1), (2) and (3) of Regulation 2013/575/EU and Section 6 and 7 of EBA Guidelines on Sound Remuneration Policies.
[368] *General Guidance on Proportionality: the Remuneration Code (SYSC 19A)*, FINANCIAL CONDUCT AUTHORITY (2017), https://www.fca.org.uk/publication/finalised-guidance/guidance-on-proportionality-ifpru-firms-sysc-19a.pdf (last visited Sep 17, 2020).
[369] *Final Guidelines on Sound Remuneration Policies*, EUROPEAN BANKING AUTHORITY (2018), https://eba.europa.eu/regulation-and-policy/remuneration/guidelines-on-sound-remuneration-policies (last visited Sep 17, 2020).
[370] *Opinion of the European Banking Authority on the Application of the Principle of Proportionality to the Remuneration Provisions in Directive 2013/36/EU*, EUROPEAN BANKING AUTHORITY (2015), https://eba.europa.eu/sites/default/documents/files/documents/10180/983359/588134c4-c438-4315-9b61-4fb5b4e67b15/EBA-Op-2015-

stated the exemption from specific rules about remuneration for small financial institutions, it insisted on the applicability of the bonus cap rules to all financial institutions, without leaving room for proportionality. The United Kingdom government has often reported how the application of the bonus cap rules to all financial institutions, regardless of their size, can generate competition problems and, in particular, the maintenance of lucrative offers that are competitive with the global market.[371]

The new Capital Requirement Directive V will also continue to apply the controversial bonus cap. The position of both the European legislator and the supervisory authority regarding the bonus cap will no longer be a problem for the United Kingdom, which left the EU on January 31st 2020 and is now in a transition period.[372] However, it is important to highlight that it is sometimes not always clear how and to what extent the member states of the European Union can apply the principle of proportionality. Sometimes the European supervisory authorities intervene, as happened in the case in question, to clarify the scope. However, in this case, the supervisory authority provided these clarifications only after the member states' implementation. This lack of clarity

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25%20Opinion%20on%20the%20Application%20of%20Proportionality.pdf (last visited Sep 17, 2020).

[371] Ben Wright, *Bankers' Bonus Farce is Undermining London Status as Financial Center* THE TELEGRAPH (2014), https://www.telegraph.co.uk/finance/comment/11249344/Bankers-bonus-farce-is-undermining-Londons-status-as-financial-centre.html (last visited Sep 17, 2020).

[372] Peter Barnes, *Brexit: What Happens Now?* BBC (2020), https://www.bbc.com/news/uk-politics-46393399 (last visited Sep 18, 2020).

could generate problems for the achievement of effective harmonization and an effective application of the principle of proportionality. With the new discipline, the European legislator increased the level of proportionality in its regulation on Capital Requirements, following the member states' comments in response to the Call for Evidence. In any case, we see that the scheme remains similar to the previous Capital Requirements package because the new discipline states the general directions, leaving the competent authorities the task of defining precisely the principles of the primary legislation. This mechanism happened, for example, in the discipline on the Net Stable Funding Ratio, where the European legislator limits itself to providing indications of principle, generically delegating the competent authority. This raises serious doubts about what the competent authority must do and the limits of its functions.

3.10 Conclusions.

In conclusion, the principle of proportionality applied to the European Union's banking regulation has some features that characterize it compared to other international experiences. First of all, this principle has a special *status*, given that it is located within a Treaty. This principle inevitably compares with the dynamics within the European Union. The European Union acts as a harmonizing entity of the law between the individual member states, with specific objectives of integration of the Single Market. For this reason, the

discipline of fair competition, which allows companies in one Member State to compete on equal terms in the markets of all the other member states; and the four freedoms (freedom of movement of goods, persons, services and capital) are of fundamental importance. Another critical element that has been established in response to the financial crisis is the Banking Union. Currently, it consists of two elements: single supervisory mechanism (SSM), which has the task of supervising the largest and most important banks in the euro area and the single resolution mechanism (SRM), which aims at the orderly resolution of failing banks, trying to reduce the repercussions for European citizens and the real economy as much as possible.

Although the trend of the European Union seems to be towards ever greater integration, there remains the tendency of the European legislator to establish, for example through directives, the principles of law and to leave it to the member states to carry out the objectives with the means and methods which they deem appropriate. In the banking field, the European legislator delegates the supervisory authorities to define the technical standards to be applied. However, the definition of vague and not concretely defined principles can give rise to uncertainties and misunderstandings, which need further clarification at the European level. This chapter also reported that sometimes the powers delegated by the European legislator to supervisors are not sufficient to allow the achievement of the objectives that banking regulation aims to achieve. Hence, this chapter underlined that some scholars considered that the principle

of proportionality is likely to be a principle with only theoretical value within the European Union.

The fundamental problem is that within the European Union, there is no universal methodology for applying the proportionality principle. The previous paragraphs reported that the member states sometimes use a case-by-case approach, sometimes use thresholds to define the scope of exemptions or specific disciplines. Other times, they do not make distinctions between small, medium, and large financial institutions. Unlike the United States legal system, the European Union legislator implemented the Basel agreements to all banks in its territory, while these agreements have been designed to be applied only to internationally active banks. We, therefore, see the first big difference in the application of the proportionality principle. If there is a separate regulation in the United States system based on the size and nature of the financial institution since federal law, in the European Union, this distinction is not so clear. Indeed, the European legislator delegates supervisory authorities and the member states.

With the CRR II and CRD V package, great progresses have been made in the European Union, defining more clearly what is meant by small and non-complex institutions. However, it would seem that there is still a huge amount to be organized on this legal matter in order to make the principle of proportionality more effective. Two alternative solutions could be envisaged on this point. A solution would be to give a broader delegation to the member states, allowing them to effectively exempt smaller banks from a too

burdensome discipline with increased discretion. However, such a solution would have the flaw of creating problems in terms of harmonization. Further inequalities could arise between the individual member states because there would be no level playing field.

Another solution could consist in the adoption by the European legislator of more specific rules that all member states should apply. These rules could include specific thresholds within which to exempt or simplify the banking discipline. In this sense, the Small Banking Box conceived by the German Central Bank could be a compelling suggestion to apply throughout the European Union. This would represent the preferable solution and more in line with the European Union's essence and objectives. With the recent regulation of 2019 concerning Capital Requirements, it would seem that the European legislator is progressively moving in the direction proposed by this second solution.

Chapter 4

The principle of proportionality in the Australian Banking Regulation.

> *"[…] the first way to simplify the law, and the first reason for doing it, is to reduce the number of exceptions to otherwise generally applicable norms of conduct."*
>
> Kenneth M. Hayne, Final Report of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry.

Summary: 4.1 Introduction; 4.2 The Australian Banking System; 4.3 History of Financial Regulation in Australia: from the Campbell Inquiry to the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry; 4.3.1 The Campbell Inquiry; 4.3.2 The Wallis Inquiry and the Effects of the Reform on Credit Unions and Building Societies; 4.3.3 The Australian Response to the Great Financial Crisis; 4.3.4 The Murray Inquiry; 4.3.5 Royal Commission into Misconduct in the Banking Superannuation and Financial Services Industry; 4.4 Proportionality in the Australian Banking Regulation; 4.5 Conclusions.

4.1 Introduction.

The previous chapter analyzed the EU legal system. It considered the meaning of the principle of proportionality in the European dimension and highlighted some examples of the application of proportionality in banking regulation, in particular considering the Capital Requirements Regulations and Directives that have followed one another over the years. The fourth chapter deals with the

final legal system to examine in this thesis, *i.e.*, the Australian one. The chapter studies the Australian legal approach to the application of proportionality in the banking industry. After a brief analysis of the aspects of the banking structure in Australia and the presence of entities such as credit unions and building societies that carry out banking business alongside larger banking institutions, the chapter analyzes some examples of proportionality in banking regulation.

Observing the characteristics of the regulation, it would seem that a codified principle such as the one adopted by the European Union legislator is not present. The chapter highlights some examples from which the existence of an unwritten principle is evident. It is interesting to note how APRA, the Australian Prudential Regulation Authority, plays a fundamental role in modeling secondary regulation in such a way as to differentiate it according to the recipients.[373] However, it seems that the approach taken by the Australian legal system appears more labile than that assessed in the previous chapters. A reflection of this approach could be the composition of the Australian banking market. Indeed, the banking sector in Australia is characterized by the existence of four big banks: the Commonwealth Bank of Australia, the National Australia Bank, Westpac Banking Corporation, and the Australia New Zealand Banking

[373] The Australian Prudential Authority itself declares that: "APRA seeks to take a proportionate approach to its prudential requirements, and to tailor its activities according to risk in both supervision and in policy settings." See: *APRA's objectives*, APRA (2020), https://www.apra.gov.au/apras-objectives (last visited Sep 25, 2020).

Group Limited.[374] The Australian Prudential Regulation Authority (hereinafter also APRA) identified the above mentioned four major banks that are domestically relevant. The Prudential Authority conducted the identification according to the distinction of the Basel Committee between Global Systemically Important Institutions and Domestically Important Institution. According to APRA's data, Global Systemically Important Institutions are not present in Australia.[375]

The configuration of the Australian market must also face the growing weight of technology in the banking sector. Indeed, an essential aspect that affects the activities of small Authorized Deposit-taking Institutions is the emergence of new technologies that have now become indispensable as banking services for the customer and the optimal functioning of the bank. Smaller banks have difficulties in making the necessary investments in technology to keep pace with the digital transformation. In this sense, investments in technology represent an additional fixed cost, which joins other costs that smaller banks are struggling to bear. An effect of this fixed cost is the merging with other banking institutions, including, for example, the merger of Gympie Credit Union and

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[374] Ian Verrender, *Are Australia's Big Four Banks equipped for recession?* ABC (2020), https://www.abc.net.au/news/2020-05-04/are-australias-big-four-banks-equipped-for-recession/12210538 (last visited Sep 25, 2020).
[375]Katia D'hulster, *Concentration and Contagion Risks in the Australian Banking System*, 1 JOURNAL OF APPLIED SCIENCE IN SOUTHERN AFRICA 45 (2017).

Warwick Credit Union and Queensland Country Credit Union with Queenslander's Credit Union.[376]

The fourth chapter is structured as follows. Section 4.2 provides an overview of the current Australian banking system. Section 4.3 traces the history of Australian banking regulation, starting with the Campbell Inquiry, up to the last Royal Commissions held in the financial sector in 2019. The section is divided into five sub-sections. Sub-section 4.3.1 deals with the Campbell Inquiry in its main features. Sub-section 4.3.2 deals with the Wallis Inquiry and the effects that the reforms implemented in response to this Inquiry have had on credit unions and building societies. Sub-section 4.3.3 concerns the legislative responses that the Australian system has put in place following the Great Financial Crisis of 2007-2008 and the implemented measures. Sub-section 4.3.4 pertains to the 2014 Murray Inquiry. Sub-section 4.3.5 concerns the Royal Commission into Misconduct in the Banking, Superannuation, and Financial Services Industry. Section 4.4 analyzes some examples in which the proportionality principle is applied in the Australian financial regulation. The chapter makes its conclusions in section 4.5.

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[376] James Frost, *Banking Minnows Merge as Tech Costs Soar* AUSTRALIAN FINANCIAL REVIEW (2019), https://www.afr.com/companies/financial-services/banking-minnows-merge-as-tech-costs-soar-20190531-p51tb5 (last visited Sep 25, 2020).

4.2 The Australian Banking System.

Before entering the heart of the analysis of the principle of proportionality in Australian banking regulation, it appears appropriate to mention the functioning of the Australian financial system and its main legislative sources. It is important to specify that the Commonwealth of Australia came of being after the Parliament of the United Kingdom approved the Commonwealth of Australia Constitution Act in 1900. The new Australian federation was established on January 1st, 1901. Indeed, before that date, the Australian states where colonies of the British Empire.[377] The purpose of the Australia Constitution Act was to constitute the Commonwealth of Australia. This Act contains the Australian Constitution in section 9. The Constitution defines the legislative powers of the Australian Parliament. Moreover, the Constitution granted to the former colonies the *status* of States, *i.e.*, entities with self-governing powers. According to section 51 (xiii), the Commonwealth Parliament has the authority to emanate laws concerning the banking sector, except for state banking.[378]

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[377] *The Constitution*, PARLIAMENT OF AUSTRALIA (2013), https://www.aph.gov.au/About_Parliament/House_of_Representatives/Powers_practice_and_procedure/00_-_Infosheets/Infosheet_13_-_The_Constitution (last visited Sep 25, 2020).
[378] *The Australian Constitution*, PARLIAMENT OF AUSTRALIA (2019), https://www.aph.gov.au/about_parliament/senate/powers_practice_n_procedures/constitution (last visited Sep 25, 2020).

In *Melbourne Corp. v. The Commonwealth,*[379] the High Court defined "state banking" as the business of banking carried out by a state as a banker. The definition does not include the case in which the state is a customer of a bank. The Australian states operated as a bank for several years. The number of these banks progressively diminished due to mergers and acquisitions. Currently, there are no longer any state-owned banks.[380] In light of the above, the banking regulation that this chapter will consider will only be federal regulation. The current Australian financial system provides for various legislative acts issued by the Australian Parliament that govern the so-called "Authorized Deposit-taking Institutions" (in the future also ADIs). Authorized Deposit-taking Institutions are financial institutions in Australia that have obtained a license from the Australian Prudential Regulatory Authority (APRA - see *infra*) to carry out banking activities. This activity also includes the collection of savings from the public. The definition of Authorized Deposit-taking Institutions includes banks, building societies, and credit unions (see *infra*).[381]

The legislative acts issued by the Australian Parliament governing Authorized Deposit-taking Institutions are mainly six. They are the Banking Act enacted in 1959, the Reserve Bank Act also enacted in 1959, the Financial Sector (Shareholdings) Act of 1998, also known as FSSA; the Corporations Act of

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[379] *Melbourne Corp. V. The Commonwealth* (1947) 74 CLR 31.
[380] Alan L. Tyree, BANKING LAW IN AUSTRALIA 7 (2017).
[381] *Authorised Deposit-taking Institution (ADI)*, AUSTRALIAN GOVERNMENT AUSTRAC (2020), https://www.austrac.gov.au/glossary/authorised-deposit-taking-institution-adi (last visited Sep 21, 2020).

