Financial Stability Institute

FSI Insights
on policy implementation
No 1

Proportionality in banking regulation: a cross-country comparison

By Ana Paula Castro Carvalho, Stefan Hohl, Roland Raskopf and Sabrina Ruhnau

August 2017

BANK FOR INTERNATIONAL SETTLEMENTS

FSI Insights are written by members of the Financial Stability Institute (FSI) of the Bank for International Settlements (BIS), often in collaboration with staff from supervisory agencies and central banks. The papers aim to contribute to international discussions on a range of contemporary regulatory and supervisory policy issues and implementation challenges faced by financial sector authorities. The views expressed in them are solely those of the authors and do not necessarily reflect those of the BIS or the Basel-based Committees.

Authorised by the Chairman of FSI, Fernando Restoy.

This publication is available on the BIS website (www.bis.org). To contact the BIS Media and Public Relations team, please e-mail press@bis.org. You can sign up for e-mail alerts at www.bis.org/emailalerts.htm.

ISSN 2522-2481 (print)
ISBN 978-92-9259-088-8 (print)

ISSN 2522-249X (online)
ISBN 978-92-9259-079-6 (online)

Contents

Proportionality in banking regulation: a cross-country comparison[1]

Executive summary

The regulatory response to the 2007–09 international financial crisis resulted in a more robust but also more complex regulatory framework. The Basel standards, as developed by the Basel Committee for Banking Supervision (BCBS), are designed to apply to large and internationally active banks. But many jurisdictions have decided to apply the Basel standards to a wider set of banks.

The additional complexity of Basel III has triggered discussions on the principle of "proportionality", ie on how best to tailor regulatory requirements to non-internationally active banks, especially smaller and less complex ones. The discussion about applying a proportional approach to banking regulation is not new. The Basel framework has offered a menu of approaches since the advent of Basel II. Several jurisdictions have implemented specific regulatory standards for smaller and less complex banks. Since the introduction of risk-based supervision, the principle of proportionality has played an established role in day-to-day bank supervision.

This note compares the proportionality approaches that have already been applied, or are planned, in six jurisdictions: Brazil, the European Union, Hong Kong SAR, Japan, Switzerland and the United States. These approaches differ considerably, in terms of criteria and the thresholds used to decide which banks are subject to a specific set of rules, and also in terms of the regulatory standards that are subject to a proportional implementation.

The key feature of a proportionality regime is the criteria used to identify the banks to which a proportional framework is applied. The criteria for identification/segmentation vary widely across jurisdictions, although a bank's size plays a major role. In addition to size, the bank's business model and business activities are critical considerations when applying a proportional regulatory treatment.

In practice, full Basel standards are generally enforced, as a minimum, on mid-sized to large banks. In many jurisdictions, banks with balance sheets of more than EUR 20–30 billion are generally subject to the full Basel standards. The United States and Brazil apply Basel-based standards to large international banks, although the alternative prudential requirements applied to other banks are not necessarily less stringent, and often align with Basel standards and principles.

The criteria used in segmenting banks for possible exemptions in regulatory requirements follow different schemes. In three countries – Brazil, Japan and Switzerland – banks are divided into specific categories according to their size and/or international activity. Banks in the same category are subject to a specific set of rules that differ from the ones applied to banks in other categories. By contrast, in the European Union, the United States and Hong Kong SAR, rules corresponding to specific Basel standards are adjusted for banks meeting set criteria, eg market risk can be measured according to a simplified method for banks with a small trading book. These two different schemes are often applied in

[1] Ana Paula Castro Carvalho, Central Bank of Brazil; Stefan Hohl, Roland Raskopf, Bank for International Settlements and Sabrina Ruhnau, Deutsche Bundesbank.

We would like to thank Kheng-Piew Ch'ng, Alan Clifford, Rodrigo Lara Pinto Coelho, Adrienne Coleton, Anna Hewko, Daryl Ho, Thomas Odegard, Kenji Ooki, Nina Reiser, Otavio Ribeiro Damaso, Martin Sprenger, Uwe Steinhauser, Greg Sutton and Jean-Philippe Svoronos for their valuable input and advice.

combination, meaning that specific exemptions can be granted in addition to the selection of banks into different regulatory categories.[2]

Another relevant feature is the scope of the regulatory adjustments for smaller or less complex banks. These proportional adjustments aim at reducing the operational burden for banks. Observed exemptions from the Basel standards often apply to the liquidity framework, the disclosure requirements, counterparty credit risk, the large exposures framework and the measurement of market risk. Other regulatory areas, which are more principle-based by design, such as Pillar 2 and interest rate risk in the banking book, offer more scope to further reduce the regulatory burden.

The "proportionality strategy" should acknowledge the limits posed by other relevant policy objectives. In particular, regulators must weigh the implications for financial stability and for the domestic competitive environment. Policy choices must face complex trade-offs in this respect. It would seem reasonable to aim for a proportional compliance and reporting burden for smaller and less complex banks but without jeopardising their minimum desired solvency and liquidity. In other words, proportionality should entail rules which are simpler but not necessarily less stringent.

2 Switzerland, for example, makes the principal distinction between banks in categories 1–3 and 4–5 and also grants specific exemptions independent of the categorisation.

Introduction – applying proportionality in banking regulation

1. **Global coordination has contributed to the development of more consistent and comparable regulatory and supervisory standards**. International standards are required to ensure that all banks which can transmit risks across borders meet sufficiently stringent solvency and liquidity requirements, both to facilitate a level playing field at the global level and to favour the integration of global banking markets.

2. **An important feature of Basel I, II and III is that they are not designed to be applied to the whole banking system in all jurisdictions**. The Basel core principles for effective banking supervision do not require jurisdictions to apply the capital adequacy regimes of Basel I, Basel II and/or Basel III to non-internationally active banks. This accords with the aims of international cooperation in this area, which place the emphasis on global financial stability and fair competition in international markets.[3]

3. **The Basel framework is therefore consistent, in principle, with the concept of "proportionality", ie tailoring regulatory requirements to non-internationally active banks, especially smaller and less complex ones**. Indeed, Basel I, II and III already incorporate some limited elements of proportionality by offering a menu of approaches for calculating risk-weighted assets (RWAs) including simpler standardised approaches (see Box 1).

4. **The application of proportionality beyond the instances embedded in the Basel framework implies that regulatory requirements may differ significantly across banks in the same jurisdiction depending on their size or other characteristics**. The impact of these differences in a competitive environment can partially explain why, when implementing the Basel framework, a number of countries chose to apply the standards to all banks in their jurisdictions, however sometimes with minor exceptions. In contrast, some countries decided to apply the full Basel standards only to internationally active banks, while banking institutions outside this category are either exempted from certain rules or eligible for simplified requirements.

5. **The Basel III framework differs from its predecessors in that it encompasses a wider range of minimum standards that go beyond the definition of regulatory capital (BCBS (2011)) and the corresponding calculation of minimum capital requirements for different risks (BCBS (2006, 2016a, 2016b))**.[4] It also includes capital buffers, a liquidity framework (Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR)), a leverage ratio and specific requirements for global systemically important banks (G-SIBs).

6. **The post-crisis regulatory framework has arguably added complexity and has increased compliance and reporting costs**. In particular, the new standards for market risk, the LCR and NSFR, the new standard on interest rate risk in the banking book (IRRBB), the revised Pillar 3 templates and the enhanced Counterparty Credit Risk (CCR) approach may contribute significantly to increasing the regulatory burden for banks. In particular, the new and more complex standards result in increased reporting requirements, because supervisors need more data to monitor and verify them. Implementing the full set of new regulations is especially demanding on banks' human and IT resources.

