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Workshop 6
Proportionality

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The *Core Principles for effective banking supervision* ("Core Principles") give greater emphasis to the principle and application of proportionality. Proportionality ensures that applicable rules and supervision practices are consistent with banks' systemic importance and risk profile and are appropriate for the broader characteristics of a particular financial system. The objective of proportionality is to reflect jurisdictions' circumstances and supervisory capacity, not to dilute the robustness of the standards. To fulfil their purpose, the Core Principles must be capable of application to a wide range of jurisdictions whose banking sectors may include a broad spectrum of banks (from large internationally active banks to small, non-complex deposit-taking institutions). To accommodate this breadth of application, a proportionate approach is adopted, both in terms of the expectations on supervisors for the discharge of their own functions and in terms of the requirements that supervisors impose on banks.

High-level considerations

In 2022 the Basel Committee published *High-level considerations on proportionality* to provide practical support to supervisory authorities seeking to implement proportionality in their domestic regulatory and supervisory frameworks.[1]

Financial systems vary in the distribution of banks' size, international activity, level of sophistication and predominance of domestically owned (including government-owned) versus foreign-owned banks. Some financial systems comprise large internationally active banks and small banks serving local communities. Other financial systems consist primarily of small local institutions, some of which might undertake bank-like activities without themselves being banks.

The nature of banks within a financial system may influence the supervisor's approach to proportionality. In a number of jurisdictions that include large, internationally active banks that are subject to the Basel Framework, simpler rules are implemented for less complex banks. However, simplifications that might be appropriate for small banks in jurisdictions with less complex banking systems are not necessarily appropriate for small banks in more complex financial markets.

Similarly, the legal powers, organisational arrangements, availability of resources and levels of independence of supervisors may also differ across jurisdictions. Generally, these factors tend to influence the design and implementation of proportionate regulation and supervision frameworks.

The Core Principles are minimum criteria for an effective regulatory and supervisory framework and should underpin any proportionate approach. Supervisors should bear in mind the following considerations to help ensure that the proportionality approach adopted is consistent with financial

1 BCBS (2022).

system robustness, safeguards financial stability and limits regulatory arbitrage opportunities across and within jurisdictions:

- Proportionality approaches that are consistent with the Core Principles preserve financial stability.
- The Basel Framework is the standard for internationally active banks and already embeds a menu of options with various elements of proportionality and flexibility that could be supervisors' first choice whenever appropriate and possible.
- Depending on local circumstances, it might be appropriate to tailor regulation for non-internationally active banks including potentially applying the Basel Framework in its current form (ie Basel III), or earlier or modified forms, for jurisdictions that have simpler banking systems.
- Effective proportionate approaches strive to be both conservative and simple to understand and implement.
- Proportionality can help supervisors achieve an appropriate intensity of supervision for all banks commensurate with their risk profile and systemic importance.
- Proportionate approaches provide regulatory certainty, without being overly static.
- Proportionality approaches that include supervisory discretion allow supervisors to respond to bank behaviours and financial system developments.

Proportionality approaches

The *High-level considerations on proportionality* provide practical examples that supervisors could consider when implementing proportionality in their jurisdictions.

Segmentation

Supervisors that apply proportionality may choose to define groups of banks subject to different elements of regulation. For example, a jurisdiction might consider a proportionality arrangement where all banks are subject to the same set of rules, or one in which different regulations apply to different sets of banks. In jurisdictions where supervisors apply different rules to different sets of banks, key considerations include the definition of segmentation metrics and thresholds, and the role of supervisory judgment. Segmentation criteria considered by supervisors could include and be based on the banks (i) size / systemic importance; (ii) the level and extent of international activity; and (iii) risk profile and business model.

Capital (Core Principle 16 and Basel Framework CAP)

The definition of capital underpins the quality and availability of capital to absorb losses. As the Basel Framework recognises different capital instruments, each with varying degrees of complexity and different loss-absorbency features, there is the potential for individual jurisdictions to introduce proportionality in the definition of capital.

In considering proportionality, when determining the quality of capital adequacy to be maintained by small and simple banks, supervisors should consider:

- whether the capital instruments meet the eligibility criteria as set out in the Basel Framework;

- whether and how the eligible components of regulatory capital are available to absorb losses on a going-concern basis (for example, common equity and disclosed reserves) and/or on a gone-concern basis;
- whether the capital base includes going- and gone-concern capital, also considering the tiers in the Basel Framework as a guidance; and
- whether the capital has permanency and certainty.

Supervisors could also include as part of their proportionate approaches, simplifying the definition of capital by, for example setting simpler approaches for including retained earnings and unrealised gains and losses in CET1 capital or adopting simpler approaches for making regulatory adjustments.