2001; the Financial Sector (Collection of Data) Act of 2001, also known as FSCODA; and finally the Financial Sector (Transfer and Restructure) Act issued in 1999 and also known as FSTRA. Based on these pieces of legislation, regulators have defined the regulatory framework in prudential standards and guidelines.[382]

In particular, the authorities that supervise financial institutions are the Australian Prudential Regulation Authority (APRA), the Australian Security and Investment Commission (ASIC), and the Reserve Bank of Australia (RBA). The Australian Prudential Regulation Authority has the task of issuing the prudential regulation related to Authorized Deposit-taking Institutions and supervising the latter. APRA also deals with the regulation and supervision of other institutions such as private and life health insurance companies as well as pension funds.[383] APRA has strong regulatory powers to intervene in the activities of Authorized Deposit-taking Institutions. Among the various powers, the Australian Prudential Regulation Authority applies and guarantees compliance with prudential standards. The Authority may also revoke the authorization of an institution under its supervision, in the event that this institution does not meet the legal requirements or prudential standards. APRA also has the power to intervene, in specific circumstances, to protect depositors

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[382] Ian Paterson, *Banking Regulation in Australia: Overview* PRACTICAL LAW THOMSON REUTERS (2020), https://uk.practicallaw.thomsonreuters.com/w-006-9098?transitionType=Default&contextData=(sc.Default)&firstPage=true#co_anchor_a112520 (last visited Sep 21, 2020).
[383] *Idem*.

and maintain the financial system's stability. On this point, APRA can also take control of the Authorized Deposit-taking Institutions in difficulty.[384]

APRA has developed a regulatory framework based on the principles of the Basel Committee for Banking Supervision, which include, among others: the requirements relating to capital adequacy, credit risk, market risk, liquidity, credit quality, large exposures, credit card risk management, audit, and reporting. The Australian Prudential Regulation Authority also has the role of a national statistical agency for the financial sector. In this sense, the Authorized Deposit-taking Institutions must regularly provide financial information to APRA, using standardized forms.[385]

In 2001, the Australian Security and Investment Commission Act founded the Australian Security and Investment Commission. It is the regulatory and supervisory authority responsible for market conduct and investor protection. It administers the Corporation Act, including the provisions relating to financial reporting, corporate fundraising and external administration and insolvency. ASIC is also responsible for investor protection in the area of financial services regulation. Its role mainly consists in encouraging performance in the financial system, promoting informed participation of investors and consumers in the

[384] *Idem*.
[385] *Idem*.

financial system and making public information relating to companies or other bodies.[386]

The Australian financial system also has a central bank, the Reserve Bank of Australia, which began operations in January 1960.[387] The implementing legislation attributed to the Reserve Bank of Australia the central bank function of the Commonwealth Bank, which had evolved over time. Other rules separated the savings banking and commercial banking activities of the Commonwealth Banking Corporation.[388] The Reserve Bank of Australia is responsible for maintaining the stability of the financial system and monetary policy. It also promotes the safety and efficiency of payment systems, manages the issuance of banknotes, and provides financial services for the Government and its agencies. RBA also manages Australia's official reserves and provides liquidity lines to Authorized Deposit-taking Institutions. Among its many responsibilities, the Reserve Bank of Australia also has to issue financial stability standards and monitor compliance to standards for clearing structures. It also has the task of making the best contribution to controlling risks in the

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[386] *Our Role*, AUSTRALIAN SECURITIES AND INVESTMENTS COMMISSION (2020), https://asic.gov.au/about-asic/what-we-do/our-role/ (last visited Sep 21, 2020).
[387] Bijit Bora & Mervyn K. Lewis, *The Australian Financial System: Evolution, Regulation, and Globalization*, 28 LAW & POLICY IN INTERNATIONAL BUSINESS 788 (1997).
[388] The Commonwealth Bank of Australia was established in 1911 by the Commonwealth bank Act. This Act gave the Commonwealth bank only the functions of commercial and savings banking. At a later time, the Commonwealth Bank gradually evolved its central banking activities. See: *The Beginnings Through to Development as a Central Bank*, COMMONWEALTH BANK OF AUSTRALIA (2020), https://www.commbank.com.au/about-us/our-company/history/1912-1960.html (last visited Sep 19, 2020).

financial system, keeping the currency stable, and promoting competition in the payment services market.[389]

In addition to the Australian Prudential Regulation Authority, the Australian Security and Investment Commission, and the Reserve Bank of Australia, other authorities play a very important role in the Australian financial system. They are Federal Treasury, Australian Competition and Consumer Commission (ACCC), Australian Taxation Office (ATO), Australian Transaction Reports & Analysis Center (AUSTRAC), Foreign Investment Review Board (FIRB). The Federal Treasury is the executive branch of the Australian Government. Its field of activity is mainly related to economic policy. Another relevant role of the Federal Treasury is to advise on political processes. It also has the role of promoting a secure financial system and safeguarding the public interest in consumer protection and foreign investment.[390]

The Australian Competition and Consumer Commission deals with competition and verifying compliance with the Competition and Consumer Act 2010 of Australia (CCA). In particular, this Act prohibits the stipulation of anti-competitive agreements aimed at fixing prices, market sharing, boycott, and unfair commercial practices.[391] The Australian Taxation Office is the primary

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[389] Ian Paterson, *op. cit.*

[390] *The Department*, AUSTRALIAN GOVERNMENT THE TREASURY (2020), https://treasury.gov.au/the-department (last visited Sep 22, 2020).

[391] *About Us*, AUSTRALIAN COMPETITION & CONSUMER COMMISSION (2020), https://www.accc.gov.au/about-us (last visited Sep 22, 2020).

agency involved in collecting Australian government revenue and related issues, such as aggressive tax planning and persistent tax debtors. The Australian Taxation Office also holds the Australian Business Register.[392] Another important figure in the Australian financial system is the Australian Transaction Reports & Analysis Center (AUSTRAC). It is the Australian anti-money laundering and terrorist financing regulator. It collects and analyzes financial reports and information to generate financial intelligence.[393]

Finally, the Foreign Investment Review Board is a body established in 1976 with the purpose of advising the Treasurer and the Government on Australia's foreign investment policy (the Politics) and its administration. The Board has only advisory functions. It examines foreign people's proposals to invest in Australia and makes recommendations to the Federal Treasurer, who is responsible for making decisions.[394] After this overview of the legislative sources system in the Australian financial landscape and on the regulatory and supervisory authorities operating in the Australian financial system, the next paragraphs will consider the main events that have characterized the Australian financial system's regulation.

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[392] *Who We Are*, AUSTRALIAN GOVERNMENT AUSTRALIAN TAXATION OFFICE (2020), https://www.ato.gov.au/About-ATO/Who-we-are/ (last visited Sep 22, 2020).
[393] *AUSTRAC Overview*, AUSTRALIAN GOVERNMENT AUSTRAC (2020), https://www.austrac.gov.au/about-us/austrac-overview (last visited Sep 22, 2020).
[394] *About FIRB*, AUSTRALIAN GOVERNMENT FOREIGN INVESTMENT REVIEW BOARD (2020), https://firb.gov.au/about-firb (last visited Sep 22, 2020).

4.3 History of Financial Regulation in Australia: from the Campbell Inquiry to the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry.

The previous paragraph analyzed the main characteristics of the current Australian financial system in order to give an overview that allows a full understanding of the legal system covered by this chapter. This section will deal with the main events that have characterized the path of financial law in the Australian legal system. Compared to the other two legal systems examined in the second and third chapters, the Australian legal system's peculiarity is given by the presence in the Australian legal system of Royal Commissions and related inquiries that have followed one another over the years. These Royal Commissions address highly relevant issues of national concern. They, therefore, play a very important role also in the field of financial and banking law.[395]

Before getting into the heart of the Royal Commissions that have followed one another over the years in the Australian system that deal with banking and, more

[395] For an overview of the Royal Commissions see *British Tribunals of Inquiry: Legislative and Judicial Control of the Inquisitorial Process-Relevance to Australian Royal Commissions*, PARLIAMENT OF AUSTRALIA (2003), https://www.aph.gov.au/About_Parliament/Parliamentary_Departments/Parliamentary_Library/pubs/rp/rp0203/03RP05#executivesummary (last visited Sep 25, 2020).

generally, financial issues, it is important to specify what Royal Commissions are and how they work. The Royal Commissions and their inquiries play a fundamental role in the Australian legal system. The Royal Commissions and related Inquiries are considered the highest form of inquiry into matters of public importance. On behalf of the Crown and the Government Ministers' advice, the Governor-General formally establishes the Royal Commission. In general, the Royal Commissions are divided into two main categories. On the one hand, there are Royal Commissions, which are primarily investigative and seek to find out the truth about a specific issue. On the other hand, some are advisory, which therefore seek to assist the Government in the formulation of Government policies.[396]

The Royal Commissions with investigative functions, therefore, have extensive powers in carrying out the investigation, including the power to examine witnesses, obtain evidence, and authorize police search warrants..[397] The Royal Commissions conclude with a report, which contains the investigations and studies' results. While the Royal Commission has the advisory aim, it contains numerous recommendations, which the Government considers in issuing future

[396] Barry York, *Royal Commissions: What Are They and How Do They Work?* MUSEUM OF AUSTRALIAN DEMOCRACY (2015), https://www.moadoph.gov.au/blog/royal-commissions-what-are-they-and-how-do-they-work/# (last visited Sep 22, 2020).
[397] Ian Paterson, *op. cit.*

financial regulation and policy. These purposes, advisory and investigative, can overlap each other in the same inquiry.[398]

Having clarified the meaning and role of the Royal Commissions in the Australian legal system, the following sub-sections retrace the main features of this jurisdiction's legal financial history. Indeed, Australia has a long history of public inquiries in the financial system. The following sub-sections will analyze the Campbell Inquiry, reported in 1981, which involved substantial financial deregulation. The conclusions of the Campbell Report were validated by the Martin Review Report of 1983. Financial deregulation was also examined by the House of Representatives' Standing Committee on Finance and Public Administration in 1991. It is also referred to as the Martin Committee. Also, in 1991, the Commission examined the financial system in terms of the availability of capital for investment.[399] The following paragraphs will also analyze the 1997 Wallis Inquiry, which proposed radical changes to the financial system, and its effects on credit unions and building societies. The Murray Inquiry will be also examined. This Inquiry has been established in the aftermath of the Great Financial Crisis. Finally, the Royal Commission into Misconduct in the

[398] Barry York, *op. cit.*
[399] Phil Hanratty, *The Wallis Report on the Australian Financial System: Summary and Critique* PARLIAMENT OF AUSTRALIA (1997), https://www.aph.gov.au/About_Parliament/Parliamentary_Departments/Parliamentary_Library/pubs/rp/rp9697/97rp16#INTRO (last visited Sep 23, 2020).

Banking Superannuation and Financial Services Industry, which ended in 2019, will be discussed.

4.3.1 The Campbell Inquiry.

The Australian financial landscape has changed dramatically over the decades. It has transformed into a virtually deregulated system in the five years following the appointment of an important investigation into the financial system, the Campbell Committee of 1979, which issued a report in 1981.[400] The main interests of the Campbell Committee were to promote an efficient, competitive, and stable financial system. In this sense, the investigation recommended the abandonment of a wide range of direct controls by the state, in order to almost completely rely on free-market methods of intervention in the financial system.[401]The Committee considers that the most efficient way to organize economic activity is through a competitive market, subject to a minimum level of regulation and minimum government intervention.[402]

Among the many areas of intervention, the Campbell Committee also analyzed the Reserve Bank of Australia's role concerning the appropriateness of its

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[400] Bijit Bora & Mervyn K. Lewis, *op. cit.*, 792.
[401] *Australian Financial System Final Report of the Committee of Inquiry*, AUSTRALIAN GOVERNMENT THE TREASURY (1981), https://treasury.gov.au/sites/default/files/2019-03/p1981-fsi-Chpt1-12.pdf (last visited Sep 20, 2020).
[402] *Idem*, 758.

degree of independence in fulfilling its monetary, external, and prudential responsibilities. In particular, the Commission stressed that the Reserve Bank should have been responsible for the formulation and implementation of prudential policies. The Committee also felt that the Reserve Bank of Australia should assume overall responsibility for monitoring domestic payment systems' operations and development.[403]

Subsequently to the Campbell Committee, which ended with the 1981 report, and the functions of the Reserve Bank of Australia were changed in 1983, with the abolition of exchange control due to the Australian dollar fluctuations. The Reserve Bank of Australia then gradually took over the specialized banking supervision functions.[404] Financial deregulation, which began with the Campbell Inquiry, was then revised by the Wallis Committee, which published its report in March 1997. The Wallis Inquiry will be discussed in the next sub-section.

4.3.2 The Wallis Inquiry and the Effects of the Reform on Credit Unions and Building Societies.

[403] *Idem*, 761.
[404] *A Brief History*, RESERVE BANK OF AUSTRALIA (2020), https://www.rba.gov.au/about-rba/history/ (last visited Sep 20, 2020).