[3] This note focuses on prudential standards applicable to banks only. Therefore, any references to entities or institutions refer to banking entities or institutions, unless otherwise specified. Similarly, regulation and supervision refer to prudential regulation and supervision and not, eg, to accounting standards.

[4] Basel III is a comprehensive set of regulatory reforms developed by the Basel Committee in response to the global financial crisis in 2007-08. These reforms have so far increased the level and quality of capital, enhanced risk coverage, constrained bank leverage and improved bank leverage. See www.bis.org/bcbs/basel3.htm. Further reforms to the calculation of capital requirements, including those for credit risk and operational risk and a capital floor, are still to be finalised.

Box 1

Aspects of proportionality embedded in the Basel framework

The Basel regulatory framework comprises a set of global minimum standards for internationally active banks. Jurisdictions can adopt domestic regulation that exceeds the Basel minimum, often called "gold-plating" or "super-equivalent". The 1988 Capital Accord (Basel I) set a minimum risk-based capital requirement for banks as the main instrument for limiting risks and losses to protect financial beneficiaries including depositors. Basel I required capital for credit risk, and market risk was added in 1996. The innovation in market risk marked the advent of proportionality in the Basel framework by offering both a standardised approach and an internal models-based approach. Basel I required that internationally active banks, maintained a capital ratio of no lower than 8% based on the definition of regulatory capital and risk-weighted assets (RWAs). Due to progress in risk management, the increasing complexity of banking businesses and the growing importance of cross-border activities in the banking sector, Basel I soon turned out to be too rudimentary.

Thus, the key objective of Basel II, or the revised Framework, was to better match capital requirements to risks by improving their risk-sensitivity and also by including operational risk. Basel II introduced the three-pillar approach by extending the minimum capital requirements (Pillar 1), by emphasising the importance of an adequate supervisory review process for each bank's own capital planning (Pillar 2) and by enhancing market discipline through mandatory disclosure (Pillar 3). Pillar 2 is a principle-based approach which requires judgement by supervisors. Pillar 2 is a prime example of the proportionality element of the Basel framework as supervisors will, in exercising their judgement, take into consideration among other things size, complexity, business model and risk profiles of individual banks. The revised Framework aimed at improving risk management in banks through the use of three mutually reinforcing pillars and the provision of a range of options for determining capital requirements including the greater use of banks' own risk assessment as inputs to capital calculations. As such, Basel II offers a menu of approaches ranging from simpler approaches to more advanced approaches for calculating risk-weighted assets for credit risk, market risk and operational risk.

The different approaches offered in Basel II illustrate how proportionality can be applied in the Basel framework. Different banks may use different approaches to calculate RWAs. In credit risk, two model-based approaches, the Foundation and the Advanced Internal Ratings-Based Approach are complemented by the supervisory defined Standardised Approach (SA) for credit risk. Simpler versions of the latter include, for example, the exclusion of the use of external ratings, which reduces the supervisory burden when evaluating them. More examples can be found in credit risk mitigation, and in the treatment of guarantees and credit derivatives as well as collateral. Approaches for operational risk include a full models-based approach, the Advanced Measurement Approach, a Standardised Approach including the Alternative Standardised Approach and a simple Basic Indicator Approach. The proportional aspect is also reflected in the different qualitative risk management standards banks must comply with, in line with the different approaches.

Basel III introduced a comprehensive strengthening of regulatory standards in response to the global financial crisis beyond Basel II. These standards capture a wider range of risks and, most importantly, they require higher-quality capital as well as more stringent requirements for loss absorption. The Basel regulatory framework now includes a leverage ratio, capital buffers, and standards restricting liquidity risk and maturity transformation. In addition, the development of Basel III has been guided by balancing risk sensitivity, simplicity and comparability while aiming at reduced variability in risk-weighted assets. These additional minimum standards, in combination with the continued use of bank's internal approaches for RWA calculation, arguably increase the complexity of the Basel framework. In order to mitigate this complexity, the BCBS issued in 2017 a consultative document on a simplified version of the Standardised Approach in the revised market risk framework with the aim of addressing implementation challenges for banks with smaller or simpler trading books.

Effective implementation of the Basel framework does not require its application to all banks in a particular jurisdiction. With the implementation of Basel II, the BCBS specifically encouraged national supervisors to determine both the set of banks falling under the new regulatory regime and the range of approaches within the revised Framework. When considering the set of banks within the scope of the national implementation, supervisors should take into account quantitative as well as qualitative criteria such as a bank's size and risk profile, the complexity of its activities and its international presence. Essentially, the Basel framework is not a one-size-fits-all approach.

7. **By comparison with regulation, supervisory frameworks typically embed a larger amount of proportionality**. The Core principles for effective banking supervision call for a risk-based (proportional) supervisory approach that takes into account banks' risk profile and systemic importance.[5] However, experience with the Basel II and Basel II.5 implementations has shown that the burden on supervisors could possibly be alleviated if the scope of some standards were to be more narrowly focused.

8. **Regulators and supervisors seek to enhance the use of proportionality without compromising other social objectives**. Most important is the need to preserve financial stability and to ensure a level playing field in domestic banking markets. Policymaking in this domain must face complex trade-offs.

9. **Proportionality may potentially affect financial stability if not properly designed**. For example, any reduction in regulatory costs requires simpler and less complex rules that typically entail less risk-sensitive prudential requirements. This could potentially generate incentives for unsound risk management by banks.

10. **The impact of proportionality on the domestic competitive environment is far from straightforward**. A differentiated approach for smaller banks will change the competitive game for banks participating in the same market. Moreover, a proportionality regime may have the potential to discourage corporate activities both at the domestic and cross-border levels that might otherwise be useful in improving the structure of the banking industry. Whether the potential distortions generated by proportionality are larger or smaller than the ones introduced by a potentially excessive regulatory burden for smaller firms will always be subject to discussion.

11. **This note compares the cases of six jurisdictions that are implementing, or planning, a proportional framework for their prudential banking regulation: Brazil, the European Union, Hong Kong SAR, Japan, Switzerland and the United States**. The purpose is to provide an overview of some *regulatory* choices already made or in the planning process that could help focus the discussion on different options for applying proportionality in banking regulation.[6]

12. **A proportional regime is typically characterised by two components: (i) the criteria used to exempt a bank from (a subset) of the regular (Basel) regulatory requirements; and (ii) the scope of exemptions and the alternative rules applied to qualifying banks**. The following sections of this note discuss, respectively, the selection criteria and the scope of the regimes applied, or planned, by the six jurisdictions analysed in this note. A more detailed description of the proportionality approaches carried out in the six countries can be found in the Annex.

Defining criteria for the application of proportionality

13. **Methods used to introduce proportionality in a regulatory regime generally correspond to one of the following models**: (i) establish categories of banks according to different qualitative and/or quantitative characteristics and apply a specific regulatory regime for each of the categories (*categorisation approach for proportionality, CAP*); and (ii) establish 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 risk (*specific standard approach for proportionality, SSAP*). In reality, the

[5] The International Association of Insurance Supervisors (IAIS) has similarly outlined a "proportionality principle", recognising that supervisors need to adjust supervisory requirements and actions in accordance with the nature, scale and complexity of risks posed by individual insurers (IAIS (2012)).

[6] Bank licensing systems and the treatment of start-ups and fintechs are not in scope. The same is true for certain other aspects of the post-crisis reforms, such as the resolution framework and specific requirements for G-SIBs and D-SIBs, since they are proportional by regulatory design.

approaches followed in most jurisdictions may combine the CAP and SSAP models. However, it is possible to broadly classify the six jurisdictions in terms of their proximity to one or the other approach, as shown in Table 1.

