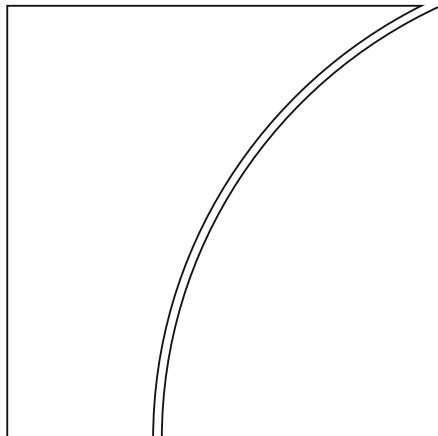


# Basel Committee on Banking Supervision



## Regulatory Consistency Assessment Programme (RCAP)

### Assessment of Basel large exposures framework – Brazil

March 2019



BANK FOR INTERNATIONAL SETTLEMENTS

**Note that this report refers to the RCAP grades prior to October 2025. The grade 'materially non-compliant (MNC)', ie one notch above the lowest grade, has since been renamed to 'partially non-compliant (PNC)' for greater clarity**

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## Glossary

BCB	Banco Central do Brasil (Central Bank of Brazil)
BIS	Bank for International Settlements
BRL	Brazilian real
C	compliant (grade)
CMN	Conselho Monetário Nacional (National Monetary Council)
D-SIB	domestic systemically important bank
FPR	risk-weighting factor
FSB	Financial Stability Board
GDP	gross domestic product
G-SIB	global systemically important bank
LC	largely compliant (grade)
LEX	large exposures
LTV	loan-to-value ratio
MNC	materially non-compliant (grade)
NC	non-compliant (grade)
OSFI	Office of the Superintendent of Financial Institutions
RCAP	Regulatory Consistency Assessment Programme
SA-CCR	standardised approach for measuring counterparty credit risk exposures
SFN	Brazilian national financial system
SIG	Supervision and Implementation Group
S1–5	Segments 1–5

## Preface

The Basel Committee on Banking Supervision (Basel Committee) accords high priority to the implementation of regulatory standards underpinning the Basel III framework. The prudential benefits from adopting Basel standards can only fully accrue if these are implemented fully, consistently and in a timely manner by all member jurisdictions. The Committee established the Regulatory Consistency Assessment Programme (RCAP) to monitor, assess and evaluate its members' implementation of the Basel framework.

This report presents the findings of an RCAP Assessment Team on the domestic adoption of the Basel large exposures (LEX) framework in Brazil. The assessment focused on the completeness and consistency of the domestic regulations in force on 31 December 2018, as applied to commercial banks in Brazil, with the Basel LEX framework. Issues related to prudential outcomes, the resilience of the banking system or the supervisory effectiveness of the Brazilian authorities were not in the scope of this assessment. The assessment relied on regulations, other information and explanations provided by the Brazilian authorities, and ultimately reflects the view of the Basel Committee.

The RCAP Assessment Team was led by Carolyn Rogers, Assistant Superintendent at the Office of the Superintendent of Financial Institutions (OSFI), Canada. It comprised four technical experts, from China, Hong Kong SAR, Peru and South Africa (see Annex 1). The main counterpart for the assessment was the Central Bank of Brazil (BCB). The work was coordinated by the Basel Committee Secretariat with support from OSFI staff.

The assessment comprised three phases: (i) a self-assessment by the BCB (June to September 2018); (ii) an assessment phase (September to December 2018), including an on-site assessment involving discussions with the Brazilian authorities and representatives of Brazilian banks; and (iii) a review phase (January to February 2019), including a technical review of the Assessment Team's findings by a separate RCAP Review Team, the Committee's Supervision and Implementation Group, the RCAP Peer Review Board and the Basel Committee. More information on the RCAP assessment process is available on the Committee's website.<sup>1</sup>

The RCAP Assessment Team acknowledges the cooperation received from BCB counterparts throughout the assessment process. In particular, the team thanks the staff of BCB for playing an instrumental role in coordinating the assessment exercise.

<sup>1</sup> See [www.bis.org/bcbs/implementation.htm](http://www.bis.org/bcbs/implementation.htm).