The Financial System Inquiry, also known as the Wallis Inquiry, [405] was established in 1996 to perform three main tasks. First, the 1996 Financial System Inquiry had to evaluate the Australian experience of financial deregulation. The Inquiry then had to identify the main elements that characterized the change in the financial system. Finally, the Financial System Inquiry recommended regulatory changes that were appropriate in light of the Australian financial system's continuing evolution. [406] While the Campbell Inquiry focused primarily on the issue of financial deregulation, the Wallis Inquiry focused more on the reconfiguration of regulation and regulatory institutions. The goal was to facilitate appropriate responses to financial conditions changes while protecting financial stability. Therefore, the Wallis Report of 1997 recommended making fundamental changes to the financial regulation provisions, also in light of profound technological changes, economic policy, and changing customer needs.[407]

The Inquiry concluded with several recommendations,[408] and with the observation that in the Australian legal system, there was the convergence of financial markets. This observation led to the outcome that the Australian financial system should be based on sectors and not in institutions. Hence, the Inquiry advised elaborating a single licensing regime for all deposit-taking

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[405] From the name of its Chairman, Mr. Stan Wallis.
[406] Ian R. Harper, *The Wallis Report: An Overview*, 30 AUSTRALIAN ECONOMIC REVIEW 288 (2002).
[407] *Ibid.*
[408] The recommendations are more than one hundred.

institutions. The Inquiry also suggested reorganizing the banking regulation according to the role and function of institutions.[409]

Among the various recommendations, the Wallis Report suggested forming a single regulator for the entire financial supervision system, the Australia Prudential Regulation Commission. This proposal was motivated by the need to have a more efficient financial system, which guaranteed greater flexibility.[410] The Wallis Report also suggested rethinking some existing supervisors' functions and roles, including the Reserve Bank of Australia. The Wallis Report then proposes the abolition of the four main banks' ban to merge with each other. Some of the various recommendations in the Wallis report have been challenged. For example, it was discussed that the presence of a single supervisory authority for the entire financial system could have a negative impact on the stability and efficiency of the financial system. Similarly, the reformulation of the Reserve Bank of Australia's role to separate its responsibility for monetary policy from its prudential function has been challenged.[411]

An important innovation for the purposes of this thesis, which is brought by the Financial System Inquiry, is that starting from 1997, all companies that carry out banking activities must obtain authorization from the Australian Prudential

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[409] Phil Hanratty, *op. cit.*
[410] Phil Hanratty, *op. cit.*
[411] *Ibid*.

Regulation Authority. As anticipated above, the Australian Prudential Regulation Authority Act established APRA in 1998 to regulate the institutions involved in deposit-taking, superannuation, and insurance. As part of its powers, APRA develops prudential standards, which regulate the activity of financial institutions. According to section 11AF of the Banking Act 1959, Australian Prudential Standards have the force of law.[412]

This reform that succeeded the Wallis Inquiry therefore had a very important impact on credit unions and building societies. Preliminarily, it must be specified that credit unions are cooperative societies that lend money to their members and accept deposits. Anywone can join a credit union and become a member. Each member owns the organization they belong to and have the right to vote in the organization.[413] A building society is a type of financial institution that provides banking services to its members, especially savings and mortgages landing. Prior to the reforms that followed the Financial System Inquiry, building societies and credit unions were not considered banks.[414] A paradigmatic case is *Australian Independent Distributors Ltd v. Winter,* in which the High Court of Australia judged if a society that accepts deposits from its member could be considered carrying the business of banking. The High

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[412] Alan, Tyree, *op. cit.*,5.
[413] *What is the Difference Between a Credit Union, Mutual Bank, a Mutual Building Society and a Publicly-listed Bank?* CUSTOMER OWNED BANKING ASSOCIATION (2020), https://www.customerownedbanking.asn.au/consumers/faqs/34-what-is-the-difference-between-a-credit-union-or-a-mutual-building-society-and-a-bank (last visited Sep 24, 2020).
[414] Alan, Tyree, *op. cit.*, 6.

Court declared that the society did not carry the business of banking because it was empowered to lend only to its members.[415]

The Wallis Reforms represents one of the breaks of the structure of the banking sector, especially for this typology of financial institutions. The reforms following the Wallis Inquiry established the APRA in 1998, which became responsible for the ADI's prudential regulation. Under this regime, ADI must comply with a uniform set of rules relating to capital adequacy, as well as other prudential standards analogous to those that have long been implemented in the banking system.[416]

After this reform, any firm that performs the business of banking must obtain authorization by the Australian Prudential Regulation Authority (APRA) to be an authorized deposit-taking institution (ADI). Hence, the Financial Sector Reform changed the legislative competence of credit unions and building societies, moving it from state legislation to Commonwealth company's legislation. APRA regulated credit unions and building societies as Authorized deposit-taking institutions. They are also subject to the regulation of the Australian Securities and Investments Commission, Australia's corporate regulator. In 2010, the Federal Government declared that certain building societies and credit unions could become banks. In this sense, they are not

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[415] *Australian Independent Distributors Ltd v. Winter* [1964] HCA 78; 112 CLR 443
[416] Therese Wilson, *Be Careful What You Ask For*, 15 GRIFFITH LAW REVIEW 381 (2006).

subject to the prohibition of using the name "bank" under section 66 of the Banking Act 1959. These mutual banks are often defined as customer-owned banks, in which each member has one vote, regardless of the account balance and the number of accounts detained.[417]

From the legislative development aimed at including credit unions and building societies in the category of banks, with the consequent compliance with the regulatory standards envisaged for banks, it is evident that there has been the same application of similar legislation for banking types institutions that have profoundly different characteristics. In this sense, in light of the considerations made in the second and third chapters of this thesis, these institutions can struggle to apply the same regulation in more complex financial structures. However, it is interesting to note that this legislative equivalence of building societies and credit unions with banks, although it entails major compliance difficulties, has been gladly accepted by the building societies and credit unions themselves. Indeed, building societies and credit unions in the occasion of the Wallis Inquiry declared to be strongly supportive about being under a single regulatory scheme. As reported by Wilson, this behavior is driven by the desire to have the same tools to be able to compete with the banking sector. The consequence of the one-size-fits-all regulation has been the formation of larger credit unions.[418]

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[417] Alan, Tyree, *op. cit*.,7.
[418] *Idem,* 371.

However, considering the uniform application of the banking regulation, scholars highlighted that mutual organizations that operate in more traditional ways have more difficulties in meeting the new regulatory requirements.[419]

These difficulties in maintaining strict compliance rules formulated for financial institutions of greater complexity, although positively accepted by credit unions and building societies, constitute regulatory barriers for these entities' existence in the Australian financial market. Furthermore, their existence in the market is very important to ensure access to credit for customers' categories, including some consumers, who would generally have difficulty accessing banking services.

Wilson highlighted the role of credit unions in facing the problem of financial exclusion in Australia. The scholars in the United Kingdom coined the term financial exclusion, defined as "those processes that prevent poor and disadvantaged social groups from gaining access to the financial system."[420] People with low incomes who remain excluded from access to credit from traditional channels generally tend to resort to alternative credit channels, such as payday lenders. However, these alternative channels may have the consequence of being even more onerous, leading to over-indebtedness. In this sense, Wilson stressed that historically the role of credit unions was to

[419] *Idem*, 375.
[420] Therese Wilson, *op. cit.,* 373.

accommodate the need for access to credit for the most disadvantaged population with tools that this population can afford. The modalities consisted of the collection of savings among the members of the credit union, which are subsequently used to grant credit at affordable rates.[421]

In this sense, given the important role these institutions play in terms of access to credit, it appears in everyone's interest to ensure these institutions' presence in the market. However, the regulatory trend that is being recognized would seem to continue to have a poorly proportioned approach, with the tendency to apply a one-size-fits-all regulation. This trend can only make the permanence of these institutions in the market increasingly at risk, due to the difficulties of remaining compliant with the banking regulation.

The difficulties of these institutions in being compliant with regulatory requirements then exacerbated due to the global financial crisis. Although the crisis affected Australia to a lesser extent than other states, it has nevertheless produced dramatic effects.

4.3.3 The Australian Response to the Great Financial Crisis.

Australia was not immune to the effects generated by the financial crisis of 2007-2008. However, the Australian Prudential Regulation Authority declared

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[421] *Idem*, 374.

that the effects of the financial crisis in Australia have not been as dramatic as in other countries, including the United States. According to APRA, the crisis's experience in Australia had less severe effects due to the fact of having a strong economy, as well as having taken appropriate measures in time to counter the crisis.[422] For Authorized Deposit-taking Institutions, the crisis mainly consisted of a liquidity crisis, caused by the severe contraction of liquidity globally. The crisis was initially dealt with in an emergency by the Reserve Bank of Australia. Subsequently, the Commonwealth provided a guarantee of wholesale deposits and financing. This funding proved to be crucial for the ADIs, which were thus able to continue their business. These interventions were temporary, and they were removed in 2010 when the markets stabilized.[423]

According to a study of Amir Moradi-Motlagh and Alperhan Babacan concerning the impact of the great financial crisis in the efficiency of Australian banks, it seems that small Australian banks suffer from inefficiencies and are far less profitable than their primary counterparts. The authors conclude by stating that the fact that the number of banks has shrunk, and small banks have poor performance implies that regional banks still on the market are facing severe challenges.[424]

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[422] *Regulation Impact Statement Implementing Basel III Capital Reforms in Australia*, AUSTRALIAN PRUDENTIAL REGULATION AUTHORITY (2012), https://www.apra.gov.au/sites/default/files/September-2012-Basel-III-capital-regulation-impact-statement.pdf (last visited Sep 25, 2020).
[423] *Ibid.*
[424] Amir Moradi-Motlagh & Alperhan Babacan, *The Impact of the Global Financial Crisis on the Efficiency of Australian Banks*, 46 ECONOMIC MODELLING 406 (2015).

In response to the crisis, and to implement Basel III, the Australian legislator adopted a series of changes to many prudential standards and related reporting standards about capital adequacy. In particular, where modified Prudential Standard APS 110 on capital adequacy;[425] APS 111 on measurement of capital;[426] APS 112 concerning the standardized approach to credit risk;[427] APS concerning the internal ratings based approach to credit risk;[428] APS concerning market risk;[429] APS on the interest rate risk in the banking book;[430] Prudential Standard in securitization;[431] and Prudential Standards on public disclosure of prudential information.[432] Moreover, Basel III was implemented through the

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[425] *Prudential Standard APS 110 Capital Adequacy (APS 110)*, AUSTRALIAN PRUDENTIAL REGULATION AUTHORITY (2016), https://www.apra.gov.au/sites/default/files/160101-APS-110_0.pdf (last visited Sep 25, 2020).

[426] *Prudential Standard APS 111 Capital Adequacy: Measurement of Capital (APS 111)*, AUSTRALIAN PRUDENTIAL REGULATION AUTHORITY (2018), https://www.apra.gov.au/sites/default/files/aps-111-january-2018.pdf (last visited Sep 25, 2020).

[427] *Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit Risk (APS 112)*, AUSTRALIAN PRUDENTIAL REGULATION AUTHORITY (2019), https://www.apra.gov.au/sites/default/files/Final-Prudential-Standard-APS-112.pdf (last visited Sep 25, 2020).

[428] *Prudential Standard 113 Capital Adequacy: Internal Ratings Based Approach to Credit Risk (APS 113)*, AUSTRALIAN PRUDENTIAL REGULATION AUTHORITY (2013), https://www.complianceonline.com/articlefiles/Australia_General_Insurance_Capital_Adequacy_Prudential_Standard_113.pdf (last visited Sep 25, 2020).

[429] *Prudential Standard APS 116 Capital Adequacy: Market Risk (APS 116)*, AUSTRALIAN PRUDENTIAL REGULATION AUTHORITY (2015), https://www.apra.gov.au/sites/default/files/141120-APS-116_0.pdf (last visited Sep 25, 2020).

[430] *Prudential Standard APS 117 Capital Adequacy: Interest Rate Risk in the Banking Book (Advanced ADIs) (APS 117)*, AUSTRALIAN PRUDENTIAL REGULATION AUTHORITY (2013), https://www.complianceonline.com/articlefiles/Australia_Basel%20III_Prudential_Standard_117.pdf (last visited Sep 25, 2020).

[431] *Prudential Standard APS 120 Securitization (APS 120)*, AUSTRALIAN PRUDENTIAL REGULATION AUTHORITY (2018), https://www.apra.gov.au/sites/default/files/aps_120_securitisation.pdf (last visited Sep 25, 2020).

[432] *Prudential Standard APS 330 Capital Adequacy: Public Disclosure of Prudential Information (APS 330)*, https://www.apra.gov.au/sites/default/files/130409-aps-330-draft-final_0.pdf, AUSTRALIAN PRUDENTIAL REGULATION AUTHORITY (2013),

introduction of a new reporting standard concerning Fair Values, as well as minor changes to other reporting standards. [433] Although Australia has not suffered the financial crisis as in other geographic areas such as Europe and the United States, the Australian legislator has nevertheless opted for the full implementation of Basel III through several prudential standards. In the Australian system, prudential Standards apply to all Authorized deposit-taking institutions. Hence, Prudential Standards apply also to small and medium banking institutions that are not internationally active.[434] In this sense, the Australian system trend is to apply the one-size-fits-all approach, thus ensuring uniform application of the banking discipline for regulated institutions.

4.3.4. The Murray Inquiry.

In the previous paragraph it was said that the Australian system was able to counter the effects of the crisis with a series of ad hoc measures. An important

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https://www.apra.gov.au/sites/default/files/130409-aps-330-draft-final_0.pdf (last visited Sep 25, 2020).

[433] *Reporting Standard ARS 111 Fair Values (ARS 111)*, AUSTRALIAN PRUDENTIAL REGULATION AUTHORITY (2012), https://www.apra.gov.au/sites/default/files/120608_ars111.0_reporting_standard_0.pdf (last visited Sep 25, 2020).

[434] *Regulatory Consistency Assessment Programme (RCAP) - Assessment of Basel III LCR regulations - Australia*, THE BANK FOR INTERNATIONAL SETTLEMENTS (2017), https://www.bis.org/bcbs/publ/d419.htm (last visited Sep 25, 2020).

step that was taken in the aftermath of the global financial crisis was David Murray's Financial System Inquiry. Indeed, in the aftermath of the global financial crisis, the Treasurer, in December 2013, established an inquiry in order to review Australia's financial system. The final report was released in 2014 (the so-called Murray Inquiry). The Murray Inquiry made 44 recommendations concerning the Australian Financial System. The Inquiry found that the Australian regulatory system was, in general terms, acceptable and with many strong characteristics. However, the Inquiry found some weaknesses, for example, in taxation and regulation, which could distort the flow of funding in the real economy. According to the Inquiry, Australia's financial system is still susceptible to financial shocks; superannuation was not delivering retirement incomes adequately.

