The regulatory landscape: 10 years from the financial crisis November 2018

# Workshop 3
# Proportionality and the Basel framework

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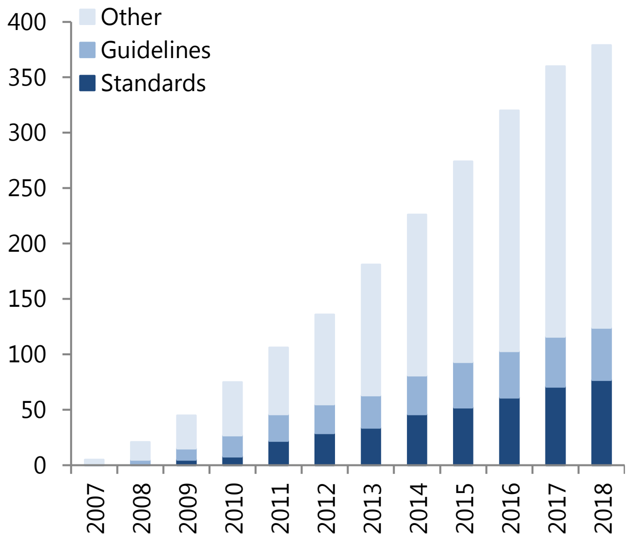
Over the past decade, the Basel Committee has pursued a comprehensive and wide-ranging set of post-crisis reforms. These reforms have strengthened global bank regulatory standards by addressing the main fault-lines in the banking system as exposed by the global financial crisis. These shortcomings include an unsustainable growth in leverage and credit, inadequate levels of loss-absorbing capital, a high degree of systemic risk, and excessive exposure to liquidity risk.

While the Committee's post-crisis reforms have helped strengthened the resilience of banks and enhanced global financial stability, they have also resulted in an increasingly voluminous and somewhat complex framework (Graph 1). This, in turn, could potentially pose challenges for some banks and supervisory authorities in implementing and overseeing the Basel framework. And it has raised questions about adequately balancing simplicity, comparability and risk sensitivity.[1]

What is the role of proportionality in regulation and supervision? To what extent does the Basel framework adopt proportionality? Is there a need for further measures related to proportionality at the global level? This note outlines some of the issues which will be covered in this workshop.

**Graph 1:** Cumulative number of publications by the Basel Committee[(a)]




Source: Basel Committee and Secretariat calculations

(a) "Standards" includes proposed and finalised standards. "Guidelines" includes sound practices. "Other" includes implementation and monitoring reports, working papers and newsletters.

## Proportionality, regulation and supervision: A conceptual assessment

Prudential regulation seeks to internalise the externalities resulting from the distress or failure of individual banks and the banking system (Dewatripont and Tirole (1994)). In principle, the externalities may vary based on the risk profile of each bank. In that regard, proportionality can be loosely defined as setting standards for banks – encompassing both prudential and the associated administrative (eg reporting) requirements – that are commensurate with their risk profiles in order to achieve a desired (common)

[1] See, for example, Basel Committee (2013).

objective. This "tailored" approach to regulation seeks to reflect the different nature of banks' business models, systemic importance, cross-border activity and more generally the risks to which they are exposed. The aim of proportionality is therefore not to reduce the resilience of banks or the banking system, but rather to reflect the relative differences in risk across banks.

## Advantages of proportionality

In principle, there could be advantages to applying a proportionate regulatory framework. These could include the following:

- **Maximising the net benefits of regulation:** By definition, the net benefits of regulation are maximised when the difference between the (marginal) benefits and costs is greatest. Yet these benefits and costs may vary across different types of bank. For example, the benefits of reducing the probability and impact of a bank failure may be lower for a small domestic regional bank than for a large universal international bank, as the externalities caused by such a failure would differ between each type of bank. Similarly, the costs, particularly the private costs to banks (eg fixed costs of complying with regulation) may vary for different types of bank. Accordingly, a "tailored" approach to regulation could be more effective in ensuring that risks stemming from different models are adequately mitigated in a manner commensurate with a bank's size and systemic importance.
- **Simplifying the regulatory framework:** Over time, the Basel regulatory framework has become increasingly complex. A number of factors have contributed to this ever-growing complexity, including (i) a drive towards greater risk sensitivity; (ii) innovation in financial markets and alignment with banks' risk management practices; and (iii) the process of reaching international agreement on standards that must be applied across many jurisdictions. While most of the complexity stems from the internally modelled approach, the quest for ever-greater risk sensitivity has also resulted in more complex standardised approaches and a more complex number of risk categories. For example, a back-of-the-envelope calculation suggests that a bank would need to take over 100 steps to determine its capital requirements under the revised standardised approach for market risk, compared with about 10 steps for the current one. Many of the approaches in the Basel framework – whether internally modelled or standardised – may not be particularly suitable or relevant for some types of bank.
- **Levelling the playing field across banks:** In principle, relatively bigger banks may benefit from greater economies of scale than smaller banks when it comes to meeting administrative requirements. A tailored approach to these administrative requirements could help equalise the average cost of compliance across banks and result in a greater level playing field. In addition, proportionality could also have an impact on the level of competition in the banking system, to the extent that a more competitive banking system (relative to the current system) would contribute to greater financial stability.[2]
- **Enhancing supervisory efficiency:** From a supervisory perspective, the main benefit of a proportional approach is to enhance regulatory efficiency and the return on regulatory/supervisory resources. This is particularly important for jurisdictions that are constrained by shortages of supervisory resources and are faced with the challenge of attracting, training and retaining qualified supervisory staff.