Calculation of risk-weighted assets (Core Principles 16, 17, 22 and 25)

The Basel Framework contains different approaches for calculating risk-weighted assets (RWA), including both standardised approaches and internal model-based approaches for some risk categories. RWA are a key input in determining banks' capital adequacy ratios. Jurisdictions with simpler financial systems and smaller and simpler banks could consider implementing the simplest approaches available for each risk category. For example,

- **Credit risk:** already provides for a choice between a standardised approach and an internal ratings-based approach. The calculation of RWA under the standardised approach could be further simplified by establishing less granular definitions of (sub)asset classes and exposures compared with the Basel Framework.
- **Operational risk:** when implementing Basel III, jurisdictions with smaller and less complex banking systems may find it appropriate to recalibrate the business indicator (BI) buckets so that thresholds reflect domestic conditions. The thresholds in the Basel III standard may be too large for application for jurisdictions with smaller banking systems.

Leverage ratio (Core Principle 16 and Basel Framework LEV)

The Basel III leverage ratio complements risk-based capital requirements by providing a safeguard against excessive leverage and model risk. Jurisdictions might choose to implement a simpler version of the Basel III leverage ratio to help preserve the safety and soundness of small and simple banks, while limiting the operational burden of calculating the exposure measure. This could be achieved by simplifying the calculation of individual components of the leverage ratio, particularly those that are not material for small and simple banks.

Liquidity requirements (Core Principle 24)

The Basel Framework includes two liquidity requirements: the Liquidity Coverage Ratio (LCR), a measure which promotes short-term resilience, and the Net Stable Funding Ratio (NSFR), which requires banks to maintain a stable funding profile in relation to the composition of their assets and off-balance sheet activities. The Basel Framework allows some possibilities for a proportionate approach such as simplifying the definition of High Quality Liquid Assets (HQLA), aligning the HQLA definitions with balance sheet statement lines or other supervisory reporting requirements, or merging certain categories (eg stable and less stable deposits with more conservative outflow rates). Regarding the NSFR, this could be simplified by limiting the time horizon to two buckets. Supervisor might also consider establishing a lower reporting frequency for certain banks to limit the operational burden of calculating the LCR and NSFR.

Pillar 2 (Core Principles 1, 2, 8, 11 and 16)

The Pillar 2 supervisory review process ensures that banks have adequate capital and liquidity to support all material risks in their business, especially with respect to risks not fully captured by Pillar 1. It also encourages sound risk management and a holistic risk-based perspective by both banks and supervisors.

Supervisors can use a proportionate approach that reflects their assessment of relevant risks of a bank, provided it meets the requirements under the Core Principles by deciding on the level of granularity of requirements for smaller banks. Supervisors can also consider proportionality when they decide on the breadth of coverage of the specific Pillar 2 components. This would allow for small banks with simpler methodologies to meet internal capital adequacy assessment process (ICAAP) requirements. For example, these banks could conduct sensitivity analyses to harness the value of a forward-looking risk management tool, without incurring disproportionate costs by running a fully-fledged suite of stress tests.

Corporate governance and risk management (Core Principles 14, 15 and 26)

Banks are required to have robust corporate governance policies and processes covering, for example, strategic direction, group and organisational structure, control environment, responsibilities of the bank's board and senior management, and compensation. Supervisors may need to consider proportionality for differentiating qualitative requirements applicable across a range of banks, particularly those related to corporate governance and risk management.

The board's responsibility to establish comprehensive risk management strategies, policies and procedures, identify the material risks facing the bank and set appropriate risk tolerance and risk appetite exists regardless of the size of the bank. However, there are potential ways these requirements can be adjusted for smaller and simpler banks.

The risk management function is a key element of the second line of defence of banks. While larger and more complex banks are required to appoint a Chief Risk Officer (CRO) with sufficient stature, independence, resources and access to the board, in the case of some simple and small banks, supervisors might allow the bank to either not appoint a CRO or assign the same responsibilities to another officer.

While all banks need an internal audit function as well as other key internal control functions, for smaller banks the committees relating to areas of audit and risk (among others) could be tailored to the circumstances of the firm. For example, the number of committees and members could be smaller.

Appointing a Chief Audit Executive (CAE), CRO and Chief Compliance Officer (CCO) may increase the cost of compliance to a level that may not be commensurate with the bank's scale and complexity of activities and level of risk exposures. In such cases, supervisors may consider assigning more than one function to the same individual. For example, designating the CCO and the CRO in a concurrent capacity. It would then be the delegator's responsibility to ensure that the delegatee possess all the qualifications necessary to handle the roles.

Q1. What has been your experience in designing and implementing a proportionate regulatory and supervisory framework in your jurisdiction? What factors have influenced your decision to adopt proportionality?

Q2. Which areas of the Basel Framework have you found challenging in implementing proportionality?

Q3. Do you think more international work on proportionality would be helpful? In what areas can the Committee do more?

References

Basel Committee on Banking Supervision (2022): "High-level considerations on proportionality", July.