Moreover, the Inquiry highlighted the prevalence of unfair consumer outcomes as well as issues in competition. On this point, the Inquiry specified that the regulation does not focus on the advantages of innovation and competition.[435] Although the Inquiry considered that competition generally appears to be adequate, the Australian system is characterized by its high concentration. High concentration could lead to the possibility that the benefits of competition will be limited in the future, making proactive control over time. For the purposes of the present thesis, it is important to highlight that the recommendation of the

[435] David Murray, et al., *op. cit.*

Australian Government in the Murray Inquiry stressed the importance of competition, given the disproportionate effect that regulation could have on smaller firms. It is necessary to preserve competition through a periodic review of the state of competition in the Australian financial system.[436] The Inquiry analyzed and made recommendations concerning five main themes, divided into five chapters. Chapter 1 analyzed the resilience of Australia's Financial system; chapter 2 is related to the enhancement of the superannuation system; chapter 3 attains at innovation in the financial sector as a benefit for consumers, businesses, and government. Chapter 4 is focused on the fair treatment of consumers, while chapter 5 concerns a robust regulatory system, which is capable of maintaining trust and confidence in the financial system.[437]

The Australian Government declared that the Murray Inquiry was moved by the public interest and, in particular, the interest of consumers, businesses, taxpayers, the Government, and the economy.[438] The Government reacted to the recommendations made by the Murray Inquiry through a series of changes and enhancements of existing measures.

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[436] *Idem*, 255.
[437] *Ibid.*
[438] *Ibid.*

4.3.5 Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry.

Another investigation that deserves to be mentioned in this chapter is the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry. This Commission was established after five years from the Murray Inquiry, The purposes of this Royal Commission were "to inquire into, and report on, whether any conduct of financial services entities might have amounted to misconduct and whether any conduct, practices, behavior or business activities by those entities fell below community standards and expectations."[439] The Australian Government established the Royal Commission on December 14th, 2017, according to the Royal Commission Act 1902.[440] On the one hand, a boost towards this inquiry was the recommendation of a parliamentary inquiry to establish a Royal Commission, in light of the lack of regulatory intervention by the competent authorities.[441] On the other hand, a series of scandals in the financial sector emerged.

In particular, there was a money-laundering scandal at the time of the investigation. The Commonwealth Bank of Australia has failed to report

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[439]Kenneth M. Hayne, *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry Final Report* ROYAL COMMISSION 1 (2019), https://www.royalcommission.gov.au/sites/default/files/2019-02/fsrc-volume-1-final-report.pdf (last visited Sep 25, 2020).
[440] *Idem*, xxxv.
[441]Pat McGrath & Michael Janda, *Senate Inquiry Demands Royal Commission into Commonwealth Bank*, ASIC ABC (2014), https://www.abc.net.au/news/2014-06-26/senate-inquiry-demands-royal-commission-into-asic-cba/5553102?nw= (last visited Sep 25, 2020).

suspicious transactions and violated several provisions of the Anti-Money Laundering and Terrorist Financing Act.[442] The National Australia Bank was also involved in financial planning scandals and impropriety in foreign exchange trading.[443] The Honorable Kenneth M. Hayne served as the sole Commissioner of the Royal Commission. He was the former Justice of the High Court of Australia. The Commissioner noted that bonuses, incentives, and commission schemes measured sales and profits, but not compliance with the law and regulatory standards. Therefore, very often, the institutions that violated the law were not held adequately into account.[444]

The final report was published on February 4th, 2019, together with the government's response to the recommendations of the Royal Commission.[445] The Final Report is divided into eight chapters. The first chapter is introductory and contains the underlying principles and general rules that the Royal Commission applied in its inquiry. Chapter 1 also contains recommendations divided by subject matter. Chapter 2 focuses on the banking sector and its specificities, namely lending, banking services, the enforceability of industry

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[442] Mattew Doran & Michale Janda, *Commonwealth Bank to Pay $700m Fine for Anti-money Laundering, Terror Financing Law Breaches* ABC NEWS (2018), https://www.abc.net.au/news/2018-06-04/commonwealth-bank-pay-$700-million-fine-money-laundering-breach/9831064 (last visited Apr 29, 2020).
[443] James Frost & James Eyers, *CBA and NAB Admit Impropriety in Foreign Exchange Trading* AUSTRALIAN FINANCIAL REVIEW (2016), https://www.afr.com/companies/financial-services/cba-and-nab-admit-impropriety-in-foreign-exchange-trading-20161221-gtfv3c (last visited Apr 28, 2020).
[444]Kenneth M. Hayne, *op.cit.*
[445] Phillip Hawkins, *Financial Services Royal Commission* PARLIAMENT OF AUSTRALIA (2019), https://www.aph.gov.au/About_Parliament/Parliamentary_Departments/Parliamentary_Library/pubs/BriefingBook46p/FinancialServicesRC (last visited Sep 25, 2020).

codes and processing and administrative errors. The third chapter concerns financial advice. It deals with issues such as professional discipline, inappropriate advice, and fees for no service. The fourth chapter makes recommendations regarding the superannuation regulatory framework. [446]

The fifth chapter is dedicated to the insurance sector, considering general insurance, life insurance, and the rules governing the insurance contract and claims management. The sixth chapter concerns remuneration, culture, and governance. The section dedicated to governance and the role of the board debates the Commonwealth Bank scandal relating to the failure to comply with the AML/ CTF laws. The Royal Commission discusses the further example of the National Australia Bank regarding the adviser service fees. The seventh chapter focuses on regulation by APRA and ASIC, while the eighth chapter contains other essential steps, including simplification, to meet the intent of the law.[447]

According to the Royal Commission, the responsibility for misconduct in the financial services sector is primarily attributable to the boards of directors and senior managers. The Commissioner Hayne points out that supervisors play a crucial role in this context. In the Final Report, the Royal Commission made 24 recommendations concerning institutions and individuals regarding dishonest

[446] Kenneth M. Hayne, *op.cit.*
[447] *Ibid.*

misconduct. The Final Report also attributed responsibility to regulators to take appropriate action to improve the financial services sector, including a request for APRA to have more oversight.[448] Some authors noted that the Royal Commission offered for the first time a regulatory framework that integrates law, morals, and public expectations.[449] From the overview of the history of banking regulation in Australia carried out in the previous paragraphs, there is a general tendency to apply a one-size-fits-all approach by the Australian legislator. Despite this trend, proportionality is well present in the Australian legal system, although to a lesser extent than in the legal systems analyzed in the second and third chapters of this thesis. The next paragraph notes the presence of proportionality in the financial regulation sector and, more specifically, banking.

4.4 Proportionality in the Australian Banking Regulation.

Concerning the presence of elements of proportionality in Australian banking regulation, it should, *in primis,* stressed that there is a general tendency by the legislator to apply the same banking rule to all ADIs, regardless of the nature,

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[448] *Idem.*
[449] Justin Obrien, *"Because They Could": Trust, Integrity, and Purpose in the Regulation of Corporate Governance in the Aftermath of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry*, 13 LAW AND FINANCIAL MARKETS REVIEW 141–156 (2019).

complexity, and size of the institution. Sometimes the legislator expects to simplify the legislation for everyone. For example, a simplification happened in the Future of Financial Advice legislation (from now on also FOFA). The legislator simplified FOFA to reduce compliance costs for small businesses, financial advisors, and consumers who require financial advice.[450]

Another example is related to the fact that the Australian legal system implemented the Basel agreements providing that the scope was not limited to internationally active banks but extended to all Authorized Deposit-taking institutions (ADIs). Despite this general trend, some examples of proportionality can be seen even in the Australian legal system. However, it seems that the examples are less copious than in the legal systems analyzed in the previous chapters, namely the United States and the European Union. An example of proportionality could be the Banking Executive and Accountability Regime (hereinafter also BEAR), which became law in February 2018. The BEAR is part of the Part IIAA of the Banking Act of 1959. The BEAR intended to strengthen the framework of responsibility of the Authorized Deposit-taking Institutions. The legislative framework is reinforced by attributing responsibility for specific activities to senior executives. The Regime also

[450] *Delivering Affordable and Accessible Financial Advice*, AUSTRALIAN GOVERNMENT THE TREASURY (2013), https://ministers.treasury.gov.au/ministers/arthur-sinodinos-2013/media-releases/delivering-affordable-and-accessible-financial (last visited Sep 25, 2020).

provided new powers to the Australian Prudential Authority APRA to investigate potential BEAR violations.[451]

The BEAR is a valid example of the application of the principle of proportionality because of the modifications made by the Treasury. The Treasury's consultation distinguishes and defines the Authorized Deposit-taking Institutions based on their size. Indeed, some aspects of the discipline provided by the BEAR depend on the size of the ADIs. Aspects include, for example, the commencement date, the deferral of variable remuneration, and the maximum civil penalty in case of violation of the BEAR. The determination states that a small ADI will be less than or equal to $ 10 billion out of a three-year average of total resident assets. An ADI, to be considered medium, must have between $ 10 billion and $ 100 billion on a three-year average of total resident assets. A large ADI, on the other hand, has an amount equal to or greater than $ 100 billion out of a three-year average of total resident assets.[452]

However, it would seem that the distinction of the ADIs in small, medium, and large will disappear with the introduction of the new Financial Accountability Regime (FAR). The new regime is expected to enter into force by the end of

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[451] *Banking Executive Accountability Regime*, AUSTRALIAN PRUDENTIAL REGULATION AUTHORITY (2019), https://www.apra.gov.au/banking-executive-accountability-regime (last visited Sep 25, 2020).
[452] *Treasury Laws Amendment (Banking Executive Accountability and Related Measures) Bill*, AUSTRALIAN GOVERNMENT THE TREASURY 14 (2019), https://treasury.gov.au/sites/default/files/2019-03/EXPLANATORY-MEMORANDUM_0.pdf (last visited Sep 25, 2020).

2020, but implementation will probably be gradual. With the entry into force of the FAR, the distinction of ADIs into small, medium, and large sizes will be replaced by "core compliance" and "enhanced compliance" entities. The core compliance entities will enjoy some exemptions. For example, they will be exempted from the obligation to present accountability maps and statements to supervisory authorities. The enhanced compliance entities must instead comply with all the obligations under the Financial Accountability Regime.[453] Concerning the discipline of financial accountability, the trend is to restrict the application of proportionality, passing from the distinction into three categories (Small, medium, and large) to two: "core compliance entities" and "enhanced compliance entities."

Another example of proportionality relates to the minimum capital requirements. In particular, all locally incorporated banks must retain a minimum requirement of at least 8% of the bank's risk-weighted assets. However, APRA has the power to increase these minimum capital requirements for individual banks. APRA exercises its power if it considers it necessary to increase the requirements taking into account the risk profile of the individual institution. In this context, APRA in 2019 decided to apply additional capital requirements for three major banks, namely Australia and New Zealand

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[453] Jonathan Gordon & Silvana Wood, *Bear Has Gone To(o) Far* ASHURST, https://www.ashurst.com/en/news-and-insights/legal-updates/bear-has-gone-too-far/ (last visited Apr 29, 2020).

Banking Group (ANZ), National Australian Bank (NAB) and Westpac. The increase in capital requirements followed APRA's 2018 decision to apply a capital supplement to the Commonwealth Bank of Australia (CBA), following the results of the Prudential Inquiry APRA initiated towards CBA. Following the Inquiry, APRA wrote to the boards of directors of 36 major banks, insurers and superannuation licensees, in order to verify whether the weaknesses found in the CBA Inquiry also existed in the other institutions. Although APRA found general financial soundness of the institutions examined, it nevertheless noted that some institutions presented the same problems identified in the CBA Prudential Inquiry. These circumstances, therefore, made the regulatory intervention of APRA necessary.[454]

Although, in such circumstances, a reference to proportionality is not explicitly identified, an example of the application of proportionality through the case-by-case approach can be seen in APRA's conduct. Indeed, APRA analyzed the major banks, insurers, and superannuation licensees and applied additional capital requirements in those larger institutions that needed an *ad hoc* adjustment. Moreover, APRA proposed to develop a simplified regulatory framework to be applied to small and less complex ADIs. Although this is not a regulation, it is interesting to consider future approaches to proportionality

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[454] *APRA Applies Additional Capital Requirements to Three Major Banks in Response to Self-assessments*, AUSTRALIAN PRUDENTIAL REGULATION AUTHORITY (2019), https://www.apra.gov.au/news-and-publications/apra-applies-additional-capital-requirements-to-three-major-banks-response-to (last visited Sep 25, 2020).

from the Prudential Authority. Indeed, the approach adopted by APRA was to develop regulation based on the standards of the Basel Committee to all ADIs, regardless of size, nature, and complexity. The regulatory framework outlined in the banking sector has become increasingly complicated since the global financial crisis.[455]

APRA, therefore, recognized that for smaller banking institutions, the cost of implementing the measures has become increasingly onerous and complicated. This cost could have a higher weight than the benefits deriving from prudential regulation. Hence, in its discussion paper concerning the revisions to the capital framework for Authorized Deposit-taking Institutions, APRA proposed proportionate and tailored prudential regulation for small ADIs, in order to reduce compliance costs without compromising prudential security and solvency. APRA decided to intervene in the simplification of operational risk, counterparty credit risk, leverage ratio, and public disclosures. This approach appears to be an attempt by the Supervisory Authority to mitigate the burden for the small banks. APRA is working on it through a dialogue with the banking industries on the areas that might be simplified.[456]

On June 12th, 2019, APRA published a document that proposes a review of the capital framework for the Authorized Deposit-taking Institutions. In particular,

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[455] *Idem*.
[456] Aidan O'Shaughnessy, *Apra Discussion Paper: Revisions to the Capital Framework* AUSTRALIAN PRUDENTIAL REGULATION AUTHORITY (2018), https://www.apra.gov.au/sites/default/files/aba_1.pdf (last visited Sep 25, 2020).

chapter 6 provides a simplified framework to apply to smaller, less complex ADIs. For example, in terms of disclosure, the simplified requirement proposed by APRA would consist of the centralized publication by APRA of the main prudential measures on behalf of small ADIs. The measures should allow greater reliance on ADIs on financial reports on remuneration and capital instruments. APRA believes that the appropriate size threshold for applying the simplified discipline is $ 15 billion in total assets. Simplified rules would automatically apply to ADIs that meet these eligibility criteria, and there would be no automatic opt-out provision. However, APRA maintains the discretion to apply the more complex discipline to a single ADIs, even if the latter has the requirements for the application of the simplified discipline.[457]

The idea of proportionality is present also in the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry. The Royal Commission highlighted, in the section dedicated to remuneration, that there are limits in what should be regulated and prescribed in the design of the remuneration systems.[458] In declaring so, the Royal Commission affirmed that one size does not fit all, and quoted a principle of the Financial Stability

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[457] *Revisions to the Capital Framework for Authorised Deposit-taking Institutions. Response to Submissions*, AUSTRALIAN PRUDENTIAL REGULATION AUTHORITY (2019), https://www.apra.gov.au/sites/default/files/response_to_submissions_-_revisions_to_the_capital_framework_for_adis.pdf (last visited Sep 25, 2020).