[2] The relationship between competition and financial stability is complex. There is a rich literature on this issue which points to competing theories: a "competition-fragility" view, whereby higher competition leads to more risk and the erosion of bank charter value (eg Keeley (1990); Allen and Gale (2004); and Beck et al (2006)), and a "competition-stability" view, whereby more competition promotes financial stability (eg Boyd and De Nicolò (2005); and Acharya et al (2012)).

## Disadvantages of proportionality

The potential benefits of a proportionate regulatory framework need to be balanced against the potential costs. These could include the following:

- **Increased arbitrage opportunities:** Depending on how it is designed, a tailored approach to regulation could potentially result in banks arbitraging the definitions used for segmenting different types of bank. This could result in banks shifting their business model or activities in order to benefit from more favourable regulations without a commensurate reduction in their risk profile.
- **Fragmented regulatory framework:** Greater proportionality could result in a more fragmented regulatory framework, with multiple regulatory approaches necessitating different supervisory approaches and responses. This could increase complexity for central banks and regulators, and thereby hinder their ability to adequately oversee the resilience of the banking system.
- **Potential for cliff effects:** Depending on how a proportionate framework is designed, banks may be subject to a "cliff effect" if they move from one set of requirements to another as a result of a change in their classification (eg if size is used as a determinant for setting different requirements across banks, a change in the size of the bank across the proportionate threshold would subject the bank to a different set of requirements).

Q1. Are there other factors that could warrant a proportionate approach to regulation and supervision? To what extent do the advantages of a proportionate regime outweigh the disadvantages?

## Proportionality and the current Basel framework

The Basel regulatory framework – encompassing the suite of Basel II and Basel III standards – applies to "internationally active banks".[3] While this term is not further defined, its inclusion in the framework is intended to make clear that there is no expectation that the Basel standards should apply to all banks in a jurisdiction. And the Committee does not necessarily expect the Basel framework to be implemented by non-BCBS jurisdictions. Indeed, there may be valid reasons for such jurisdictions to adopt a different regulatory framework, or only specific aspects of the Basel framework, for their banking systems.

The Committee also recognises the role of proportionality in supervision. Indeed, the Core Principles for Effective Banking Supervision note that "supervisory practices should be commensurate with the risk profile and systemic importance of the banks being supervised".[4] So a "risk-based", or proportionate, approach to supervision is in line with the Core Principles.

Yet even within the limited scope of the Basel framework, there are usually a number of different approaches available for determining risk-weighted capital requirements (Table 1). Put differently, the Basel framework can be viewed as setting out a proportionate approach for internationally active banks. These additional approaches take the form of either a more "risk-sensitive" standardised approach (eg as in the case of the credit risk mitigation framework), or a less complex advanced approach (eg as in the case of the internal ratings-based approaches).

[3] See Basel Committee (2006).

[4] See Basel Committee (2012).