Examples of proportionality strategies

Table 1

Categorisation approach (CAP)		Specific standard approach (SSAP)	
	Classification of banks		Exceptions in following areas
Brazil	Five categories	European Union[7]	- Trading book - Disclosure - CCR - Large exposures
Japan	Two categories	Hong Kong SAR	- Credit risk - Liquidity framework - Large exposures
Switzerland[8]	Five categories	United States	- Advanced approaches - Counterparty credit risk - Stress tests and capital planning - Trading book - Liquidity framework

Sources: National data (see Annex); table collated by the FSI.

14. **While the CAP is the proportionality model broadly followed in Brazil, Japan and Switzerland, SSAP is the model prevailing in the European Union, Hong Kong SAR and the United States**. Within the CAP jurisdictions, Brazil has divided its financial system into five segments, taking into account size, cross-border activity and banks' risk profile. Switzerland also groups banks and securities dealers into five categories based on measurable criteria related to total assets, assets under management, privileged deposits[9] and required capital. Finally, Japan roughly divides its banking system into two categories: internationally active institutions that apply full Basel standards and banks that are subject to domestic regulation. As for SSAP jurisdictions, the European Union, for example, already implements exemptions or simplifications for market risk and disclosure requirements. The United States targets areas such as liquidity requirements, market risk and stress testing. Local liquidity requirements rather than the Basel LCR measure are also applied to certain qualifying banks in Hong Kong SAR.

15. **The CAP establishes consistent prudential rules for banks sharing similar characteristics in a particular jurisdiction**. It also allows the regulator to link the regulatory treatment with the supervisory approach and the envisaged resolution strategies for the same group of banks. That permits a consistent policy framework to be adopted for each group of banks.

16. **The SSAP entails a more granular tailoring of regulatory requirements to the specific characteristics of each bank by taking into account its business and overall risk profile**. In other

7 The EU law provides exemptions and simplifications for all areas when it comes to a comparison with Basel standards. The Annex provides a more detailed description of the full EU treatment of proportionality. Some of the prudential topics shown in this table are not yet implemented in a proportional way. The EU is planning to provide simplifications in this areas (more information is provided in the Annex).

8 Switzerland also grants specific exemptions independent of the categorisation, for example, in market risk and large exposure requirements. It therefore provides an example of how the two schemes can be combined.

9 Privileged deposits benefit from protection up to a maximum of CHF 100,000 per client in bankruptcy proceedings.

words, this approach permits the adoption of simplified regulation on specific areas (such as market or counterparty risk) precisely when they are of little relevance for banks' business activities and the assessment of their risk profile. By doing so, it is more likely to achieve the objective of reducing the regulatory burden without unduly weakening overall prudential standards, ie solvency or liquidity safeguards.

17. **Different criteria are used to categorise banks under both the CAP and SSAP. However, size is a prominent feature in both approaches**. Under the CAP, size is the dominant criterion for assigning banks to different categories. Moreover, although under the SSAP specific exemptions are granted on the basis of concrete criteria, there is also typically an overarching size threshold. Table 2 depicts the implicit size thresholds, already in place or envisaged, in the different jurisdictions below beyond which either exemptions or limited application of the Basel framework apply. In general, these size thresholds are set in either absolute or relative terms to different aggregates, for example, in relation to total exposures, GDP or capital.

Implicit size thresholds for the application of the Basel framework[10] Table 2

Jurisdiction (1)	Thresholds (for specific areas) (in general) (2)
Brazil	- **Total exposure/GDP > 10%** (≈ EUR 170.4bn) - Total assets abroad ≥ US$ 10bn
European Union[11]	- **Total assets ≥ EUR 30bn** - Total assets ≥ EUR 5bn and ≥ 20% nat. GDP
Hong Kong SAR[12]	- **Total assets ≥ HK$ 250bn** (≈ EUR 28.8bn)
Japan	- **Smallest bank subject to the Basel framework** (≈ EUR 28.4bn)
Switzerland	- **Total assets ≥ CHF 15bn** (≈ EUR 13.8bn) - Assets under management ≥ CHF 20bn - Privileged deposits ≥ CHF 0.5bn - Required equity capital ≥ CHF 0.25bn
United States	- **Total assets ≥ US$ 250bn** (≈ EUR 222.5bn) - On-balance sheet foreign exposures ≥ US$ 10bn

Sources: National regulation (see Annex); exchange rates provided by the ECB (as of 21 June 2017).

18. **Quantitative thresholds for full application of the Basel framework vary across jurisdictions**. These thresholds have varying significance, as they are typically complemented by other quantitative or qualitative indicators to determine the regulatory regime that is applied to each bank. Yet effective thresholds seem to be comparatively low in Switzerland, quite high in Brazil and the United States and somewhere in between in Hong Kong SAR and the European Union. It is important to note, however, that the structural characteristics of the banking sectors clearly require different thresholds. For example, given the large number of small banks in Switzerland (categories 4–5), banks that are subject to the full Basel standards (categories 1–3) account for only around 10% of the banks, but the top three banks

10 If the SSAP is applied, for example in the European Union, relatively large banks above the implicit size threshold might be exempted from a particular regulatory requirement.

11 According to Article 430a in the proposal by the European Commission: this article defines "large banks" for the purpose of the disclosure requirements (Pillar 3). Banks above this threshold will not be granted any exceptions within Pillar 3.

12 The threshold depicted for Hong Kong SAR relates to the application of the Basel liquidity standards.

account for more than 70% of the total banking assets of the country's top 20 banks. In Japan, where there is no quantitative size threshold, the stringent criteria for considering a bank internationally active (simply owning branches or subsidiaries abroad) create an implicit size threshold similar to that of the European Union and Hong Kong SAR.

19. **Size-related thresholds alone do not capture the full extent of banks' business models and related risks**. Other variables used in both approaches are criteria for describing either the legal entity basis as well as the supervisory judgment of the bank. For example, in order to categorise banks, criteria in use include (i) being a "listed institution" – for the European Union;[13] (ii) obtaining supervisory approval – for Hong Kong SAR; (iii) the business model – for Brazil and Hong Kong SAR; (iv) the bank's role in the banking system – for Hong Kong SAR; (v) risk profile – for Brazil, the United States, Hong Kong SAR and Japan; (vi) supervisory decision – for Hong Kong SAR and Brazil; and (vii) involvement in cross-border activities – for Japan.

20. **In SSAP jurisdictions, size-related thresholds are often applied as part of a special regulatory regime, particularly for the treatment of market and counterparty credit risk as well as disclosure requirements**. According to an EU proposal, banks with a small or medium-sized trading book, ie when the nominal values are below EUR 50 million and EUR 300 million, respectively, remain subject to the existing Basel 2.5 framework. The United States exempts all banks from the full market risk requirements under Basel 2.5 in the case of insignificant trading activities, ie when aggregated trading assets do not exceed US$ 1 billion or 10% of total assets. In terms of counterparty credit risk, the European Union again plans to distinguish between small and medium-sized bank risk profiles. Different requirements apply to banks with derivative positions not exceeding either 5% or 10% of total assets as well as EUR 20 million and EUR 150 million, respectively. For disclosure requirements, the European Union plans to apply proportionality especially to banks with total assets of less than EUR 1.5 billion. The threshold in Hong Kong SAR for disclosure requirements is slightly lower, at HK$ 1 billion. In the area of credit risk, proportionality is applied to banks with total assets of less than HK$ 10 billion. Strict criteria are adopted for the exemption from market risk capital requirements (ie market risk positions never exceeding HK$ 60 million and 6% of a bank's total on- and off-balance sheet exposures) to ensure that only banks with very small trading books are excluded. A local liquidity requirement is applied to banks with total assets and international exposures, as measured by the aggregate amount of external claims and liabilities, of less than HK$ 250 billion.