## Executive summary

Brazil implemented the LEX framework as a minimum standard as of 1 January 2019. The Brazilian LEX regulation is applicable to large or internationally active banks on a consolidated basis. The LEX framework is applied to other banks proportionally, taking into account their size and complexity. The framework was implemented via a resolution issued by the National Monetary Council (Conselho Monetário Nacional, CMN) in July 2018.

Overall, as of 31 December 2018, the large exposures regulation in Brazil is assessed as compliant with the Basel LEX framework. This is the highest possible grade.] Each component is also assessed as compliant.

The Assessment Team recognises the efforts made by the BCB to improve the consistency of its LEX regulation throughout the assessment process. These amendments, notably in the area of the value of exposures, became effective prior to 31 December 2018 (see Annex 3 for a complete list of the amendments), the cutoff date for the assessment.

The Assessment Team believes it would be helpful if the Basel Committee provides further clarification on whether a 15% or a 25% limit should be applied in cases where one global systemically important bank (G-SIB) has a single exposure to the subsidiary of another G-SIB, without having any other exposures to the G-SIB or to any other entities belonging to that G-SIB.

## Response from the BCB

The BCB acknowledges its gratitude to Ms Carolyn Rogers, Mr Brian Rumas and all the RCAP-LEX Assessment Team members for the productive discussions and insightful comments on the implementation of the Basel large exposures framework in Brazil. The BCB would like to thank the Canadian Office of the Superintendent of Financial Institutions, the China Banking and Insurance Regulatory Commission, the Superintendence of Banking, Insurance and Private Pension Funds Administrators of Peru, the Hong Kong Monetary Authority, the South African Reserve Bank and the Basel Committee on Banking Supervision for supporting this process.

The Brazilian authorities concur that the RCAP process is an important tool to ensure a full, timely and consistent implementation of the Basel standards, in order to strengthen public confidence in the banking system and in prudential regulation. Clear, consistent and universal rules are essential to provide a level playing field for financial institutions.

The BCB expresses agreement with the Assessment Team on the overall findings and observations, and has submitted to the National Monetary Council all the necessary amendments to the LEX regulation comprised in Resolution CMN 4,698 of 27 November 2018. This common understanding achieved by both parties reflects the high level of commitment and collaborative work experienced throughout the assessment process.

Once again, the BCB would like to seize this opportunity to reaffirm its firm commitment to the Basel III regulatory reforms and, furthermore, acknowledge the importance of the Basel standard in consolidating its supervisory practices related to the large exposures limits.

# 1 Assessment context

## 1.1 Status of implementation of the large exposures framework

The National Monetary Council (Conselho Monetário Nacional, CMN) and the BCB are responsible for implementing the Basel LEX framework by issuing the relevant regulation. Resolution CMN 4,677 of 31 July 2018, which establishes maximum limits for client exposure and a maximum limit for the amount of large exposures, came into force on 1 January 2019 for large or internationally active banks. This resolution strengthens the requirements on limits to client exposure previously set up by Resolution CMN 2,844 of 29 June 2001.

## 1.2 Regulatory system

The Brazilian national financial system (SFN) was established and operates under the provisions of Law 4,595, issued on 31 December 1964, which created the CMN and the BCB. The primary authority responsible for banking regulation is the CMN and the main banking supervision authority is the BCB.

Banking prudential regulations are proposed by the BCB and approved by the CMN in the form of resolutions. These are the highest level of primary regulation. Regulations approved by the Board of the BCB within the scope of its regulatory powers are published in the form of circulars. Banking regulations published in the form of resolutions and circulars are considered to be equally enforceable, and failure to comply with any of these can lead to supervisory actions by the BCB, which is responsible for ensuring the banks' compliance with the regulation.

The BCB has developed a modelling of contagion to estimate risks and potential impacts in the financial system caused by defaults of companies in the real economy sector. The BCB also seeks to estimate the interbank contagion, represented by the impact of problems in a single financial institution on the rest of the system.<sup>2</sup>

## 1.3 Structure of the banking sector

As of September 2018, some 135 banks were operating in Brazil. Around 70% of the assets of the banking system are concentrated in the five largest banks. These banks, two of which are government-controlled, have been designated as domestic systemically important banks (D-SIBs). Banks' activities are focused on traditional intermediation and are concentrated in the domestic market, with foreign operations mainly supporting Brazilian corporates overseas.