**Table 1:** Approaches in Basel framework – ranked by simplicity[a]

| Risk category | Current approaches | Revised approaches |
|---|---|---|
| Credit risk | Simplified standardised approach | Standardised approach |
| | Standardised approach | Foundation internal ratings-based approach |
| | Foundation internal ratings-based approach | Advanced internal ratings-based approach |
| | Advanced internal ratings-based approach | |
| Credit risk mitigation | Simple approach | Simple approach |
| | Comprehensive approach: supervisory haircuts | Comprehensive approach: supervisory haircuts |
| | Comprehensive approach: own haircut estimates | Repo VaR |
| | Repo VaR | Modelling of loss-given-default for unsecured exposures |
| | Modelling of loss-given-default | |
| Counterparty credit risk | Standardised approach for measuring counterparty credit risk | Standardised approach for measuring counterparty credit risk |
| | Internal models method | Internal models method |
| Credit valuation adjustment | Standardised CVA risk capital charge | Simple multiplier of counterparty credit risk requirement |
| | Advanced CVA risk capital charge | Basic approach |
| | | Standardised approach |
| Securitisation framework | Ratings-based approach | External ratings-based approach |
| | Supervisory formula approach | Standardised approach |
| | Internal assessment approach | Internal ratings-based approach |
| Market risk | Standardised measurement method | Simplified standardised approach |
| | Internal models approach | Standardised approach |
| | | Internal models approach |
| Operational risk | Basic indicator approach | Standardised approach |
| | The standardised approach | |
| | Alternative standardised approach | |
| | Advanced measurement approach | |
| Leverage ratio | Single exposure measure | Single exposure measure |
| Large exposures | Single approach | Single approach |
| Liquidity Coverage Ratio | Single approach | Single approach |
| Net Stable Funding Ratio | Single approach | Single approach |
| Disclosure | High-level description of qualitative and quantitative disclosures | Specific templates in fixed or flexible format |

Source: Basel framework and subjective assessment.

(a) Basel II and III approaches ranked in descending order of simplicity based on subjective assessment. The simplest approach for each risk category is highlighted in blue.

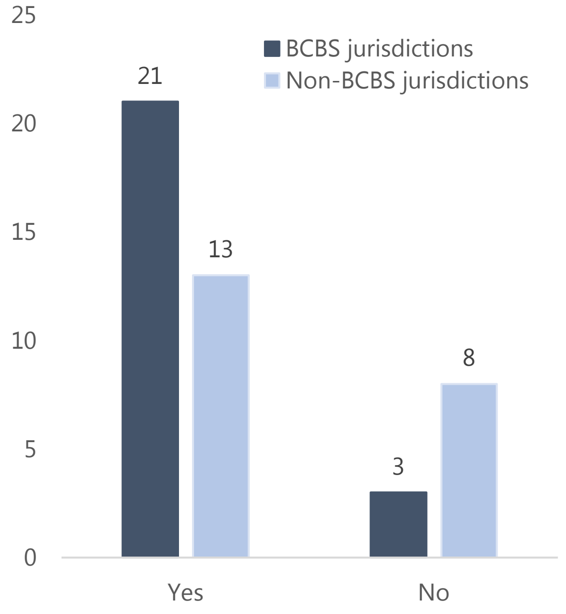
In contrast, there is only a single approach available for other regulatory metrics (eg the leverage ratio, liquidity standards and large exposures framework). This may reflect the aim of keeping the latter simpler and more robust relative to the risk-based capital framework. But there are also recent cases of simplifying both the number and design of approaches within the risk-based framework: the operational risk framework will consist of a single standardised approach for all banks in the future.

Q2. To what extent does the existing Basel framework incorporate proportionality for internationally active banks?

## Proportionality and current jurisdictional practices

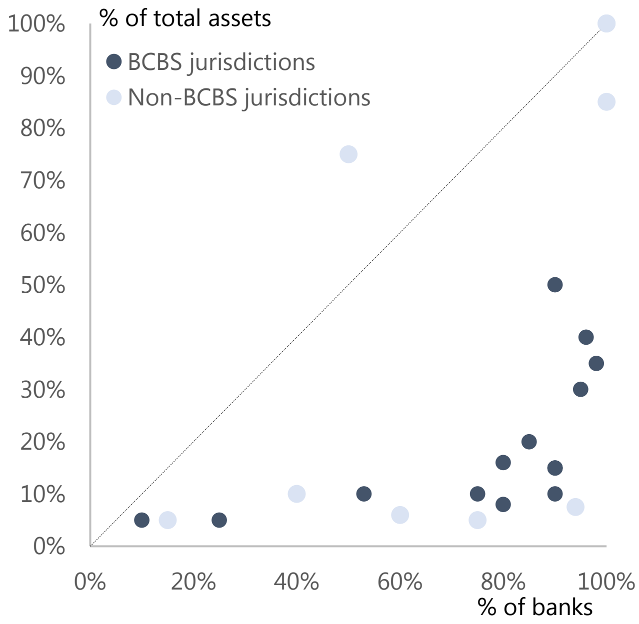
The Basel Committee and Basel Consultative Group (BCG) recently conducted a stocktake of its members' proportionality practices. About 75% of members indicated that they currently apply proportionality measures (Graph 2). The range of banks in a jurisdiction subject to proportionality measures varies (Graph 3). In most cases, proportionality measures are applied to a subset of banks only.