Targeted areas of proportionality

21. **The proportionality regimes offer regulatory relief mostly in areas in which standards are relatively complex and often imply a high burden of compliance including financial costs for banks**. Below, we outline some of the areas covered by the proportionality regimes analysed. More details can be found in the Annex.

22. **Liquidity requirements**: Most jurisdictions have exempted or modified the LCR requirements for a subset of their banks. These countries have introduced alternative liquidity requirements for banks that are not subject to Basel III. Brazil, for example, has introduced the Basel LCR standard for internationally active banks in segment S1 (see Annex) in addition to close monitoring of liquidity risk, which is applied to all banks. Hong Kong SAR has implemented a local liquidity standard for banks that are out of scope for the Basel LCR standard. Switzerland applies the Basel LCR standard to all banks, but requires fewer reporting templates for smaller banks. For example, category 4 and 5 banks in Switzerland have to disclose only the numerator and denominator as well as the LCR itself. Europe applies the Basel LCR standard and the same supervisory reporting templates to all banks. In the European Union, competent authorities may

13 For the purpose of Pillar 3 requirements.

exempt banks from the LCR requirements at an individual level, under certain conditions that ensure that a bank will be able to receive the necessary liquidity from the group it belongs to. In particular, specialised credit institutions (institutions that collect little in the way of deposits and lend only to very specific sectors) may be granted the option to apply specific inflow cap waivers to the extent that they are exposed to a lower liquidity risk profile. This is subject to official validation. The United States requires all bank holding companies (BHCs) with more than US$ 250 billion in total consolidated assets or US$ 10 billion in foreign exposure to comply with a Basel III-based LCR. It requires BHCs with total consolidated assets of at least US$ 50 billion that do not meet these thresholds to comply with a modified minimum LCR.

23. **Counterparty credit risk (CCR)**: In all jurisdictions covered in this note, except Japan, some adjustments of the CCR standard for specific banks are in place or foreseen. The European Union, for example, has drafted a regulation in which simplified methods, including the option of continuing to use the Basel II.5 method for calculating CCR, are permitted for small banks with limited derivative exposures. The United States permits only banking organisations using the advanced approaches of the risk-based capital framework to apply the internal models methodology for purposes of the counterparty credit risk framework. These institutions are also required to calculate a credit valuation adjustment (CVA) to the risk-weighted asset amount.

24. **Large exposures (LE)**: The European Union, Switzerland and Hong Kong SAR have issued or plan to issue regulations that incorporate a proportional feature for LE. The European Union, and similarly Switzerland, allow banks with, among other conditions, eligible capital below EUR 600 million to determine their own large exposure limit for interbank exposures. This limit must not exceed 100% of the bank's eligible capital and EUR 150 million. As a result, the standard limit of 25% is not binding for these institutions. Hong Kong SAR has simplified the calculation of credit risk mitigation (CRM) for large exposures at qualifying banks. The United States has issued a proposal (not yet implemented) that would apply only to BHCs with total consolidated assets of US$50 billion or more.

25. **Credit risk**: In addition to the menu of approaches offered in the Basel framework, most jurisdictions covered in this note have already implemented proportionality in the calculation of RWAs for credit risk. The United States has also implemented a domestic standardised approach for credit risk; advanced approaches banking organisations calculate capital using both this standardised approach and the Basel III-based approach. Hong Kong SAR has implemented a simplified credit risk framework based on Basel I that can be used by very small banks, provided they have supervisory approval. Switzerland allows small banks (categories 4 and 5) and medium-sized banks (category 3) with negligible investments in funds to use a simplified credit risk RWA calculation for mutual funds instead of the application of the "look-through approach" or "mandates-based approach".

26. **Market risk**: The European Union, the United States, Switzerland and Hong Kong SAR have implemented the Basel Framework for market risk to institutions above specific thresholds for the trading book. In addition, the European Union is proposing to increase the existing threshold for small trading books, as described above, where banks falling below the threshold can use the simplified approach in calculating a banking book capital charge for equity and debt positions. In the United States, only banking organisations with aggregate trading assets and liabilities of more than US$ 1 billion or representing at least 10% of total assets are subject to the domestic implementation of market risk-based capital requirements reflecting Basel II.5 standards. Switzerland allows banks with insignificant trading activities to use a simplified approach for the calculation of market risk capital (calculating a banking book capital charge for equity and debt positions). In Hong Kong SAR, banks with market risk positions below HK$ 60 million and 6% of their total on- and off-balance sheet exposures may be exempted from the market risk capital framework, and instead calculate the regulatory capital for their market risk positions under the credit risk capital framework.

27. **Minimum capital ratios**: Only Japan has established a different minimum capital ratio for non-internationally active banks. In particular, Japan requires its non-internationally active banks to maintain a minimum capital ratio of 4% of RWAs.

28. **Interest rate risk in the banking book (IRRBB)**: The United States, Switzerland and Brazil have, or plan, differing IRRBB standards for different banks. In the United States, many of the IRRBB principles outlined in the standards have been implemented through the "Joint Agency Policy Statement: Interest Rate Risk" as well as the "Interagency Advisory on Interest Rate Risk." The governance requirements for IRRBB vary depending on the size, scope and complexity of a bank's activities. For example, centralised asset-liability management is required for larger banks. Similarly, the European Union guidelines on IRRBB fully recognise the principle of proportionality, specifying supervisory expectations that are mainly qualitative. Switzerland plans to exempt banks in categories 4 and 5 from certain technical requirements such as the provision of an independent validation function. Brazil, in line with its general approach to bank categorisation, plans to have differing standards for different bank categories.

29. **Capital planning and supervisory review**: Brazil, the European Union and the United States have adopted a proportional treatment for Pillar 2. In Brazil, the Basel II Internal Capital Adequacy Assessment Process (ICAAP) has been implemented for larger banks only. The Supervisory Review and Evaluation Process (SREP) in the European Union is used to assess and evaluate the risks for each bank on an ongoing basis and to determine additional capital and liquidity requirements. The European Banking Authority provides guidelines that explicitly take into account the principle of proportionality in the extent and frequency of the assessment that is linked to the categorisation of banks.[14] However, since Pillar 2 is principle-based, all countries have differing expectations for different banks based on size, activity and risk profile. Stress testing plays an important part in the capital planning process for banks in the United States and is legally implemented in a proportional way. BHCs with total assets of at least US$ 10 billion are subject to an annual company-run stress test. BHCs with total consolidated assets of US$ 250 billion or more, or total non-bank assets of US$ 75 billion or more, are subject to quantitative and qualitative requirements whereas BHCs below these thresholds are exempted from the latter.

30. **Disclosure requirements**: All six jurisdictions apply the principle of proportionality for Pillar 3, mostly with reference to the substance and frequency of disclosure. The EU Commission's proposal on disclosure requirements differentiates between "large institutions", "small institutions" and/or "non-listed institutions", as described above. Small institutions are subject only to selected annual disclosures. Similarly, Switzerland provides banks in categories 4 and 5 with relief regarding frequency and content. Hong Kong SAR bases its threshold for disclosure on total assets and customer deposits. Banks with total assets (less provisions) of less than HK$ 1 billion and total customer deposits of less than HK$ 300 million can (subject to supervisory approval) be exempted from disclosure requirements.