Resolution CMN 4,553 of 30 January 2017 establishes the segmentation of financial institutions and other institutions licensed by the BCB for the purposes of a proportional implementation of prudential regulation. The resolution allocates banks to five segments:

- Segment 1 (S1) comprises six banks whose size is equal to or greater than 10% of Brazil's GDP; or with relevant international activity, regardless of their size;<sup>3</sup>
- Segment 2 (S2) comprises six banks whose size is less than 10% and equal to or greater than 1% of GDP;

<sup>2</sup> See Financial Stability Board, *Peer review of Brazil, Review Report*, April 2017, [www.fsb.org/wp-content/uploads/Brazil-peer-review-report.pdf](http://www.fsb.org/wp-content/uploads/Brazil-peer-review-report.pdf).

<sup>3</sup> International activity is deemed relevant when the total consolidated foreign assets of an institution are equal to or greater than USD 10 billion.

- Segment 3 (S3) comprises 37 banks whose size is less than 1% and equal to or greater than 0.1% of GDP;
- Segment 4 (S4) comprises 86 banks whose size is less than 0.1% of GDP; and
- Segment 5 (S5) includes institutions whose size is less than 0.1% of GDP with a simplified risk profile. S5 institutions are allowed to use an optional simplified methodology to calculate the minimum requirements for regulatory capital. Note that no banks are included in this category.

The total stock of loans and leases in the banking and non-banking sectors stood at BRL 3,916 billion (57.6% of GDP) as of September 2018. Of this amount, BRL 3,537 billion (52.1% of GDP) was domestic lending. The banking sector held BRL 3,771 billion, the credit unions BRL 111 billion, and the non-banking sector BRL 34.2 billion of the total. Bank lending is diversified, with the energy sector accounting for the highest share of bank loans (12.2%). The top five sectors accounted for 49.1% of total bank lending as of September 2018.<sup>4</sup> The S1 represents 73% of total banking credit.

In evaluating the materiality of its findings, the RCAP Assessment Team focused on the five Brazilian D-SIBs (all of which are subject to the LEX framework).

## 1.4 Scope of the assessment

The Assessment Team considered the large exposure limits applicable to commercial banks in Brazil as of 31 December 2018. The assessment had two dimensions:

- a comparison of domestic regulations with the Basel LEX framework to ascertain that all the required provisions have been adopted (*completeness* of the regulations); and
- whether there are any differences in substance between the domestic regulations and the Basel LEX framework and, if so, their significance (*consistency* of the regulations).

In its assessment, the RCAP Assessment Team considered all binding documents that effectively implement the Basel LEX framework in Brazil. Annex 2 lists the Basel standards used as the basis for the assessment. The assessment did not evaluate the resilience of the banking system in Brazil or the supervisory effectiveness of the BCB.

The outcome of the assessment is summarised using a four-grade scale, both at the level of each of the three key components of the Basel LEX framework and at the level of the overall assessment of compliance. The four grades are: compliant, largely compliant, materially non-compliant and non-compliant.

## 2 Assessment findings

### 2.1 Assessment grades and summary of findings

Overall, the Assessment Team finds the implementation of the LEX framework in Brazil to be compliant with the Basel standards. This grade takes into account the rectifications issued by the Brazilian authorities in November 2018, as described in Annex 3.

<sup>4</sup> Source: BCB, September 2018.

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**Assessment grades****Table 1**

Component of the Basel NSFR framework	Grade
Overall grade	C
Scope and definitions	C
Minimum requirements and transitional arrangements	C
Value of exposures	C

Assessment scale: C (compliant), LC (largely compliant), MNC (materially non-compliant) and NC (non-compliant).

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### 2.1.1 Scope and definitions

The Brazilian regulation on the scope and definition requirements is compliant with the Basel LEX framework. No findings were identified.

On the scope, the BCB applies the LEX framework to a wider range of financial institutions than just internationally active banks. These institutions are required to comply with the framework on a proportional basis, taking into account their size and complexity. One observation relating to the scope of application was noted.

### 2.1.2 Minimum requirements and transitional arrangements

The Brazilian regulation on the minimum requirements and transitional arrangements is compliant with the Basel LEX framework. No findings were identified.

### 2.1.3 Value of exposures

The BCB regulation on the value of exposures is compliant with the Basel standard. No findings were identified.

## 2.2 Detailed assessment findings

### 2.2.1 Scope and definitions

This component is compliant with the Basel LEX framework. No findings were identified.

