Proportionality in banking supervision – Executive Summary

The Basel Framework is the full set of standards for the oversight of internationally active banks (IABs) in member jurisdictions of the Basel Committee on Banking Supervision (BCBS). This framework includes the Core Principles for Effective Banking Supervision (BCPs) and regulatory (Pillar 1), supervisory (Pillar 2) and disclosure (Pillar 3) standards. Although the BCPs are universally applicable, the remaining elements of the Basel Framework (the three pillars) are the standard for IABs.

To accommodate the diversity of banks and banking systems, the BCPs embed the concept of proportionality. Proportionality allows assessments of compliance with the BCPs that are commensurate with the risk profile and systemic importance of a broad spectrum of banks. Similarly, the Basel Framework allows for some proportionality by providing supervisory authorities with options for adopting simpler standardised approaches. In some jurisdictions, even the simpler approaches under the Basel Framework might require further adaptation. To support those authorities seeking to implement proportionality, the BCBS published its high-level considerations on proportionality. The considerations are voluntary and do not alter existing BCBS standards, guidelines or sound practices.

Overarching considerations in applying proportionality

Banks vary based on size, their international activities, level of sophistication and ownership structure. The institutional characteristics of supervisory authorities can also differ in legal powers, organisational structure, resource availability and independence. These differences can influence the proportionality approaches taken. Regardless of these variations, all proportionality approaches should remain consistent with the BCPs, foster financial system soundness, safeguard financial stability and limit regulatory arbitrage across and within jurisdictions.

In designing proportionality approaches, one of the most fundamental issues involves segmentation: that is, how to differentiate among banks for purposes of applying tailored requirements. The table below sets out issues to consider in establishing a segmentation structure.

Segmentation elements	Considerations
Number of segments	Categorising banks into different segments may be helpful when a financial system exhibits significant heterogeneity.
Metrics for segmentation	Defining the different segments with both quantitative (eg size, international activity) and qualitative criteria (eg banks' business models, risk profiles) can be useful in determining the nature of risks inherent in different segments.
Setting threshold values	Determining variables that separate banks in each segment must also be considered.
Migration between segments	Establishing rules on the migration between segments provides regulatory certainty whenever changes in size, risk profiles and activities occur.
Role of supervisory judgment	Allowing room for supervisory judgment to move institutions between segments may be useful for reflecting the particularities of banks within each segment; supervisory judgment to override segmentation rules should be subject to a high bar.

Applying proportionality to risk-based capital (RBC) requirements

Some considerations in determining proportionality approaches to the RBC ratio are outlined below. This includes both the definition of capital (numerator) and the calculation of risk-weighted assets (RWAs) for credit, market and operational risks (denominator).

RBC components		Considerations
Numerator – quality of capital		• **Review quality of eligible capital:** Review if capital instruments meet the eligibility criteria in the Basel Framework, including permanence, certainty and ability to absorb losses on a going-concern basis. • **Adopt simpler capital definitions:** Some options include adopting a simpler capital structure (eg fewer tiers of capital) or specifying simpler approaches for making regulatory adjustments in the numerator, as such adjustments have detailed rules that may not be relevant in simpler banking systems. • **Set conservative calibration:** Consider historical experience to determine if minimum capital levels in the Basel Framework are sufficient given jurisdiction-specific characteristics, including loss history and macro developments.
Denominator	Credit RWAs	• Simplify standardised approaches by establishing less granular definitions of (sub)asset classes and exposures compared to the Basel Framework. • Use objective drivers of risk to differentiate classes of credit exposures. • Apply risk weights for unrated exposures to the entire asset class (eg where external ratings are not available for exposures to banks and corporates). • Use streamlined methodologies when exposures are immaterial. • Streamline the criteria for eligible credit risk mitigation techniques by considering only those techniques that are relevant and can be legally enforced.
	Market RWAs	• **Jurisdictions with small trading book exposures in small banks:** Implement a flat surcharge that increases capital requirements by a fixed amount relative to a bank's RWAs for other risks (eg credit RWAs) or total assets. • **Foreign exchange (FX) risk:** Implement more risk-sensitive approaches for FX risk only (eg use relevant balance sheet line items to calculate a measure of banks' open FX positions and apply risk weights to those amounts).
	Operational RWAs	• Recalibrate the business indicator buckets to reflect domestic conditions. • Set a flat surcharge for operational risk based on the bank's RWAs for other risks (eg credit RWAs) or total assets if recalibration is not feasible.