[458] Hayne, Kenneth M., et al., *op. cit.*, 350.

Board, which says: "financial firms differ in goals, activities, and culture, as do jobs within a firm."[459]

As regards the stress test, APRA conducted the assessment of the 2018-2019 period on 28 ADIs.[460] Interestingly, APRA, unlike the supervisors of the European Union and the United States, did not place a threshold above which test specific banks but divided the participating banks into two groups. The justification provided by APRA for the creation of the two groups was that this choice would have ensured a more significant comparison. Group 1 included major Australian ADIs, *e.g.*, the Commonwealth Bank of Australia, Australia and New Zealand Banking Group Limited, National Australia Bank Limited and Westpac Bank. Group 2 consisted of other participants with total assets of between $ 3 billion and $ 25 billion.[461] Participants in group two included, for example, Australian Central Credit Union Ltd, Credit Union Australia Ltd, and Newcastle Permanent Building Society Limited. The stress test, therefore, concerned a more diverse and smaller sample of institutions than the stress tests

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[459] *FSF Principles for Sound Compensation Practices*, FINANCIAL STABILITY FORUM (2009), https://www.fsb.org/wp-content/uploads/r_0904b.pdf (last visited Sep 25, 2020).

[460] According to the Reserve Bank of Australia, the total number of ADIs in Australia is 138, of which 91 are banks and 47 are credit unions and building societies, so the sample would represent around the 20% of the total number of ADIs. See: *Main Types of Financial Institutions*, RESERVE BANK OF AUSTRALIA (2019), https://www.rba.gov.au/fin-stability/fin-inst/main-types-of-financial-institutions.html (last visited Sep 25, 2020).

[461] John Lonsdale, *Stress Testing Assessment: Findings and Feedback* AUSTRALIAN PRUDENTIAL REGULATION AUTHORITY (2020), https://www.apra.gov.au/sites/default/files/2020-02/Stress testing assessment findings and feedback.pdf (last visited Sep 25, 2020).

carried out by the supervisory authorities of the European Union and the United States.

From the analysis of the elements of proportionality in the Australian financial regulation, it appears that although this principle is present in the legal system, as shown in the first chapter of this thesis, its presence is less constant than in the other legal systems examined. On this point, some academics have emphasized the presence of some problems within the Australian legal system, related, among other things, to the disproportionate application of the financial sector regulation.[462]

4.5 Conclusions.

The fourth chapter addressed the particularities of the application of the proportionality principle in the Australian legal system. The competence for banking regulation in the Australian legal system is under the responsibility of the Commonwealth of Australia. Indeed, the Commonwealth has the power to regulate banking activity according to section 51 (xiii) of the Australian Constitution. An important element concerning the assessment of the level of

[462] Pamela Hanrahan, *Improving the Process of Change in Australian Financial Sector Regulation*, 27 ECONOMIC PAPERS: A JOURNAL OF APPLIED ECONOMICS AND POLICY 23 (2008).

application of proportionality is related to the fact that the Australian system does not limit the scope of the Basel agreements to internationally active banks but extends the scope to all Authorized Deposit-taking Institutions. In this sense, the Australian legislator's choice appears closer to the choice made by the European Union legislator, which has also extended the application of the Basel agreements to all banks.

Although federal legislation does not explicitly refer to the application of proportionality in banking regulation, it is evident that this principle is present in the system. Sometimes this principle is applied on a case-by-case basis by the prudential authority. An example of this case-by-case approach of proportionality is APRA's decision to apply additional capital requirements to the three larger banks, *i.e.*, Australia and New Zealand Banking Group (ANZ), National Australian Bank (NAB), and Westpac.

The Australian legal system is interesting because it highlights different ways of applying the proportionality principle. For example, although applying the same rule to all Authorized Deposit-taking Institutions, in some cases, the banking regulation differs the term within which to apply the new rule based on the size and characteristics of the ADIs. For example, the Banking Executive Accountability Regime- BEAR postponed the commencement date based on the Authorized Deposit-taking Institutions' size. In this way, the smaller Institutions have more time than the others to be compliant with the new legislation. This way of applying proportionality could be interesting in a

context in which banks are already operating in the market. However, this method does not facilitate access to the market for banking institutions about entering the market. The Australian market trend is consistent with the emerging trend in the European Union and the United States. Indeed, it consists of a reduction in the number of banks on the market.

The Australian financial sector regulation appears to be oriented to the one-size-fits-all approach, which gives little value to the Authorized Deposit-taking Institutions' differences. This approach creates difficulties for smaller institutions to comply with the regulation and remain in the market. Although several scholars highlighted this problem, this issue does not seem to be the main concern that the Australian legislator aims at sorting out. Indeed, it would seem that the Australian legislator is more oriented towards solving financial stability and consumer protection problems. These issues related to legislative choices will be analyzed more specifically in the next chapter, making a comparative analysis of the three legal systems examined in these last three chapters.

Chapter 5

Comparative Analysis.

> *"[the comparatist] studying different laws outside the context of their own culture is like a colour-blind painter: what he paints is foggy shapes and lines only."*
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> Banakas Efstathios, The Method of Comparative Law and the Question of Legal Culture Today, 3 TILBURG LAW REVIEW, 153 (1994).

Summary: 5.1 Introduction; 5.2 Comparative Analysis; 5.2.1 Identifying Similarities and Variations; 5.2.2 Explaining Similarities and Variations; 5.2.3 Critical Policy Evaluation; 5.3 Conclusions.

5.1 Introduction.

The previous chapters described the banking regulation of the three jurisdictions: the US, the EU, and the Australian legal systems. The analysis highlighted some examples of rules that apply proportionality, making distinctions based on the characteristics of the entities subject to regulation. Following the laws' description, chapter five deals with the comparative analysis of the three legal systems examined. Comparative law scholars have often complained that comparative private law sometimes lacks an appropriate comparison. For example, Linda Hantrais stated that comparativist's work is

usually confined to presenting an accurate parallel description of legal systems.[463]However, authors like Siems highlighted that the comparative analysis should not be limited to a description of the laws but should be followed by identifying the similarities and differences, avoiding a list of all the variations, and using categories and concepts.[464]

This chapter identifies these aspects in common and differences after identifying the similarities and variations and critical policy evaluation. The chapter is divided as follows: paragraph 5.2 deals with the comparative analysis. The comparative analysis is further divided into three subparagraphs. Subparagraph 5.2.1 identifies the similarities and differences in the three legal systems examined, while the subparagraph 5.2.2 explains these similarities and differences. Finally, subparagraph 5.2.3 critically evaluates the legislative and regulatory choices made by the three legal systems examined. The chapter concludes with paragraph 5.3.

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[463] Linda Hantrais, INTERNATIONAL COMPARATIVE RESEARCH: THEORY, METHODS AND PRACTICE 35 (2009).
[464] Mathias Siems, *op. cit.* 24.

5.2 Comparative Analysis.

The Trento theses are an interesting basis from which to start for comparative analysis. Hence, before proceeding with the comparative analysis, it seems appropriate to briefly explain what Trento's theses are and their role in the comparative law landscape. The Trento Common Core of European Private Law is a project that was directed by Mauro Bussani and Ugo Monateri. The project is based on the ideas of Rodolfo Sacco and Rodolfo Schlesinger, and it was founded in 1987.[465] It involves several scholars[466] who generally work in a wide range of languages that tend to be associated with their national law.[467]

The project aimed to analyze the extent to which the legal solutions made in the different jurisdictions are precisely the same, have elements of similarity or are entirely different.[468] This basis could constitute the starting point of this comparative analysis. In order to proceed with this, it is necessary first to specify what the Trento's theses are, and then apply them in the present legal comparison. The Trento's theses are five. The first thesis describes the primary task of legal comparison. In accordance with the first thesis, the primary mission

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[465] Ugo Mattei & Anna di Robilant, *The Art and Science of Critical Scholarship. Post-modernism and International Style in the Legal Architecure of Europe*, 1 EUROPEAN REVIEW OF PRIVATE LAW 51(2002).
[466] The circle of authoritative scholars was composed by: Francesco Castro, Paolo Cendon, Aldo Frignani, Antonio Gambaro, Marco Guadagni, Attilio Guarnieri, Piergiuseppe Monateri, Rodolfo Sacco.
[467] Nicholas Kasirer, *The Common Core of European Private Law in Boxes and Bundles*, 3 EUROPEAN REVIEW OF PRIVATE LAW 417–437 (2002).
[468] Ewoud Hondius, *The Trento Common Core Project*, 3 EUROPEAN REVIEW OF PRIVATE LAW 420 (2002).

of legal comparison is to acquire a better knowledge of legal data. The first thesis considers legal comparison as a science. The additional legal comparison tasks, including identifying the best legal model, are only a possible research aim, although they are relevant.[469] The second thesis postulates that comparative science includes measuring the differences and similarities between the different legal systems. The second thesis represents a very relevant point for legal comparison; in fact, it postulates that the jurist does not do comparative science as long as she is limited to the parallel exposition of the solutions expressed in the different areas or cultural exchanges.[470]

The third thesis postulates that comparison is historical science. The comparativist pays attention to the various legal phenomena that have occurred in the past or the present. The comparativist considers the legislator's acts, the judge's rulings, and the doctrine's work as historical facts and tends to ascertain what really happened.[471] The fourth thesis considers the merits of legal comparison. It provides that the knowledge of comparative legal systems has the value of checking the formants' coherence present in each legal system and the elements that make up the individual formants. Legal formants are a legal construction developed by Rodolfo Sacco (the so-called "theory of legal formants"). In particular, the formants are defined as the elements that constitute

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[469] *Manifesto culturale: Le tesi di Trento*, FACOLTÀ DI GIURISPRUDENZA - UNIVERSITÀ DI TRENTO (2001), http://www.jus.unitn.it/dsg/convegni/tesi_tn/le_tesi.htm (last visited Oct 1, 2020).
[470] *Ibid.*
[471] *Ibid.*

the "living law." They may vary in number and type from country to country, and therefore it is not possible to draw up a list of all existing legal formants. However, they can be divided into three different types, namely legislative, jurisprudential, and doctrinal.[472] Returning to the Trento theses' description, the fourth thesis focuses on coherence. It also postulates that the comparativist must verify each system's consistency after identifying these elements. In the works of Rodolfo Sacco before the Trento theses, this work consisted of verification of logical coherence.[473]

Finally, the fifth thesis postulates that the jurist of a given juridical system does not have the monopoly of knowledge of her own juridical system to which she belongs. On the one hand, the jurist belonging to a specific legal system is favored by the possibility of collecting several data. Still, on the other hand, she is disadvantaged by assuming that her system's theoretical statements are entirely consistent with the system's operational rules.[474] These theses can constitute a good cornerstone from which to start for this comparative analysis. Therefore, this chapter will measure the identities, similarities, and differences between the legal systems analyzed without limiting itself to the mere

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[472] For an in-depth analysis of the theory of legal formants see: Rodolfo Sacco, *Legal Formants: a Dynamic Approach to Comparative Law (Installment I of II)*, 39 THE AMERICAN JOURNAL OF COMPARATIVE LAW 1–34 (1991); Rodolfo Sacco, *Legal Formants: a Dynamic Approach to Comparative Law (Installment II of II)*, 39 THE AMERICAN JOURNAL OF COMPARATIVE LAW 343–401 (1991)
[473] Antonio Gambaro, *The Trento Theses*, 4 GLOBAL JURIST FRONTIERS 12 (2004).
[474] *Manifesto culturale: Le tesi di Trento*, *op. cit.*

exposition of the legal solutions elaborated by the three jurisdictions examined concerning proportionality.

Regarding the identification of similarities and differences, drawing inspiration from the lesson of the British philosopher John Stuart Mill, Gerhard Dannemann stated that the similarities and differences are equally relevant for legal comparison. The mutual interaction between the two, rather than focusing on the same similarities and differences, aims to advance our knowledge substantially.[475] For these reasons, the first sub-section aims at identifying variations and similarities in the different legal systems analyzed. The search for explanations for these differences and similarities occurs in the next phase of comparison, which is the analytical one, described in the second subsection. Finally, the third subsection is focused on learning between legal systems and critically evaluating the legislative choices made in the different legal systems.

5.2.1 Identifying Similarities and Variations.

The first phase that this comparative analysis aims to take is the identification of the similarities and differences of the legislative choices of the different legal

[475] Gerhard Dannemann, *Comparative Law: Study of Similarities or Differences? in* THE OXFORD HANDBOOK OF COMPARATIVE LAW 384–418 (2006).

systems, aimed at ensuring proportionate regulation in the banking sector. A first similarity that emerges from the three legal systems' study is that Australia, the United States, and the European Union are all Basel Committee members. In other words, they follow the same international standards for banking regulation.[476] The Basel Committee has developed several international standards over the years, intending to apply them to internationally active banks.[477] However, the description of the laws carried out in chapters second, third, and fourth of this thesis shows that the Basel standards have been implemented differently in the jurisdictions examined.