### 2.2.2 Minimum requirements and transitional arrangements

This component is compliant with the Basel LEX framework. No findings were identified.

### 2.2.3 Value of exposures

This component is compliant with the Basel LEX framework. No findings were identified.

## 2.3 Observations on the implementation of the large exposures framework in Brazil

The following observations highlight certain special features of the regulatory implementation of the Basel LEX framework in Brazil. These are presented to provide additional context and information. Observations are considered compliant with the Basel standards and do not have a bearing on the assessment outcome.

### 2.3.1 Scope and definitions

Basel paragraph number	Scope and level of application – paragraphs 10 and 11
Reference in the domestic regulation	Article 2 of Resolution CMN 4,677 of 2018 Article 2, paragraph 1, of Resolution CMN 4,553 of 2017
Observation	<p>The Brazilian LEX framework fully applies to banks allocated in Segment 1 (S1) according to Resolution CMN 4,553 of 30 January 2017. S1 comprises large banks, defined as banks whose size is equal to or greater than 10% of Brazil's GDP; or with relevant international activity, regardless of their size. Banks allocated to Segments 2 to 5 (S2–5) must comply with large exposures requirements proportionally, taking into account their size and complexity. These requirements also came into force on 1 January 2019 for banks allocated to S2. Banks then subject to the LEX framework in Brazil account for around 85% of the total exposure of the Brazilian banking system.<sup>5</sup> Note that the requirements will come into force from 1 January 2020 for banks allocated to S3, S4 and S5.</p> <p>The Basel LEX standard requires application at the same level as the risk-based capital requirements, ie at every tier within a banking group. The Brazilian rules, however, only apply at the top consolidated level without considering the tiers below. This issue is not specific to the implementation of the Basel LEX standard but was previously identified in the RCAP-Capital for Brazil in December 2013.<sup>6</sup></p>

<sup>5</sup> Data as of September 2018.

<sup>6</sup> See page 18 of RCAP Brazil capital assessment report, [www.bis.org/bcbs/implementation/l2\\_br.pdf](http://www.bis.org/bcbs/implementation/l2_br.pdf).

## Annexes

## Annex 1: RCAP Assessment Team and Review Team

## Assessment Team Leader

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## Assessment Team members

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Superintendence of Banking, Insurance and Private Pension Funds  
Administrators of Peru  
  
Hong Kong Monetary Authority  
South African Reserve Bank

## Supporting members

## Review Team members

Mr Toshio Tsuiki	Basel Committee Secretariat
Mr Defri Andri	Indonesia Financial Services Authority
Mr Alexandre Kurth	Swiss Financial Market Supervisory Authority
Mr Nicolas Péligry	French Prudential Supervision and Resolution Authority

## Annex 2: List of Basel standards and implementing regulations issued by the Brazilian authorities

The following Basel standards were used as the basis of this RCAP assessment:

- *Supervisory framework for measuring and controlling large exposures*, September 2016
- *Frequently asked questions on the supervisory framework for measuring and controlling large exposures*, September 2016

Table A.1 lists the regulations issued by CMN to implement the large exposures framework in Brazil. Previous RCAP assessments of Brazilian implementation of the Basel standards considered the binding nature of regulatory documents in Brazil.<sup>7</sup> This RCAP Assessment Team did not repeat that assessment, but instead relied on the previous assessments' findings. Those assessments concluded that the types of instrument described in Table A.1 could be considered as binding on banks and supervisors for the purposes of an RCAP assessment.

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Overview of relevant regulations on large exposures

Table A.1

Domestic regulations	Type, version and date
Resolution CMN 4,677	Establishes maximum limits for client exposure and for the amount of large exposures, issued on 31 July 2018.

Source: BCB.

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<sup>7</sup> See Annex 6 of RCAP Brazil LCR assessment report published in October 2017, [www.bis.org/bcbs/publ/d420.pdf](http://www.bis.org/bcbs/publ/d420.pdf).