Applying proportionality to other Pillar 1 regulatory requirements

The table below highlights some considerations in determining proportionality approaches for other Pillar 1 requirements. These include:

- **the leverage ratio (LR):** the LR complements RBC requirements by providing a backstop against excessive leverage and model risk. The LR is calculated as a measure of Tier 1 capital (numerator) over a bank's total exposures (denominator)
- **two liquidity standards:** the Liquidity Coverage Ratio (LCR), a measure that promotes short-term resilience, and the Net Stable Funding Ratio (NSFR), which requires banks to maintain a stable funding profile in relation to their asset composition and off-balance sheet activities; and
- **the large exposures (LEX) standard:** the LEX limits the maximum loss that a bank could face in the event of a sudden counterparty failure, by limiting the size of a bank's LEX to a single counterparty or to a group of related counterparties to 25% of the bank's Tier 1 capital

Other Pillar 1 requirements		Considerations
Leverage ratio	**Numerator**	• Use same (simpler) definition of capital as used in the numerator of the RBC ratio.
	Denominator	• Replace the calculation of derivatives or securities financing transaction exposures with values already calculated for credit RWAs, or use a more simplified approach. • Adopt simplifications for other off-balance sheet exposures that are used to calculate credit RWAs. • Rely on values used by banks in their financial statements or regulatory reporting.
Liquidity	**LCR**	• Simplify the high-quality liquid assets (HQLAs) definition by accepting only level 1 assets. • Align HQLA definitions with balance sheet items or supervisory reporting. • Treat balance sheet items such as stable and less stable deposits, level 2a and 2b assets or operational and non-operational deposits as a single category.
	NSFR	• Limit NSFR time horizon to two buckets, such as "less than one year" and "one year or longer"; lower reporting frequency for simpler banks.
Large exposures		• The scope for a proportional approach to the LEX is limited, owing to the particular relevance and importance of managing LEX in small banks.

Applying proportionality under Pillars 2 and 3

The Pillar 2 supervisory review process includes an assessment of banks' internal capital adequacy assessment processes (ICAAPs), risks not covered under Pillar 1, capital adequacy, and governance and risk management. The Basel Framework also requires compliance with Pillar 3 disclosure requirements. Below are some considerations in applying proportionality to Pillars 2 and 3 of the Basel Framework.

Pillars 2 and 3	Considerations
Pillar 2 – ICAAP, other risks and capital adequacy	• **ICAAP requirements:** Streamline ICAAP reports to cover only key risks; permit smaller banks to use simpler methodologies to assess the impact of external conditions on their business and future capital adequacy. • **Interest rate risk in the banking book:** Require a standardised risk charge instead of allowing the use of internal models to calculate capital requirements. • **Exposures to related parties:** Exposures to related parties, including through service contracts, asset purchases and sales, are not covered under Pillar 1 and may require Pillar 2 actions, such as requiring collateralisation of such exposures. • **Concentration risk:** Concentration risk exposures to the same counterparty or to asset classes, products, collateral or currencies may be difficult to avoid in some economies, and Pillar 2 actions are key in addressing it. • **Capital adequacy:** Set trigger and target capital ratios or define categories above minimum ratios (eg "well capitalised" and "adequately capitalised") to identify the bank's capitalisation.
Pillar 2 – corporate governance and risk management	• **Fitness and propriety (FAP) assessment of bank boards:** Board member expertise and the time each board member is expected to allocate to such work may vary according to the bank's risk profile, size, complexity and systemic importance. • **Number and nature of board committees:** Simple and small banks may be allowed to convene streamlined board committees. • **Risk management:** Appointing a chief audit executive, chief risk officer and chief compliance officer may not be commensurate with the needs of smaller banks. In such cases, the bank may assign more than one function to the same individual.
Pillar 3 – disclosures	• Adopt less detailed requirements in terms of mandatory templates and data points, provided that disclosure requirements comply with the relevant BCPs. • Reduce submission frequencies for quantitative and qualitative disclosures.

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