31. **Recovery planning**: Most of the jurisdictions covered in this note require their systemically important banks to prepare recovery strategies. The European Union generally requires all banks to develop recovery plans and update them annually. However, the plans may differ in their content, level of detail as well as frequency of updating depending on a bank's size, complexity, interconnectedness and other criteria for applying simplified requirements to recovery planning. Another example is Switzerland: institutions in categories 3, 4 and 5 are generally not obliged to do recovery planning. In Brazil, only a specific set of banks is required to formulate a recovery plan as specified by the international standards.

32. **Table 3 provides a summary of most of the areas currently targeted for a proportional implementation beyond the menu of approaches offered by the Basel framework**. The table distinguishes between Pillars 1, 2 and 3. The broad allocation includes current regulation and current proposals on potential future implementation.

[14] According to the respective guidelines, the categorisation of institutions into four categories should be based on their size, structure, internal organisation and scope, and on the nature and complexity of their activities. For the proportionate application of these guidelines, the frequency, intensity and granularity of SREP assessments, and the level of engagement, should depend on the institution's category.

Targeted issues for proportionality						Table 3
Issues	Brazil	European Union	Hong Kong SAR	Japan	Switzerland	United States
Liquidity regulation (LCR and NSFR)	Yes	Yes	Yes	Yes	Yes	Yes
Counterparty credit risk	Yes*	Yes*	Yes	No	Yes	Yes
Large exposures framework	Yes*	Yes	Yes*	No	Yes	Yes*
Credit risk	Yes*	No	Yes	No	Yes	Yes
Market risk	Yes*	Yes	Yes	Yes	Yes	Yes
Minimum capital ratios	No	No	No	Yes	No	No
Interest rate risk in the banking book	Yes*	Yes	No	No	Yes*	Yes
Capital planning and supervisory review**	Yes	Yes	No	Yes	Yes	Yes
Disclosure requirements	Yes*	Yes*	Yes	No	Yes	Yes
Recovery plan	Yes	Yes	Yes	Yes	Yes	Yes

*expected; **including stress testing

Colour code: purple: Pillar 1 elements, beige: Pillar 2 elements, blue: Pillar 3, brown: other.

Source: National regulation (see Annex); table collated by the FSI.

Concluding remarks

33. **The principle of proportionality has become an increasingly relevant policy issue in the context of implementing the post-crisis regulatory reform**. The increased complexity of some international standards and the resulting reporting requirements have increased the costs of compliance for financial institutions. Smaller banks face a relatively higher compliance burden. In that context, financial authorities have already introduced or are currently considering the adoption of a more proportional regulatory approach.

34. **The information provided in this paper, which relates to six jurisdictions, points to a wide variety of approaches in the application of proportionality**. Countries differ markedly in the strategy used to differentiate banks for the purpose of tailoring regulatory requirements and also in the scope of the alternative rules imposed on banks not subject to the Basel framework.

35. **In practice, the group of banks to which the full Basel framework is applied is larger than the group of internationally active banks**. The size thresholds identified in this report point to the fact

that only smaller banks and/or small operations in some business areas would benefit from further regulatory relief to reduce banks' operational costs.

36. **Striking a good balance between minimising the regulatory burden and respecting the prudential objectives is key in implementing proportionality**. This is consistent with the interpretation of proportionality as a way of reducing the regulatory burden only when less burdensome rules are effective to ensure sufficient solvency and liquidity for smaller and less complex banks. In other words, regulatory relief should be granted only to the extent that it does not threaten financial stability and the resilience of individual banks. Consideration could be given to the possibility of offsetting regulatory relief in compliance and operational costs with higher capital requirements. The reduced risk sensitivity that simpler rules typically entail may provide the rationale for such an approach.

37. **Competitive implications must be carefully analysed**. In particular, efforts should be made to prevent the proportionality regime from eroding incentives for efficiency-improving banking sector consolidation, cross-border integration and cross-border financial activity.

38. **Seeking regulatory relief on specific prudential issues when they are of little quantitative relevance for specific banks has clear merits**. This approach closely follows the principle of "same business, same risks, same rules" and thus does not overly compromise a level playing field. Yet, establishing categories of banks with a specific set of requirements in each category is somewhat simpler and can facilitate consistency between the regulatory, supervisory and resolution approaches followed for different types of bank.

39. **In any case, further analysis is required to assess the impact of different proportionality approaches**. In particular, there could be merit in studying whether a subset of simpler requirements based on a few solvency and liquidity indicators, if properly calibrated, could have equivalent prudential power to that of the more sophisticated Basel-type requirements for banks of a specific size and business model. This could provide a good analytical foundation on which to base future proportionality regimes, ideally leading to cost-efficient rules that match financial risks.

Annex: Examples of proportional approaches

The case of Brazil

In implementing Basel II and Basel II.5, Brazil has chosen to apply the minimum capital standards to the country's whole financial system. This comprises more than 1,400 institutions that range from large and complex banks to credit unions and securities dealers. In the early 2000s, the intention was that universal application of the standards would contribute to the stability of the financial system. At the same time, the one-size-fits-all regulatory approach has presented supervisory challenges, given the unavoidable necessity of exercising judgment on qualitative and quantitative requirements.

The Basel III reforms have prompted a change of approach. Brazil had already implemented proportional requirements in its Internal Capital Adequacy Assessment Process (ICAAP) and offered a simplified calculation of regulatory capital for banks with a low risk profile. However, the first direct decision to exempt institutions from the enforcement of a specific Basel standard corresponded to the minimum LCR ratio.

A process has been initiated to apply proportionality to the application of the more complex standards. That includes the market risk framework, the enhanced disclosure templates and the frameworks for recovery and resolution developed by the Financial Stability Board (FSB). In effect, the Central Bank of Brazil, the country's regulatory and supervisory authority, has abandoned the approach taken since Basel II and, instead, has undertaken a comprehensive and public segmentation of the Brazilian financial system, setting the scene for the introduction of regulatory requirements on a proportional basis.

The regulation that establishes the new regulatory framework[15] **and divides the Brazilian financial system into five segments was issued in January 2017**. It takes into account the size, the international activity, and the risk profile of the subject institutions (see Table 4). The size criterion is measured as an institution's total exposure, calculated according to the leverage ratio framework, divided by the Brazilian gross domestic product for a given year. The segmentation is applicable at the consolidated level to institutions operating in and from Brazil, which means that a foreign institution would be viewed from the perspective of the operations of its Brazilian subsidiary. The size ratio uses the total exposure measure because it includes on- and off-balance sheet items and the relative ratio ensures that the thresholds retain their significance over time. The regulation also sets the operational details on how the initial segmentation is defined, on the mechanics of calculating the thresholds, on the recategorisation of banks from one segment to another and on possible supervisory actions regarding the definition of the most suitable segment for an institution. The authority can override/adjust the segmentation in certain circumstances.

The segmentation is designed to provide a comprehensive but simple categorisation of the financial system. The aim is also to define a categorisation suitable for a variety of regulatory topics, ranging from prudential supervision to recovery and resolution issues.[16] Once the segmentation has been established, the next step is to establish different regulatory requirements using the five segments as drivers for deciding on the appropriate proportionality for each specific situation, following the implementation schedules of the post-crisis reform agenda without compromising prudential objectives.

[15] Resolution 4,553 establishes the segmentation of the financial institutions and other institutions authorised by the Central Bank of Brazil, for the proportional implementation of prudential regulation.

[16] Resolution 4,502 by the Brazilian Monetary Council stipulates that only S1 banks must comply with the minimum requirements for the preparation and implementation of recovery plans.