## Annex 3: Rectifications made by the BCB

List of rectifications by the BCB

Table A.2

Basel paragraph	Reference in Brazilian regulations	Description of the rectification
49	Resolution CMN 4,677, Article 11	Resolution CMN 4,698 has amended Article 11, paragraph 3, item II, and paragraph 4 of Resolution CMN 4,677 to adjust the value that may be deducted from the amount of exposures to other instruments in the trading book whose counterparty is the same one associated with the underlying asset of a long position in a put option. The mentioned value must be the total strike value of the option minus its replacement cost. In this case, paragraph 4 also establishes that the exposure value assigned to the counterparty related to the counterparty credit risk must correspond to the total strike value.
57	Resolution CMN 4,677, Article 17	Resolution CMN 4,698 has amended Article 17, paragraph 2, item V, of Resolution CMN 4,677. The value of exposure to the provider of the mitigant instrument must correspond, when the provider or the referenced entity of the instrument is a non-financial entity that issues credit derivatives in the form of a credit "swap", to the value of the exposure to the counterparty credit risk considered in the calculation of the $RWA_{CPAD}$ component. Such a requirement applies only for exposures related to instruments in the trading book.
70-71	Resolution CMN 4,677, Article 13	Resolution CMN 4,698 has amended Article 13, item IV, sub-item "c", of Resolution CMN 4,677. The exposure value associated with covered bonds must be considered at 20% of their accounting value if, among other aspects, the pool of underlying assets consists exclusively of exposures that qualify for a risk-weighting factor (FPR) of 35% in the calculation of capital requirements, as long as the respective loan-to-value is permanently lower than or equal to 80%.
79	Resolution CMN 4,677, Article 14	Resolution CMN 4,698 has amended Article 14, paragraph 3, item II, of Resolution CMN 4,677 to establish the exposure value assigned to the issuer of an underlying asset in the case of a fund or a securitisation structure that is composed of different seniority tranches.
90	Resolution CMN 4,677, Article 4	Resolution CMN 4,698 has amended Article 4, paragraph 2, of Resolution CMN 4,677 to make it clear that the stricter limit of 15% of Tier 1 between G-SIBs does not apply to exposures held by a Brazilian subsidiary or branch of a foreign institution listed as "global systemically important" by the FSB to an institution also listed as "global systemically important".

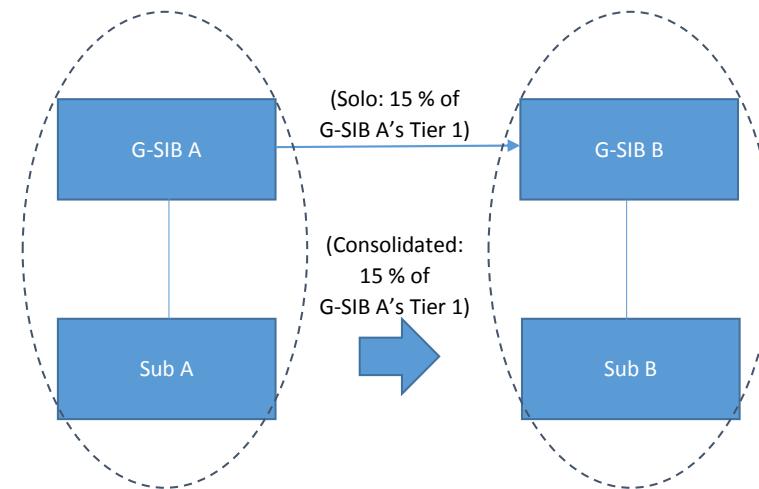
Source: BCB.

## Annex 4: Areas for further guidance from the Basel Committee

### Level of the large exposure limit for G-SIBs under LEX paragraph 16

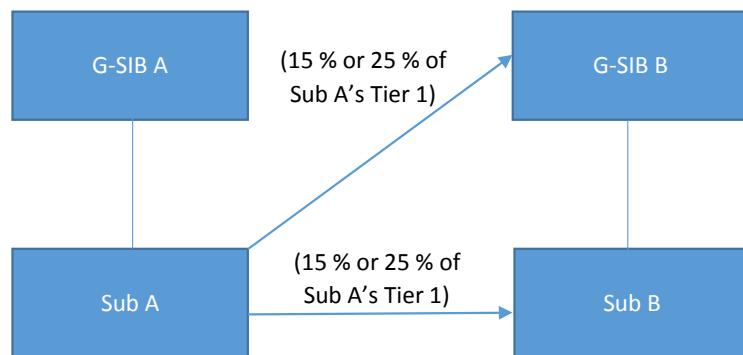
The Assessment Team has identified a need for clarification of the Basel LEX standard in terms of the application of the stricter 15% limit for a G-SIB's exposures to another G-SIB that applies on both a solo and a consolidated basis (see Chart 1 below).