**Graph 2:** Number of BCBS and BCG members that currently apply proportionality measures




Source: Basel Committee and Secretariat calculations.

**Graph 3:** Range of banks subject to proportionality measures




Source: Basel Committee and Secretariat calculations.

While the number of banks subject to proportionality measures varies across jurisdictions, these banks generally represent a relatively small share of total banking assets in the relevant jurisdiction. This is consistent with the minimum expectation of the Basel framework, namely that it should apply to large internationally active banks, with jurisdictions free to apply other standards to other banks. In some cases, respondents noted that proportionality measures are applied to a larger number of banks, which constitute a large share of total banking assets. This is primarily the case for non-BCBS jurisdictions, and is consistent with the principle that such jurisdictions are not expected to apply the Basel framework in full to some or all of the banks in their jurisdiction.

Jurisdictions rely on a number of determinants in identifying proportionality thresholds/segments. These include a wide number of balance sheet metrics and differentiations by banks' business models. In most cases, these indicators are coupled with supervisory judgment when determing the scope of banks subject to different requirements.

Most jurisdictions apply some form of proportionality related to capital and liquidity requirements. These generally take the form of a modified/simpler version of existing Basel standards, particularly for the more complex risk categories, or an exemption from such requirements for certain banks. Jurisdictions similarly apply proportionate reporting and disclosure requirements, with some banks subject to less onerous requirements and submission frequencies. Most jurisdictions also apply a proportionate approach to supervisory practices, including the intensity of on- and off-site examinations, requirements related to risk management controls and governance, and supervisory stress tests.

### Challenges with existing proportionality frameworks

While most jurisdictions did not report any operational challenges in implementing and overseeing their proportionality regimes, some respondents identified a few hurdles. These comprise the following:

- **Balancing proportionality and comparability:** In designing their proportionality requirements, some jurisdictions pointed to the delicate trade-off between the benefits of tailoring requirements for different types of banks while also preserving comparability in banks' regulatory ratios.
- **Balancing proportionality and competition:** Another challenge highlighted by some jurisdictions is how to balance the appropriate differentiation of requirements to reflect the diversity of banks without inducing unwarranted competitive inequalities. For example, one jurisdiction noted that the ex ante principle of designing simpler "capital-neutral" approaches for smaller banks is not always feasible in practice.
- **Determination of proportionality segments:** Some jurisdictions reported a challenge with identifying the appropriate determinants for proportionality segments (eg which quantitative metrics should be used, the balance between quantitative and qualitative measures etc).
- **Arbitrage of thresholds and changes in banks' business models:** A few jurisdictions reported some challenges with ensuring that banks do not arbitrage the proportionality thresholds/segments to benefit from less onerous requirements. In a similar vein, another challenge identified in implementing proportionate supervisory approaches is the ongoing pressure to keep pace with changes in banks' risk profiles and activities.

Q3. What has been your experience with designing, implementing and overseeing a proportionate regulatory and supervisory framework in your jurisdiction?

Q4. How best can a regulatory framework be designed in a proportionate way while maintaining a desired level of resilience?

## Future international work on proportionality?

As noted above, the Basel framework applies to internationally active banks in member jurisdictions. At the global level, there are no minimum standards for non-internationally active banks, and there is no formal expectation that the Basel framework should apply to banks outside Committee member jurisdictions (whether internationally active banks or other banks in those jurisdictions). In the light of these considerations, is there a need for future international work on proportionality? So the decision whether, and how, to adopt a proportionality regime is entirely at the discretion of individual jurisdictions or regions.

But there are, in principle, at least three reasons why further work on proportionality at the global level could be beneficial. First, in line with the Committee's long-standing practice of exchanging information on supervisory approaches and techniques, both Committee and non-Committee jurisdictions could gain from sharing information and their experiences about their domestic/regional proportionality practices.

Second, despite the formal scope of the Basel framework, experience suggests that, in practice, non-Committee jurisdictions face external pressures (eg from market participants, credit rating agencies and international organisations) to adopt some or all of the Basel framework, regardless of its suitability for those jurisdictions. The policy and supervisory decisions adopted by the Committee could therefore have spillover effects on non-Committee jurisdictions.

Third, while the scope of the Basel framework is limited to internationally active banks, a number of historical systemic stress events were triggered by the collective failure of smaller domestic banks (eg the UK secondary banking crisis of 1973–75 and the US savings and loan crisis of the 1980s). In the light of the growing interconnectedness of financial systems, such stress episodes could have global financial stability implications.

Q5. Is there a need for further international work on proportionality? If so, what should this comprise?

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