Indeed, the United States legislator has implemented the Basel agreements, not applying these advanced requirements to all banks, but limiting their application only to the "core banks."[478] Unlike the US system, the Basel standards in the European Union have affected all banks that carry out banking activities in the European Union territory. The European Commission justified that decision because banks authorized to exercise their banking business in one Member State have the possibility to operate in all the other member states within the Single Market, due to the freedom of movement granted by the EU law.

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[476] For a list of member states of the Basel committee see: *Basel Committee Membership*, THE BANK FOR INTERNATIONAL SETTLEMENTS (2016), https://www.bis.org/bcbs/membership.htm?m=3%7C14%7C573%7C71 (last visited Oct 9, 2020).

[477] For instance, all Basel Committee standards apply to internationally active banks: *Basel III: International Regulatory Framework for Banks*, THE BANK FOR INTERNATIONAL SETTLEMENTS (2019), https://www.bis.org/bcbs/basel3.htm (last visited Oct 9, 2020).

[478] See, for example: *Basel III Regulatory Consistency Assessment (Level 2) Preliminary Report: United States of America,* THE BANK FOR INTERNATIONAL SETTLEMENTS 24 (2012), https://www.bis.org/bcbs/implementation/l2_us.pdf (last visited Oct 9, 2020).

Therefore, they should be more likely to exercise their activity in the Single Market of the European Union other than their Member State.[479] Even in the Australian legal system, the implemented Basel prudential standards apply to all Authorized deposit-taking institutions.[480] The implementation of the Basel agreements, therefore, has a different application method in the three jurisdictions.

The previous chapters showed how all three jurisdictions apply proportionality and made relevant examples from the banking law. From the comparative study of these laws, it emerges that proportionality in banking regulation is characterized by the fact that the discipline is diversified and considers the firms' specific characteristics to which the banking regulation applies. Although proportionality is present in all the systems examined, the previous chapters showed its different meanings. Proportionality is a principle in Europe, enshrined in the Treaty on European Union. This means that the European legislator must consider this principle when regulating all areas of its competence. The consideration that proportionality in European Union law is a principle has implications for the entire banking regulation. The standards are formulated as guidelines, and the exact implementation of the principle is left

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[479] *Capital Requirements – CRD IV/CRR – Frequently Asked Questions*, EUROPEAN COMMISSION (2013), https://ec.europa.eu/commission/presscorner/detail/en/MEMO_13_690 (last visited Oct 9, 2020).

[480] *Regulatory Consistency Assessment Programme (RCAP) - Assessment of Basel III LCR Regulations – Australia*, THE BANK FOR INTERNATIONAL SETTLEMENTS (2017), https://www.bis.org/bcbs/publ/d419.htm (last visited Oct 9, 2020).

to the recipients of the standard. This issue emerged in the third chapter of this thesis, which describes, for example, that the Regulation 2019/876/EU (CRR II) introduces Section 8 of art. 430, stating that the European Banking Authority must make recommendations to reduce reporting obligations for small institutions.[481]

The examples of the application of proportionality in European Union legislative sources show that the application of proportionality intended as a principle aims to give basic recommendations, without specifying the methods by which to apply this principle. This approach has the advantage of guaranteeing greater flexibility in determining the forms on which proportionality can be applied. It also has the advantage of ensuring a longer duration of regulation. The purpose of adopting such an approach is justified because the banking sector is in rapid evolution, and less specific and principles-based discipline is destined to last longer than a more detailed one.

However, the application of proportionality as a principle has disadvantages, due to the emergence of interpretative problems. An example is the issue related to the United Kingdom's bonus cap, explained *supra* in the third chapter of this thesis. Other disadvantages are the lack of certainty and predictability of the regulatory regime, which risks not providing adequate protection to consumers and, more generally, to banking services recipients. This limitation was

[481] Article 1 (118) Regulation 2019/876/EU (CRR II).

highlighted, for example, by Julia Black in her paper on the paradoxes of principle-based regulation.[482]

A similar argument, *i.e.*, the consideration of proportionality as a principle, cannot be made for the American system. Indeed, in the US legal system, references to proportionality as a principle do not emerge. The US banking regulation does not refer to the concept of proportionality, but the tailoring of rules. For example, the Federal Reserve, the Office of Comptroller of the Currency, and the Federal Deposit Insurance Corporation called their prudential standards "Final Tailoring Rules." From the title, therefore, the willingness of the US Agencies to diversify the discipline based on the characteristics of the regulated entities is evident. The intention to avoid the one-size-fits-all approach is also apparent in the Economic Growth, Regulatory Relief, and Consumer Protection Act. It dedicates a full title to measures that bring regulatory relief to community banks.[483]

Moreover, due to the general crisis that followed COVID-19 in 2020, the US legislator came up with the Coronavirus Aid, Relief, and Economic Security Act, which provides relief for banks that meet specific requirements in section

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[482] Julia Black, *Forms and Paradoxes of Principles-based Regulation*, 3 CAPITAL MARKETS LAW JOURNAL 425–457 (2008).
[483] Title II of the Economic Growth, Regulatory Relief and Consumer Protection Act: Mike Crapo, *S.2155 - Economic Growth, Regulatory Relief, and Consumer Protection Act*, CONGRESS.GOV (2018), https://www.congress.gov/bill/115th-congress/senate-bill/2155 (last visited Oct 9, 2020).

4012.[484] This Act represents further corroboration of how the United States banking law tends to diversify, based on the particular situations of the regulated institutions, even in the event of temporary changes in the economic situation.

From the regulatory framework described in the second chapter, therefore, the US system has a very tailored regulation. The second chapter has shown how banking regulation is more proportionate than the other legal systems examined. First, the Economic Growth, Regulatory Relief, and Consumer Protection Act, which amends the Dodd-Frank Act's provisions, provides a specific title, Title II, to provide regulatory relief to community banks. Small banks can benefit from various exemptions from particular regulations. Also, some Title II provisions increase capital thresholds or create new thresholds under which banks are exempt from specific rules or are qualified to comply with reduced regulatory obligations, compared to the responsibilities that banks that do not fall within the regulatory thresholds must meet.[485] The second chapter of this thesis has shown specific provisions for community banks, such as leverage ratio, exemptions from the Volcker Rule, reduced reporting requirements, and reduced frequency of examinations by federal bank regulators.[486]

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[484] *Regulatory Capital Rule: Temporary Changes to the Community Bank Leverage Ratio Framework*, FEDERAL REGISTER (2020), https://www.federalregister.gov/documents/2020/04/23/2020-07449/regulatory-capital-rule-temporary-changes-to-the-community-bank-leverage-ratio-framework (last visited Oct 9, 2020).
[485] Mike Crapo, *op. cit.*,12.
[486] *Idem*, 14-20.

Second, US financial regulation also includes specific provisions for larger banks. In particular, the Federal Reserve, the Office of Comptroller of the Currency, and the Federal Deposit Insurance Corporation have developed tailored prudential standards for larger banks divided into four categories. The first category includes the largest and most complex banks and, therefore, subject to stricter regulation. Regulatory burdens are progressively reduced, up to the fourth category, which provides for relatively smaller and less complex companies than the previous categories and which have an amount greater than or equal to $ 100 billion in total consolidated assets.[487] In light of the above, although the US banking regulation does not openly state that its primary goal is to be proportionate, the content of the laws shows that, in reality, the US system is more careful about having tailored banking regulation than the other two legal systems analyzed.

As regards the Australian legal system, scholars developed a theoretical framework for proportionality. The first chapter showed that the High Court of Australia also applied proportionality as a principle. In this sense, proportionality in the Australian legal system is regarded as a doctrine, *i.e.*, a principle established through past case-law.[488] Regarding the Australian banking law and regulation, there are elements from which it appears that proportionality is considered as a principle as well since this concept is also

[487] Davis Polk, *op. cit.*
[488] Shipra Chordia, *op. cit.*

present in documents other than legislation and regulation. For example, in the Murray Inquiry in the section relating to the competition, there is a reference to the law's disproportionate effects on smaller firms.[489] This reference suggests that the proportionate approach is present in the doctrine and case-law and the Australian banking regulation.

The fourth chapter of this thesis showed that even in Australian regulation, there are some examples of the application of proportionality. For example, the BEAR - Banking Executive and Accountability Regime distinguishes and defines the Authorized Deposit-taking Institutions based on their size. In particular, some aspects of the discipline in the Banking Executive and Accountability Regime depend on the size of the Authorized Deposit-taking Institutions. For example, some aspects that provide for differentiation of the discipline based on the size of the Authorized Deposit-taking Institutions concern the maximum civil sanction in case of violation of the provisions contained in the BEAR, the date by which the institution must be compliant with the Bear and requirements on variable remuneration. In particular, in the fourth chapter, it was specified how the BEAR modulates the application of its discipline according to whether it is small, medium, or large ADIs and uses it as a capital parameter for their identification.[490]

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[489] David Murray, *op. cit.* 256..
[490] *Banking Executive Accountability Regime*, AUSTRALIAN PRUDENTIAL REGULATION AUTHORITY (2019), https://www.apra.gov.au/banking-executive-accountability-regime (last visited Oct 9, 2020).

The BEAR will be replaced by the new Financial Accountability Regime (FAR), which is expected to become effective by the end of 2020 and divides the institutions into "core compliance" and "enhanced compliance" entities.[491] However, in other cases, the Australian regulation does not distinguish or exempt based on the banks' nature, size, and complexity. For example, the fourth chapter showed how the Future of Financial Advice reforms (FOFA) simplifies all regulated entities' Financial Advice rules.[492]

The presence of both regulations, which distinguishes according to the recipients of the laws and regulatory norms that instead adopt the one-size-fits-all approach, can be explained by the use of anecdotal evidence. For example, APRA Chairman Wayne Byres declared that: "One of APRA's constant challenges is balancing two competing demands: a desire for a regulatory framework that appropriately differentiates across the diversity of ADIs, and simultaneously a desire to avoid differences in regulation creating competitive inequalities when different classes of ADIs compete against each other."[493]

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[491] *Implementing Royal Commission Recommendations 3.9, 4.12, 6.6, 6.7 and 6.8 Financial Accountability Regime,* AUSTRALIAN GOVERNMENT THE TREASURY 4 (2020), https://treasury.gov.au/sites/default/files/2020-01/c2020-24974.pdf (last visited Oct 9, 2020).
[492] *Delivering Affordable and Accessible Financial Advice*, AUSTRALIAN GOVERNMENT THE TREASURY (2013), https://ministers.treasury.gov.au/ministers/arthur-sinodinos-2013/media-releases/delivering-affordable-and-accessible-financial (last visited Oct 9, 2020).
[493] Wayne Byres, *Individual Challenges and Mutual Opportunities* AUSTRALIAN PRUDENTIAL REGULATION AUTHORITY (2017), https://www.apra.gov.au/news-and-publications/individual-challenges-and-mutual-opportunities (last visited Oct 9, 2020).

From this anecdotal evidence also emerges the presence of a sort of balance between two opposing needs. The reference that APRA Chairman Wayne Byres made about balancing is interesting because a fundamental activity that the superior courts in the generality of legal systems carry out is to balance between two opposing interests and decide which principle should prevail in the concrete case.[494] Hence, the reference made by APRA Chairman about balancing between different demands could evoke the concept of balancing principles. This concept could constitute a further argument in favor of the fact that proportionality in the Australian banking regulation is treated as a principle. In this sense, the Australian system would have more similarities with the European Union system than with that of the United States. The consideration of proportionality as a principle is, in fact, an element that unites both the European Union system and the Australian system. A substantial difference that can be seen is that, while in the European Union system, the principle has a matrix that dates back to a fundamental treaty, the Treaty on European Union; in Australia, it has a jurisprudential and doctrinal matrix. The High Court of Australia applied proportionality tests in areas such as constitutional guarantees and freedoms. It maintained a proportionality test similar to the one held by the

[494] The balance between conflicting rights or principles is a technique of argument widely used in jurisprudence, which has entered the doctrinal debate. See: Giorgio Pino, *Teoria e pratica del bilanciamento: tra libertà di manifestazione del pensiero e tutela dell'identità personale*, 6 DANNO E RESPONSABILITÀ 577–586 (2003).

European Court of Human Rights and European Court of Justice, as set out in the first chapter of this present thesis.

5.2.2 Explaining Similarities and Variations.

This subsection aims to evaluate and justify the similarities and differences in applying the principle of proportionality in the banking discipline of the three jurisdictions examined in this thesis. The comparative analysis is not limited to the mere description of the laws in the various legal systems. As described *supra*, Trento's third thesis postulates that the legal comparison does not produce useful results until the differences between the legal systems analyzed are measured. Based on this thesis, a limitation to the parallel exposure of the solutions adopted in various law areas is not a legal comparison.

For this reason, this subsection aims to explain how the differences and similarities present in the laws of the three legal systems are linked to more general and specific elements of the systems examined.[495]

As regards the definition of the comparativist' activity aimed at explaining the similarities and differences present in the various legal systems, what stated by Rodolfo Sacco may be useful. In his paper "Diversity and Uniformity of the

[495] Antonio Gambaro, *The Trento Theses*, 4 Global Jurist Frontiers, 1–29 (2004).

Law," Rodolfo Sacco observed that: "the explanation can be found in the nature of things. All that is real is dominated by diversity".[496] Therefore, to explain the differences and the similarities, reference is made to the conceptual structures detected by the doctrine.

Regarding the conceptual structures to use for this thesis's purposes, it is relevant to mention the concept of principle-based regulation, developed by the doctrine. In the principle-based regulation, the rules are formulated as guidelines. The implementation of the legal standard is therefore left to the recipient of the rule. In this sense, as stated by Julia Black, the principle-based regulation: "is a highly complex form of regulation belying its rhetoric of simplicity."[497] This complexity in applying principle-based regulation can be seen, for example, in the banking regulation of the European Union, which this thesis analyzed in chapter three. An explanation of this approach is found in the peculiarities of the European Union. As noted in the first chapter of this thesis, the European Union is considered a supranational entity. At the international level in the financial discipline, the Basel Committee considers it a jurisdiction.[498] In this context, an application of proportionality oriented towards a principle-based approach is justified by the fact that the European Union is a jurisdiction that internally presents the member states with their

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[496]Rodolfo Sacco, *Diversity and Uniformity in the Law*, 49 THE AMERICAN JOURNAL OF COMPARATIVE LAW 173 (2001).
[497] Julia Black, *op. cit.*, 457.
[498] See *supra*, at chapter 1.

sovereignty, albeit reduced. Indeed, the general trend consists of the progressive expansion of the integration process sectors and the European institutions' functions.[499] In this sense, a greater need for flexibility is justified, so that the member states can adapt the principles to their specificities and have a certain margin of freedom to determine how to implement proportionality.