Segmentation of Brazil's financial system			Table 4
Segment	Size ratio threshold (Total exposure/GDP)	Internationally active (Total consolidated assets abroad ≥ US$ 10bn)	Number of institutions (June 2016)
S1	Size ratio ≥ 10%	Yes	6 banks
S2	1% ≤ Size ratio < 10%	No	7 banks
S3	0.1% ≤ Size ratio < 1%	No	39, including 36 banks
S4	Size ratio < 0.1%	No	422, including 83 banks
S5	Size ratio < 0.1% and business model of non-banks	No	989 non-banks

Source: Central Bank of Brazil.

The intention is to require the full application of Basel III standards to segment S1 – comprising the six largest and most complex banks and the internationally active banks. This category includes all the D-SIBs and represents 70% of the system's total exposures, as of June 2016. On the other hand, for the S5 group – which includes 989 non-banking institutions representing 1% of the system's total assets (because they do not calculate total exposures) – appropriate simplified approaches are planned, taking into account the burden of the prudential requirement and the desired degree of conservativeness. For institutions in the intermediate segments S2, S3 and S4, the aim is to design a prudential requirement that fits their risk profile, leaving scope for specific supervisory action in terms of prescribing a more complex approach to managing and measuring the risks incurred by each institution.

The first regulation that makes use of the segmentation of the Brazilian financial system was issued in February 2017 and establishes minimum requirements for the risk management and the capital management framework. It provides specific differences on what institutions in different segments are required to implement. Examples of proportional treatment introduced in the regulation include the Basel ICAAP requirement for institutions in S1 and the provision for a simplified ICAAP to be performed by banks in S2; the explicit provision that only institutions in S1 are required to do reverse stress tests; and the establishment of simplified rules for institutions in S5.

The case of the European Union

The European Union's (EU) implementation of the Basel standards has followed the international trend of applying the prudential requirements to a broader range of institutions. In the European Union, Basel III is not limited to "internationally active banks" but is applied to all institutions via the Capital Requirements Regulation and Directive (CRR/CRD IV). The CRR/CRD IV "Single Rulebook" is a single set of harmonised prudential rules for institutions throughout the EU),[17] the aim of which is to facilitate the creation of a level playing field. Nonetheless the concept of proportionality is clearly recognised in the CRR/CRD IV.[18] In line with the general principle that regulatory requirements should be commensurate with the institution's business model and riskiness (eg in terms of size, complexity, cross-border activity and interconnectedness), the CRR/CRD IV framework provides for smaller, less risky institutions. While proportionality is embedded in the legislative text adopted by Ministers and Parliament (this is known as

[17] Which is applicable "to all financial institutions in the Single Market" European Council Conclusions, 19 June 2009.

[18] See for example recital (46) of the CRR, Article 99(5) of the CRR on reporting, Article 79 of the CRD on supervision, Article 73 of the CRD on internal capital adequacy assessment plans, and Article 74 of the CRD on recovery and resolution plans.

Level 1 in the EU[19]), it must be borne in mind that the details needed to apply rules, and indeed provide proportionality are included in regulations to facilitate the implementation of the law, ie the Delegated Act of the Commission or the Technical Standards developed by the EBA (known as Level 2 legislation[20]). Some examples are set out below.

The framework for the calculation of capital ratios makes a specific exemption for institutions with a small trading book business.[21] This enables institutions with non-significant trading activities to use a simplified framework for the calculation of capital requirements for their trading exposures – ie where the size of the on- and off-balance sheet trading-book business meets both the following conditions: (i) it is normally less than 5% of the total assets and EUR 15 million; and (b) it never exceeds 6% of total assets and EUR 20 million.

The Technical Standards on Own Funds differentiate on the basis of business models. These standards apply specific requirements to cooperative banks that reflect the most common cooperative corporate setting and codes. In particular, the fourth set of Technical Standards relates to preferential and multiple distributions. While the aims of these standards have to be met by all institutions, the specificities of non-joint stock companies justify a different treatment in two cases.[22] The large exposures limit for interbank exposures[23] may be determined by the institution if, among other conditions, it has eligible capital[24] of less than EUR 600 million. This limit must not exceed 100% of the institution's eligible capital (with a maximum of EUR 150 million).

The common supervisory reporting framework addresses proportionality in several ways. The framework alleviates the reporting burden by requiring a more limited set of templates to be reported; by requiring reporting, in some cases, at less frequent intervals; and, in other places, by requiring less detailed reporting, for some segments of the EU banking population. The criteria used for triggering reduced requirements are the following: the institution's size,[25] material exposures,[26] and investment firms.[27]

[19] It is usually the level of the law in sovereign states.

[20] It is usually the level of regulations or application decrees in sovereign states.

[21] Article 94 CRR.

[22] The first case is when only the holders of the voting instruments may subscribe to the non-voting shares, and the voting rights of any single holder is limited. In that case, there is no deprivation of voting rights for holders of non-voting instruments. The differentiated distribution on the non-voting instrument of non–joint stock companies is not driven by the absence of a voting right in the same way as for joint stock companies. The second case is when there is a cap on the distribution of the voting instrument set under applicable national law. In those two cases, the limits devised for joint stock companies are replaced by other rules that ensure the absence of a preferential right to payment of distributions, such as a limit on the overall payout ratio for CET1 instruments.

[23] Refer to article 395(1) of the CRR.

[24] Article 4(71) of the CRR defines eligible capital as the sum of (i) Tier 1 capital as referred to in Article 25 of the CRR and (ii) Tier 2 capital as referred to in Article 71 of the CRR that is equal to or less than one third of Tier 1 capital. The proposal to amend the CRR replaces "eligible capital" with "Tier 1 capital".

[25] For example, an institution is permitted to report the information on additional liquidity monitoring metrics with a reduced frequency (ie quarterly instead of monthly) when, among other conditions, its total assets are less than 1% of the national banking sector assets and EUR 30 billion.

[26] Thresholds such as in geographical breakdowns shall not be reported if exposures to foreign counterparties are lower than 10% of total original exposures; institutions do not need to report all templates on asset encumbrance when the asset encumbrance ratio is lower than 15%; and the liquidity per significant currency shall be reported only for currencies higher than 5% of total liabilities etc.

[27] Investment firms with limited authorisation to provide investment services and which do not hold client money have reduced reporting requirements.

Outlook for proposed EU regulation. The European Commission aims to enhance the proportionality of rules and reduce undue regulatory burdens, without compromising prudential objectives, as it communicated in the results of its call for evidence on the EU regulatory framework for financial services, published on 23 November 2016. The Commission's proposal for a regulation amending the current prudential regulation mandates the EBA to produce a report on the compliance burden of reporting;[28] contains proposals for reduced reporting requirements;[29] and requires the EBA to develop an electronic compliance tool[30] to assist institutions to identify the prudential rules that are applicable to them (ie signposting) with the aim of reducing the burden for smaller institutions when navigating the rules. It also introduces an increased set of proportional and specifically targeted rules in areas such as:

1. **Trading book**:[31] (i) the exemption for small trading book business on the calculation of RWAs for market risk is maintained and the definition of a small trading book business is amended with a larger nominal value of EUR 50 million[32] and a new proviso that the calculation of the trading business does not include exposures to foreign exchange and commodities, which do not belong to the trading book by definition; (ii) a definition of mid-sized trading book business, comprising not more than 10% of total assets of a bank and EUR 300 million, is added to the framework, allowing the banks that fall into this definition to calculate their market risk RWAs according to the current Basel II.5 approach for market risk – which means that the new Basel III market risk framework will not be applicable to small trading books in the EU.[33] The proposed rules also establish the operational procedures related to the fulfilment, or otherwise, of the trading book thresholds.