Chart 1



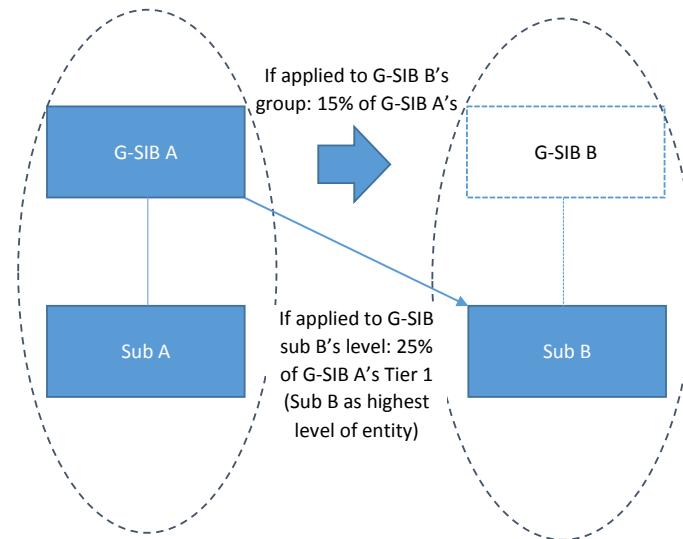
According to paragraph 92 of the Basel LEX standard: "consistent with the additional loss absorbency requirement for G-SIBs, the application of the relatively tighter limit on exposures between G-SIBs at the consolidated level **does not rule out the option** (highlighted) for host jurisdictions of subsidiaries of a group that is identified as a G-SIB to also apply the limit at the individual legal entity or consolidated level within their jurisdiction, ie to impose the 15% limit on the subsidiaries' exposures to other G-SIBs (defined at the individual legal entity or consolidated level within their jurisdiction)". This provision therefore allows jurisdictions the discretion to apply either a 15% or a 25% limit on such subsidiaries' exposures to other G-SIBs (see Chart 2).

Chart 2



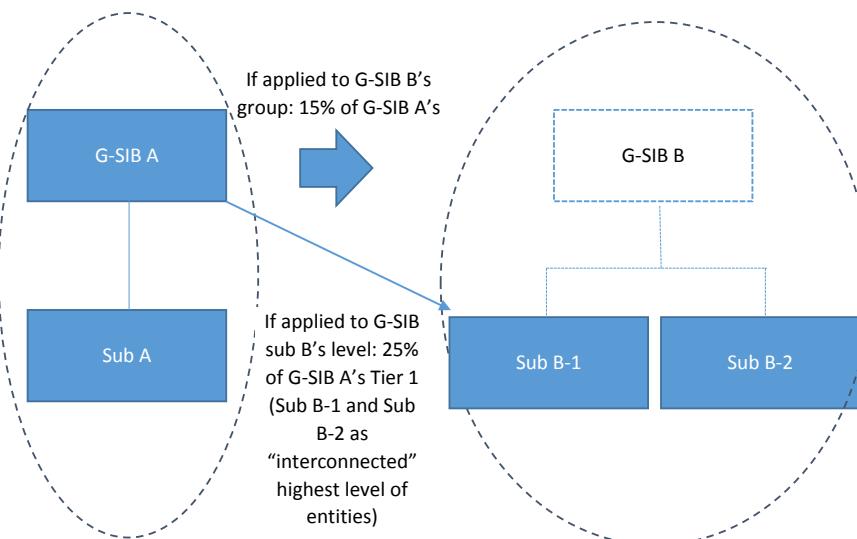
However, if G-SIB A has a single exposure to the subsidiary of G-SIB B, without having any other exposures to G-SIB B or any other entities belonging to G-SIB B, it is unclear whether this exposure would be subject to a 15% or a 25% limit (see Chart 3).

Chart 3



In the same vein, if G-SIB A has no direct exposure to G-SIB B but has two separate exposures to two subsidiaries of G-SIB B (ie interconnected), it is unclear whether the total exposure would be subject to a 15% or a 25% limit (see Chart 4).

Chart 4



The Assessment Team requests clarification from the Basel Committee on the application of the large exposure limits in the two cases identified above.