The concept of principle-based regulation is opposed to rule-based regulation, which provides a detailed description of how to behave. In the specific case of proportionality, a rule-based regulation provides for the development of rules that prescribe in detail how to apply proportionality. A similar approach emerges from the analysis of financial regulation carried out in the second chapter of this thesis. It is explained by the fact that rule-based regulation also applies to other sectors. For example, in the United States, a rule-based method called Generally Accepted Accounting Principles (GAAP) is used in accounting.[500] Another example in the US law is the Sarbanes-Oxley Act, which has a rule-based approach to governance. A feature of this Act is that it is extremely detailed and regulates practices which have been perceived to have resulted in corporate abuses.[501]

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[499] Stefano Battini, *L'Unione europea quale originale potere pubblico*, DIRITTO AMMINISTRATIVO EUROPEO 1–43 (2013).
[500] Joanne M. Flood,WILEY GAAP 2020 INTERPRETATION AND APPLICATION OF GENERALLY ACCEPTED ACCOUNTING PRINCIPLES 2 (2020).
[501] Thomas White & James Greig, *Sarbanes-Oxley Act of 2002 - A New Regime of Corporate Governance*, INTERNATIONAL BUSINESS LAWYER 415–417 (2002).

Another explanation about the different approaches adopted in the laws examined consists of the tendency, illustrated by the doctrine, to measure regulation effectiveness in different legal systems. This approach would be more present in the US legal system than in the other systems examined. In particular, this different regulatory approach was explained by Gambaro in his paper: "Measuring the law?" (original title: "Misurare il diritto?"). The article describes the lawyers' main differences in the United States compared to the lawyers who exercise their activity in Europe. Specifically, Gambaro highlighted the different conception of the jurist in the North American system as opposed to European legal sciences.[502]

The author highlighted how North American doctrine tends to consider the jurist as a sort of "social engineer." This "engineer" focuses his analysis on the mechanisms by which the legal system distributes incentives and disincentives. Based on this theory, the approach aimed at verifying incentives and disincentives justifies the development of reforms to achieve economic and social objectives.[503] According to Gambaro, in Europe, the legal sciences are still anchored in studying the law's formal characteristics. What is most appreciated is the rationality of the legal system and its degree of coherence. These differences would create difficulties in the dialogue between European

[502] Antonio Gambaro, *Misurare il diritto*, *in* I LUNEDÌ DELLE ACCADEMIE NAPOLETANE NELL'ANNO ACCADEMICO 2009 - 2010 53 (2011).
[503] *Ibid.*

and North American scholars, directing US academics to measure law and European scholars to consider law measurement as unreasonable.[504]

Hence Gambaro's reasoning identifies difficulties in transatlantic dialogues precisely because American jurists have a propensity to consider the idea that law is measurable as an accepted fact. Following this thinking, a measurable law theory can also explain its effects on the present issue. Indeed, in terms of applying proportionality in banking regulation, the US legal system's more direct approach would be justified precisely in the idea that the American legal system accepts and embraces the idea that the law is measurable. In this sense, a more targeted approach to making proportionality effective would be justified in the US system. This approach is achieved through specific provisions that bring about tangible tailoring of banking regulation, unlike the European system, where proportionate regulation has not reached the same specification level.

Regarding the Australian system, the previous chapters highlighted how the shape of the financial system regulation is influenced by transnational principles, such as the Basel Core Principles for Effective Banking Supervision. Pamela Hanrahan reported that the practice of principle-based regulation has spread in Australia, given that financial regulation has been in favor of less

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[504] *Ibid.*

precise or detailed rules. The difficulties written by Hanrahan are related to identifying the optimal level of precision that is appropriate to a rule.[505]

Therefore, the Australian system also adopts a principles-based approach. However, it does not explicitly declare proportionality in banking regulation as a principle, to the same extent that the EU legal system does. This similarity between the two systems, Australian and European, can be explained by historical factors and by the presence of legal transplants by the United Kingdom. Alan Watson describes legal transplants as moving a rule or legal system from a country to another.[506] Legal transplants have also been defined as diffusions, which involve complicated interactions between foreign and domestic actors.[507] In particular, in the Australian legal system, the original diffusion of legal culture came from Great Britain. Indeed, Australia has been part of the British Empire for more than 150 years.[508] At the same time, Great Britain had legal influences from Europe, due to its belonging to the European Union, until its official exit at the beginning of 2020.[509]

This theoretical analysis has shown that proportionality is understood as a principle or, as a rule, produces very different effects. The choice for a less

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[505] Pamela Hanrahan, *op. cit.* 17.
[506] Alan Watson, LEGAL TRANSPLANTS 21 (1974).
[507] Holger Spamann, *Contemporary Legal Transplants: Legal Families and the Diffusion of (Corporate) Law*, BRIGHAM YOUNG UNIVERSITY LAW REVIEW 1821 (2009).
[508] Murray Gleeson, *op. cit*.
[509] James Blitz, *Brexit Timeline: Key Dates in the UK's Divorce from the EU* FINANCIAL TIMES (2019), https://www.ft.com/content/723de327-09cb-4f0b-8b79-6ac8a4051aac (last visited Oct 6, 2020).

tailored banking regulation can dramatically impact competition and survival of banks, called to bear compliance costs that may prove unnecessary and, therefore, not proportionate. Speaking of legal comparison in general, Clark pointed out that comparative law constitutes fertile ground for economists looking for interesting questions to analyze.[510] This assumption is suitable for the present studies, which provide support for future empirical studies aimed at exploring questions relating to the economic effects on banks' competition and survival.

5.2.3 Critical Policy Evaluation.

As described *supra,* Trento's first thesis postulates that one reason for making the legal comparison is to have a better knowledge of the legal data. Comparative law scholars who have a primary interest in this reason would not be very enthusiastic in carrying out policy evaluations, precisely because of the prevalence of the legal systems' descriptive and cognitive aspects.[511] However, some academics consider that one of the comparative law purposes is to help national and international legislators. So, in principle, some policy assessments could be made. Although some authors have reported that it is not appropriate

[510] David Scott Clark, COMPARATIVE LAW AND SOCIETY 92 (2012)
[511] Siems, *op. cit.,* 27.

to make assessments on which legal system is better, it is, however, possible in principle to make assessments on the effectiveness of legislative choices.[512] In this sense, the comparative law scholar can assess a legislative solution's effectiveness considering a specific system's cultural, political, legal, and economic background.[513]

Following such a line of thought, the present study suggests that, at a theoretical level, the choice proposed by the United States system would seem more proportionate and efficient and for greater protection of competition. Indeed, it makes more significant distinctions in the regulation based on the characteristics of the regulated entities, unlike in the other two systems, where the law's differences based on the firms' typology and exemptions are minor and less detailed. On the other hand, Australia and the European Union laws tend to apply the same regulation to different types of banking entities. In other words, they are probably less focused on the objective of having a competitive banking market and are more focused on issues related to the stability of the entire banking system and consumer protection. Probably, the choice to lean more towards competitiveness or financial stability finds its reasons also concerning the procedures that determine the exit of banking institutions from the market. On this point, Masera stressed that since the liquidation procedures in the euro area are not harmonized, the exit of a financial institution from the

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[512] *Ibid.*
[513] *Ibid*.

market turns out to be a complicated process, unlike what happens in the United States.[514]

The choice to compete for more for a competitive market is reflected in banks' degree of concentration within the various legal systems. According to the European Central Bank, in the Single Market of the European Union: "The degree of concentration of the banking sector differs across national markets vary widely, with the share of assets of the five largest banks at a national level varying from 26% to 97%."[515]

According to data processed by the Federal Reserve Bank of St. Louis in 2017, countries such as the United Kingdom and France have concentration levels (67.13% and 71.40%, respectively) lower than the degree of concentration present in The Netherlands (92.15%) and Sweden (93.53%).[516]

According to the same source, in Italy, the level of concentration in 2017 would instead be 79.74%.[517] The level of concentration of banks is interesting when considered in relation to the European Union's legislative initiatives. A relevant example is the case of the Italian banking market, where the Italian legislator implemented various laws to implement European Union banking law into its

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[514] Rainer Masera, COMMUNITY BANKS E BANCHE DEL TERRITORIO: SI PUÒ COLMARE LO IATO SUI DUE LATI DELL'ATLANTICO? 51 (2019).

[515] *EU Structural Financial Indicators: End of 2018 (Preliminary Results),* EUROPEAN CENTRAL BANK (2019), https://www.ecb.europa.eu/press/pr/date/2019/html/ecb.pr190604~03b3c570c5.en.html (last visited Oct 9, 2020).

[516] *2017 5-Bank Asset Concentration by Nation*, GEOFRED MAP (2017), https://geofred.stlouisfed.org/map/?th=pubugn (last visited Oct 9, 2020).

[517] *Ibid*.

domestic law. A relevant text that the Italian legislator implemented to meet the European Banking Union's challenges is cooperative banks' reform. This reform started from the observation that cooperative credit banks face the challenges that the entire banking system must carry out, including the evolution of regulation and supervision.[518]

However, cooperative credit banks face these challenges in a condition of more significant weakness than other banking institutions operating in the Italian market. The Directive 2013/36/EU (Capital Requirements Directive IV), Regulation 2013/575/EU (Capital Requirements Regulation), and the establishment of single supervisory and resolution systems have emphasized banks' capitalization. The recipients of these EU regulations must have capital that is adequate to cover the risks. In this regulatory context, cooperative credit banks found themselves in a situation where self-financing, which is their primary source of capitalization, has been drastically reduced and has become insufficient.[519]

For this reason, the Italian legislator carried out the reform of cooperative banks in 2016.[520] The reform was also determined by other factors related to the

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[518] Carmelo Barbagallo, *La riforma del Credito Cooperativo nel quadro delle nuove regole europee e dell'Unione bancaria* BANCA D'ITALIA 2 (2016), https://www.bancaditalia.it/pubblicazioni/interventi-vari/int-var-2016/Barbagallo-210316.pdf (last visited Oct 6, 2020).
[519] *Idem*, 4.
[520] Law decree 14 February 2016 converted into law 8 April 2016, n. 49 and published in the Italian Official Gazette no. 87 of 14 April 2016.

regulation of the European Union. Even the resolution tools introduced with the European Directive 2014/59/EU (BRRD) determined the Italian legislator's intervention in the sense of reforming cooperative credit banks. The bank resolution tools introduced with the BRRD directive are activated in the presence of relevant public interest to preserve the financial system's stability. This interest may, therefore, not exist in the event of the failure of small banks.[521] To remedy these problems, the reform of cooperative banks drove towards bank consolidation. Changes have been made in this reform that affect the competitive structure. The reform revolves around two fundamental pillars. *In primis*, the reform provided for the creation of a holding company with minimum assets of one billion euros. *In secundis*, the reform provided for the consolidation of the entire structure of cooperative credit banks. In other words, cooperative credit banks must join a banking group, under penalty of revocation by the Bank of Italy of the banking license. This reform is an example of how the Italian legislator's choice focuses more on banks' stability objectives.[522]

Therefore, the legislative response consisted of merging several small banks into a single company with a sufficient capitalization to allow it to comply with the same standards set for larger banks. This is, therefore, an emblematic example in which, instead of issuing proportionate regulation with *ad hoc*

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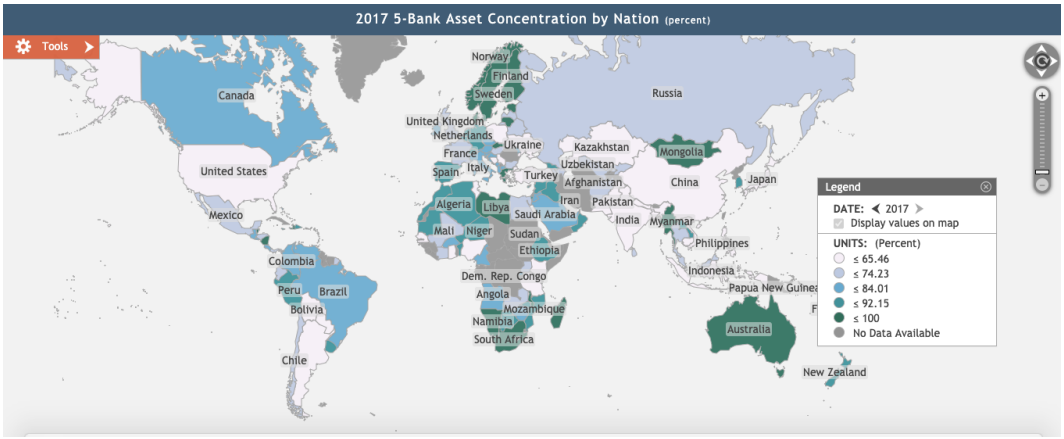
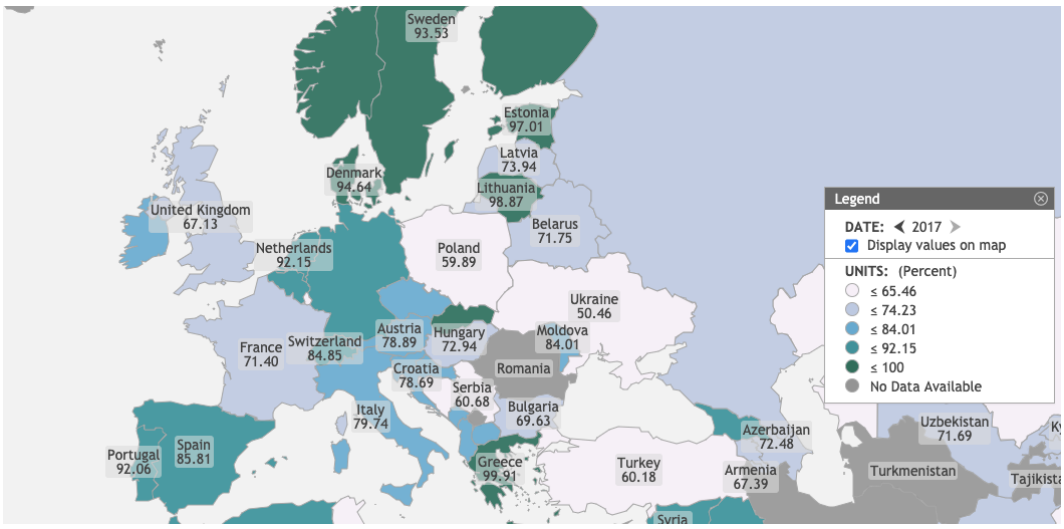
[521] *Ibid.*
[522] For studies about the reform of cooperative credit banks, see: Aurelio Mirone, *Statuto delle banche popolari e riforma del credito cooperativo,* 46 GIURISPRUDENZA COMMERCIALE 211–244 (2019); and Monica Cossu, *L'obiettivo delle ripatrimonializzazione nella riforma delle banche di credito cooperativo*, 62 RIVISTA DELLE SOCIETÀ 694–730 (2017).

measures or exemptions applicable to smaller entities, a legislator of a Member State reduces the competitiveness of the local banking market so that smaller banks can be compliant with the European Union legislation. This example shows how the aim of having greater financial stability prevails over the objective of having a competitive market and a proportionate banking regulation.