2. **Disclosure**:[34] disclosure requirements that categorise the substance and frequency of disclosures are set out in the regulatory proposal, based on whether a bank is considered a "large institution", a "small institution" and/or a "non-listed institution". At the upper end of the scale, large institutions with listed securities are required to fully comply with the Basel III disclosure framework, whereas small non-listed banks are subject only to selected annual disclosures. Large institutions include the G-SIBs and the D-SIBs; other large institutions based on size criteria (eg EUR 30 billion assets, assets/GDP ratio, four-year average calculations). An institution is considered "small" for the purposes of the disclosure framework if the value of its total assets is below EUR 1.5 billion. Finally, a "non-listed institution" is one that has not issued securities that can be traded on a regulated market of any Member State.

[28] Article 99(7) of the European Commission's proposal includes a mandate for the EBA to deliver a report to the Commission on the cost of regulatory reporting by 31 December 2019.

[29] For instance, it is proposed that small institutions as defined in Article 430a will only be required to submit regulatory reports annually as opposed to semiannually or more frequently for all other institutions (Articles 99(4), 100, 101, 394 and 430 of the European Commission's proposal).

[30] See article 519b of the European Commission's proposal.

[31] See articles 94 and 325a of the European Commission's proposal.

[32] The limit of trading assets of EUR 50 million only applies to very small institutions (or those that have a very small trading book, ie a trading book of less than 5% etc), For those firms, instead of a market capital charge, a banking book capital charge will apply to their equity and debt positions. Thus, their instruments are not exempted in any way and are instead still subject to capital requirements.

[33] As the Basel standards focus on internationally active banks, institutions with less than EUR 300 million in trading instruments cannot be considered as part of the "internationally active" BCBS scope. Nevertheless, these firms are and will continue to be subject to market risk requirements. However, the implementation of the new sensitivity-based approach (SBA) seems totally disproportionate given the size and importance of trading activities for these small banks.

[34] See article 430a of the European Commission's proposal.

3. **Counterparty credit risk (CCR)**:[35] different methods for calculating the exposure value are stipulated, depending on specific measures. The use of the simplified method (a simplified SA-CRR) depends on the size of the on- and off-balance sheet derivative positions being equal to or below 10% of the institution's total assets and EUR 150 million. Banks with derivative positions not exceeding 5% of total assets and EUR 20 million may use the Original Exposure Method (OEM), which is similar to the Basel II Current Exposure Method (CEM). The operation of the thresholds (which are assessed monthly) is detailed in the proposed regulation.

The planned increased use of proportionality in prudential regulation within the European Union reflects differences in systemic importance. It is motivated by the desirability of signposting the rules to simplify their application and of proportionate reporting requirements.[36] The proposed range of thresholds depends on the issue being regulated.

The case of Hong Kong SAR

Hong Kong SAR has applied proportionality since the implementation of Basel II, to avoid overburdening small banks. The capital requirement for non-securitisation credit risk exposures can be calculated according to the basic approach, developed from the Basel I framework and incorporating some Basel II definitions. To apply this approach, an authorised institution must obtain specific approval from the Hong Kong Monetary Authority (HKMA), which is responsible for the prudential supervision and regulation. In deciding whether an institution can use the basic approach for credit risk, the HKMA must be satisfied that its business operation is small, which means total assets of not more than HK$ 10 billion with a simple and straightforward business model.

Regarding the Basel III implementation, the HKMA has increased its use of proportionality, specifically in the liquidity framework. The LCR framework is applied to banks designated as "Category 1 institutions", which comprises institutions that are (i) internationally active; (ii) significant to the general stability and effective functioning of the banking system in Hong Kong SAR; (iii) associated with a material liquidity risk; or (iv) connected to another bank that is a Category 1 institution. The supervisory policy manual elaborates on the assessment of these conditions and explains that, in determining whether a bank is internationally active, the HKMA will take into account the level of its international exposure, as measured by the aggregate amount of external claims and liabilities, against a quantitative benchmark, initially set at HK$ 250 billion. On examining the significance to the general stability and effective functioning of the banking system, the authority considers the size of the bank's operation – total assets equal to or higher than HK$ 250 billion, and the institution's role or level of participation in the local banking system or financial markets. The quantitative benchmarks are subject to revision. The bank's liquidity risk is analysed in terms of the nature and complexity of its business and risk profile. Finally, its connections with other Category 1 institutions are evaluated with a view to preventing regulatory arbitrage in relation to the Category 2 institutions, which are subject to a local liquidity standard. As of June 2014, 12 banks were considered Category 1 institutions, accounting for around 60% of the total banking assets. The proposal for the NSFR will likely follow the same scope as for the LCR, including the calculation of a modified NSFR for some Category 2 institutions.

The HKMA also envisages the use of proportionality in the large exposures framework, which was under consultation until May 2016. The proposal is for an alternative treatment in respect of credit risk mitigation (CRM) exposure calculations. This alternative would be simpler, would not take into account any mitigation of the risk, and would be available to non-internationally active authorised institutions, defined in the consultative paper as non-D-SIBs. The HKMA also states that they welcome

[35] See articles 273a and 273b of the European Commission's proposal.

[36] Some EU member states, eg Austria and Germany, suggest enhancing the principle of proportionality within the EU regulation even further. Both countries promote the discussion on the EU level. See A Dombret (2017).

suggestions on alternative treatments in respect of other aspects of the new large exposures framework in its application to non-internationally active banks, if applying the framework is considered unduly burdensome or disproportionate for these institutions. It is emphasised, however, that any alternative treatment should not represent a markedly less stringent treatment than that proposed in the new Basel framework.

Proportionality is applied for disclosure requirements. When an institution meets certain specified criteria including total assets (less provisions) of less than HK$ 1 billion and total customer deposits of less than HK$ 300 million, then it can be exempted from disclosure requirements.

Finally, proportionality is applied in the areas of market and counterparty credit risk. In particular, banks with a small trading book can be exempted from the market risk capital framework, ie if they have market risk positions of less than HK$ 60 million and no more than 6% of the banks' total on- and off balance sheet exposures (but excluding banks that use the IRB approach for credit risk). The exempted banks are instead required to calculate regulatory capital for their market risk positions under the Hong Kong credit risk capital framework. For counterparty credit risk, the HKMA proposes to introduce a "modified CEM", which corresponds to a simplified version of the new Basel III method. This approach can be used when the institution already has supervisory approval to use the basic approach for credit risk and its total outstanding derivative contracts do not exceed 10% of the aggregate of total assets or liabilities.

The HKMA's recovery planning requirements are applied in a proportionate manner. While the HKMA expects all banks to develop and maintain recovery plans, its requirements apply to all banks in a proportionate manner, having regard to their size, structure and business mix and the systemic risks associated with their activities. Recovery planning naturally lends itself to a proportionate approach in that, for smaller banks with relatively fewer and simpler business lines, the recovery options will likewise tend to be less complex and potentially easier to implement. Equally, the HKMA recognises that the extent of application of the recovery planning requirements to a bank's downstream operations (eg overseas subsidiaries and branches) should be commensurate with the materiality of those entities or operations to the bank's group, and with the risks those operations and entities pose to Hong Kong's financial stability.

The case of Japan

Japan applies the Basel prudential frameworks to all internationally active banks. Japan's Financial Services Agency defines them as institutions with one or more branches or subsidiaries outside Japan, including bank holding companies, credit cooperatives, investment banks and some regional banks. In applying this definition, out of a total 120 banking institutions operating in Japan, 19 were considered internationally active as of September 2016, accounting for 65% of the banking system's risk-weighted assets and including three G-SIBs and four D-SIBs. These seven banks comprise 90% of the Japanese internationally active banks' total exposures, as measured in terms of the leverage ratio.