(Figure 1 – Map by Federal Reserve Bank of St. Louis)[523]

[523] *2017 5-Bank Asset Concentration by Nation*, GEOFRED MAP (2017), https://geofred.stlouisfed.org/map/?th=pubugn (last visited Oct 9, 2020).



(Figure 2- Zoom Europe. Map by Federal Reserve Bank of St. Louis)[524]

Also, in Australia, the trend is that of bank consolidation. Currently, there are four major banks, and they represent about 80% of banking activities.[525] According to data processed by the Federal Reserve Bank of St. Louis, the United States has a lower level of concentration of 46.22%.[526]

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[524] *Idem*.
[525] Michele Bullock, *Big Banks and Financial Stability* RESERVE BANK OF AUSTRALIA (2017), https://www.rba.gov.au/speeches/2017/sp-ag-2017-07-21.html (last visited Oct 9, 2020).
[526] *2017 5-Bank Asset Concentration by Nation*, GEOFRED MAP (2017), https://geofred.stlouisfed.org/map/?th=pubugn (last visited Oct 9, 2020).

(Figure 3 - Zoom Australia. Map by Federal Reserve Bank of St. Louis).[527]

(Figure 4 - Zoom United States. Map by Federal Reserve Bank of St. Louis).[528]

Ergo, legislative choices aimed at a more or less proportionate approach could reflect relevant consequences in the competitiveness of the banking industry.

[527] *Idem.*
[528] *Idem.*

In light of the above, this study on proportionality in banking regulation represents an important starting point for empirical analysis to explore research questions relating to the economic effects on competition of different regulatory approaches to implementing proportionality, also associated with the number of mergers and acquisitions, as well as the survival of smaller and less complex banks.

5.3 Conclusions.

The fifth chapter dealt with the heart of this research, *i.e.,* the comparative analysis. This analysis identified the similarities and differences between the three different legal systems; it explained them and made a critical assessment in terms of the efficiency of the legal systems examined. The main arguments that appear appropriate to highlight in these conclusions are primarily related to the common recognition of the existence of proportionality in all the legal systems examined. Despite the common presence of proportionality, the comparative analysis revealed that its application is different in the three jurisdictions. In fact, in the United States, proportionality is very well defined in detail, and there is a precise subdivision in banking regulation. Large banking institutions are now divided into four categories; there are specific provisions on community banks. Recently, due to the crisis following the Coronavirus, section 4012 of the Coronavirus Aid, Relief and Economic Security Act

provides for temporary regulatory relief for banks that meet specific requirements.

In the European Union system, the proportionate distinction of regulation is less emphasized. There are some specific rules for Global Systemically Important Institutions, and, recently, the Capital Requirement Regulation II (Regulation 2019/876 / EU) contemplates the so-called small and non-complex institutions. There is instead the tendential application of the one-size-fits-all approach in Australian banking regulation. The application of proportionality is present only in few and specific laws, such as the new Financial Accountability Regime, which distinguishes in "core compliance" and "enhanced compliance" entities. The explanation of the approaches' differences is deduced from proportionality features in the various legal systems examined. Proportionality is seen as a rule in the United States system, while it is seen as a principle in the European Union and Australia. Assessing this in terms of efficiency, it would seem, theoretically, that the most efficient system for promoting the competitiveness and survival of smaller banks through proportionality is the US system. One element in favor of this argument is the data published by the Federal Reserve of St. Louis regarding bank asset concentration. However, this research is proposed as a theoretical starting point for empirical studies on the influence of regulatory form on competitiveness and survival of banks in the three jurisdictions examined.

However, some limitations of this study cannot be denied. First of all, the thesis observes the concept of proportionality from a comparative perspective. To use Banakas' words, considering the comparativist as a "color-blind painter," the representations she provides of legal systems are just foggy lines and shapes. [529] This situation exists because the correct reconstruction of a foreign system's positive law can be arduous, precisely because the analysis relates to a system other than the one the comparativist belongs. Secondly, the correlation between the concept of proportionality and complex issues such as the competitiveness of the banking market and financial stability is not direct nor univocal. Competitiveness and financial stability are very complex concepts that involve multiple factors within the financial landscape. Therefore, the proportionality of banking regulation is not the only suitable answer to guarantee a competitive system. However, it can be used as an indicator to be considered together with other factors. Many equally important elements influence the operations of banks in the market, including, for example, the discipline on banking crisis resolution tools and procedures.

In light of the above, all the multiple factors affecting competitiveness cannot be the subject of this study, precisely because the thesis focuses on the concept of proportionality in banking regulation, which is a specific aspect that can also have repercussions in competitiveness theme. Therefore, it is desirable to carry

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[529] Banakas Efstathios, *op.cit.*, 153.

out further research to understand better the interaction of the various factors in the banking landscape in the different legal systems.

Conclusions.

"Lex est summa ratio insita in natura."
Cicero, De Legibus, Book 1, IV, 18.

This thesis focused on the analysis of the presence of the concept of proportionality in banking regulation. It argued that proportionality's effectiveness is not so related to the recognition and statement of the concept, as to the actual volume of rules that contemplate it. The analysis involved the comparative study of the United States, Australia and EU's legal systems. After a general analysis of the concept of proportionality in law, the thesis analyzed the presence of proportionality in the banking regulation of the three jurisdictions and then proceeded to the comparative analysis. This thesis's results highlighted a general application of proportionality in the banking sector in all three systems examined. An element to consider is that they are members of the Basel Committee on Banking Supervision. The thesis observed that the standards issued by the Basel Committee consider an application limited to

internationally active banks. However, only the United States limits the Basel agreements' application to these banks, provided that both the Australian and European Union regulations apply these agreements to all banks operating on their market. This aspect is certainly relevant given the evaluation of the methods of applying proportionality. Indeed, even if this thesis highlights the habitual existence of proportionality in the three systems examined, it also notes the differences. These differences derive mainly from the methods of applying proportionality.

The analysis showed that proportionality is sometimes considered as a principle and sometimes as a rule. It showed that the EU and Australian legislators consider proportionality as a principle, and therefore an element that serves as a foundation in the legal sector. The European Union legislator expressly refers to the principle of proportionality, and the Treaty on European Union contemplates it. Proportionality has specificities in the European Union when compared to other experiences. First of all, it is a principle with treaty status and is present in the directives and regulations relating to the banking sector. The third chapter made multiple references to the ways the European legislator adopted this principle. Sometimes the principle is stated abstractly, leaving the task of implementing it to the competent authorities. In other cases, more rarely, it establishes more specific criteria. The fundamental problem underlined in this thesis is that there is no clear indication regarding the application of proportionality in the banking regulatory system of the European Union. This

approximation has created inconsistencies in the application in the various member states. Therefore, it seems that further efforts to achieve more effective proportionality are necessary. However, the thesis recognized that greater proportionality signs are present in the new reform package CRR II and CRD V (Regulation 2019/876/EU and Directive 2019/878/EU). This assumption considers the new definition of small and non-complex institutions developed by Regulation 2019/876/EU (CRR II).

In Australia, courts and academics view proportionality as a doctrine, *i.e.*, a principle of law established through past decisions (particularly in *Lange*[530] and *McCloy*[531]). The thesis showed how references to this doctrine are present in Australian primary law and the regulations issued by the supervisory authorities. This thesis's first and fourth chapters showed that proportionality in Australia is considered a doctrine by jurisprudence and academics. In the financial field, however, there are few examples of applying this rule than the two previously examined systems. Indeed, there is a tendency in Australian financial regulation to apply a proportionate approach in limited sectors. A single regulatory system was supported by building societies and credit unions on the Wallis Inquiry occasion.

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[530] *Lange v. Australian Broadcasting Corporation, op.cit.*
[531] *McCloy v. New South Wales, op. cit.*

The idea of having a regulation mainly based on the one-size-fits-all approach is therefore motivated by the desire to ensure that smaller institutions have the same tools as larger institutions to be able to compete in the banking sector. However, this approach meant the development of large institutions. This circumstance does not imply that proportionality is not applied in full, as some examples suggest otherwise. For instance, in the current Banking Executive Accountability Regime- BEAR discipline, there is some differentiation of the discipline according to whether the Authorized Deposit-taking Institution is small, medium, or large. Indeed, section 7 of the Banking Executive Accountability Regime (Size of an Authorized Deposit-taking Institution) Determination 2018 specifies that an Authorized Deposit-taking institution is small if less than or equal to $ 10 billion out of a three-year average of total resident assets, medium if between $ 10 billion and $ 100 billion on a three-year average of total resident assets and large if $ 100 billion or more, out of a three-year average of total resident assets. The Financial Accountability Regime, which will come into force at the end of 2020 to replace the BEAR, also provides for a method of applying proportionality which provides for some exemptions if the entity is classified as core compliance, while the enhanced compliance entities are subject to the whole discipline provided by the Financial Accountability Regime.

Comparative analysis also revealed that proportionality is not considered a principle in the American system but seems to have the characteristics of a rule.

This thesis exposes multiple examples in which the American legislator refers to the tailoring of the law rather than proportionality. For example, the thesis revealed a tailored discipline for larger banks, divided into four categories based on their systemic importance and size. Besides, the Economic Growth provides specific provisions for the Community banks, which are financial institutions of particular relevance for the local market. Community banks have specialized knowledge of the local community and customers based on which they make their credit decisions.

In light of the above, the thesis considered the differences that exist in applying a principle-based and rule-based approach. The principle-based regulation formulates rules as guidelines, and the recipient of the standard implements the guidelines. This approach is visible, for example, in the European Union's banking regulation, where the EU legislator formulates general and abstract directives, leaving the detailed definition of the rules to the competent authorities. Conversely, a rule-based approach does not use guidelines but prescribes in detail how to apply proportionality. This approach is present in the United States banking regulation, where the federal legislator immediately indicates the specific methods of application of the tailored regulation.

Also, the thesis assessed proportionality considering the dimensions of banks. In particular, it observed the criteria based on which a bank is considered small and needs simplified regulations or exemptions. As a common aspect, for example, the thesis appraised that in the US system, the concept of community

bank defined by section 201 Economic growth consists, among the various parameters, of a total asset less than or equal to $ 10 billion (approximately € 8.5 billion). In the Australian Banking Executive Accountability Regime, the concept of a small Authorized Deposit-taking Institution provides a threshold of $ 10 billion (approximately € 6.1 billion). The capital threshold established by Regulation 2013/575/EU as amended by Regulation 2019/876/EU for small and non-complex institutions, in addition to other parameters, considers a total asset less than or equal to € 5 billion. These data show how the European Union regulation qualifies as a smaller number of banks compared to the other two systems. However, the thresholds are not the only relevant element for assessing proportionality and the volume of simplifications and exemptions that the law establishes. In this sense, the Australian system appears to be the one with the least legislative references to proportionality, having a more one-size-fits-all oriented approach.

The thesis also pointed out that proportionate regulation has relevant interconnections with the economy, given that the banking sector, directly and indirectly, affects various aspects of many economic activities. Indeed, proportionality in regulation tends to maximize regulatory benefits. Compliance costs are generally fixed costs and therefore have a greater impact on smaller banks. The thesis analyzed how proportionality, in some cases, aims to simplify regulation. The simplification is particularly important given that the banking regulatory framework has become particularly complex. Therefore,

proportionate regulation appears necessary to ensure competition and allow smaller banks to continue operating in the banking market.

In terms of limitations, the fifth chapter observed that the concepts of market competitiveness and financial stability are complex concepts involving a multiplicity of elements. Consequently, there is no direct and univocal correlation between proportionality, competitiveness and financial stability. In addition, the comparative analysis of legal systems is not the only tool to study these interactions, since further empirical studies would be indicated for studying these issues.

In conclusion, legislative choices aimed at having a little tailored discipline can have significant impacts on competition and the survival of banks, which have to incur fixed costs to ensure compliance with the rules. These costs may be unnecessary and not proportionate. This thesis suggests that, in terms of competition, the choice made by the legal system of the United States appears more proportionate, as it is the system that makes the most differentiations of the discipline based on the characteristics of the regulated subjects. In the other two systems, however, these distinctions, although present, appear less and less detailed. On the other hand, the application of the same regulation to banks with very different characteristics can indicate that the regulations are more concerned about the stability of the financial system and the protection of their customers. In this sense, this research aims to be fertile ground for future

empirical studies aimed at exploring questions about the economic effect on competition and the survival of banks in the market.

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