Non-internationally active banks are subject to rules similar to the Basel standards, including the definition of capital, although a less stringent capital requirement with a minimum capital ratio of 4% applies. The LCR framework, the portion of the Basel III liquidity reform already implemented, is not applied to non-internationally active banks, but domestic liquidity monitoring is in place. In addition, the Basel market risk framework only applies to banks with a trading book that is larger than JPY 100 billion or 10% of the bank's total assets. As in the case of other jurisdictions, certain systemically important banks are required to prepare recovery plans.

The requirements for Pillar 2 have proportional features, in line with the Basel standards. The regulatory authority has provided guidance and inspection manuals that consider the size, complexity and the business/risk profile when assessing individual institutions. This is also true for the expectations regarding institutions' risk management.

The case of Switzerland

In Switzerland, proportionality is a constitutional principle that is rigorously applied in all financial market regulation, in combination with an established principle-based approach. In line with its broader financial market strategy, Switzerland consistently implements the international minimum standards. It makes use of exemptions or derogations where these standards provide for them, with the aim of appropriately applying the proportionality principle. At the same time, the application of this principle is underpinned by a risk-based approach to supervision. The Swiss approach and the strategy adopted by FINMA, the Swiss financial market regulatory and supervisory authority, on the use of proportionality and equivalence with international standards can be illustrated by the examples presented in this Annex.

On the level of delegated regulation, FINMA uses a transparent and consistent categorisation of banks to differentiate between applicable requirements in specific areas. Throughout its regulatory and supervisory process, FINMA assigns prudentially supervised banks and securities dealers to five different supervisory categories, based on measurable criteria: total assets, assets under management, privileged deposits[37] and required capital. The institutions in categories 1 and 2 are subject to continuous and intense supervision, because of their importance and risk profile. As of December 2015, category 1 comprised two G-SIBs and category 2 included three D-SIBs. Institutions in category 5 are subject to less intense supervision and direct on-site supervision is triggered only by the occurrence of extraordinary events.

The proportionality principle incorporated in the Swiss prudential regulation is based on the categorisation system. Institutions in categories 1, 2 and 3 are considered internationally active and/or important banks and are thus subject to the full Basel framework, while banks in categories 4 and 5 qualify for a more tailored treatment. Further, banks in categories 1 and 2 (G-SIBs and D-SIBs) must comply with stricter requirements in specific areas than do category 3 banks. FINMA has used this categorisation in different circulars to implement the proportionality principle: Circular 2016/01 regarding disclosure requirements, for instance, prescribes the full international disclosure framework for banks in categories 1, 2 and 3 but requires banks in categories 4 and 5 to disclose less information less frequently. Following the same logic, the liquidity framework provides that exemptions are applicable to all banks in supervisory categories 4 and 5. Moreover, simpler and less detailed reporting on the LCR and NSFR is required from banks in these two categories.

The large exposure limit of 25% does not apply to category 4 and 5 banks for their interbank exposures to non-SIBs. The approach chosen in Switzerland is similar to the regulation applied in the European Union. In addition, only those banks are allowed to use lower risk weights for their short-term exposures (on demand and overnight) to highly rated non-SIBs.

Circular 2017/01 on corporate governance for banks makes heavy use of the risk categorisation. For example, only banks in supervisory categories 1 to 3 are obliged to appoint separate audit and risk committees and they must also appoint a chief risk officer (CRO). For banks in supervisory categories 1 and 2, the CRO must be a member of the executive board. In addition, mandatory implementation of compensation rules is restricted to banks with capital of CHF 10 billion or more.

Proportionality is also applied in circulars that pertain to capital buffers and capital planning, as well as to operational risks, (counterparty) credit and market risk. For example, FINMA provides a simplified SA-CCR for banks in categories 4 and 5 (as well as category 3 in the case of insignificant derivative exposures) (Circular 2017/07). In terms of credit risk, FINMA does not require category 4 and 5 (and in some cases category 3) banks to apply a complex "look-through" approach in order to determine the exact risk weight of fund positions in the banking book. Instead, they can use risk weights set by the authority which match standardised documentation. Irrespective of category, banks

[37] Privileged deposits benefit from protection up to a maximum of CHF 100,000 per client in bankruptcy proceedings.

with an insignificant trading book (of less than CHF 30 million and 6% of balance sheet assets) may use banking book rules to underpin the market risk of equity and debt instruments (Circular 2008/20).

Proportionality is also applied in Pillar 2. In particular, category 4 and 5 banks do not have to conduct an extensive ICAAP and are only subject to an alleviated stress test. To determine the capital requirements for interest rate risks, FINMA plans to exempt small banks from certain requirements, such as the provision of an independent validation function. Finally, recovery planning is not required for these banks as it is assumed that a normal insolvency procedure would pose no threat to financial stability.

Swiss categorisation of the banking system — Table 5

Category	Criteria (CHF in billions)	Number of institutions (2016)
1	Total assets ≥ 250 Assets under management ≥ 1,000 Privileged deposits ≥ 30 Required equity capital ≥ 20	2
2	100 ≤ Total assets < 250 500 ≤ Assets under management < 1,000 20 ≤ Privileged deposits < 30 2 ≤ Required equity capital < 20	3
3	15 ≤ Total assets < 100 20 ≤ Assets under management < 500 0.5 ≤ Privileged deposits < 20 0.25 ≤ Required equity capital < 2	29
4	1 ≤ Total assets < 15 2 ≤ Assets under management < 20 0.1 ≤ Privileged deposits < 0.5 0.05 ≤ Required equity capital < 0.25	63
5	Total assets < 1 Assets under management < 2 Privileged deposits < 0.1 Required equity capital < 0.05	202

Source: FINMA, *Annual Report*, 2016, p 94.

The case of the United States

The United States has applied the full Basel standards to a specific group of banks and bank holding companies.[38] These banks are often collectively termed advanced approaches banking organisations. They are generally banking organisations with consolidated total assets equal to US$ 250 billion or more or with on-balance sheet foreign exposures equal to US$ 10 billion or more and their depository institution subsidiaries.[39] Some 13 bank holding companies meet these criteria (as of December 2016), representing approximately 70% of total US bank holding company assets and nearly all the relevant international exposures of the US banking sector. Eight of the 13 bank holding companies are also considered to be G-SIBs. Advanced approaches banking organisations are subject to Basel III-based risk-based capital, leverage and liquidity coverage ratio standards (in addition to the longstanding on-balance-sheet US

[38] Bank holding companies are top-tier entities in the corporate structure of banks in the United States.

[39] Some intermediate holding companies of foreign banking organisations exceed these thresholds but are not subject to Subpart E of the Board's regulatory capital rules.

leverage ratio[40]). In addition, US G-SIBs are subject to an enhanced leverage ratio standard requiring them to hold a buffer of 2% above the minimum Basel III-based leverage ratio of 3% to avoid restrictions on distributions and certain discretionary bonus payments; risk-based capital surcharges floored by the Basel G-SIB methodology; total loss-absorbing capacity and long-term debt requirements; and additional stress testing shocks and capital planning expectations as implemented through the Comprehensive Capital Analysis and Review (CCAR). Bank holding companies and savings and loan holding companies, with assets of more than US$ 1 billion, that do not qualify as advanced approached banking organisations are subject to a US-based standardised approach for credit risk and on-balance-sheet leverage ratio. Holding companies with less than US$ 1 billion in total assets are generally not subject to consolidated capital requirements.

Post-crisis, the US has widened the range of prudential requirements for large banking organisations. The Dodd-Frank Act's enhanced prudential standards are applicable to US bank holding companies and foreign banking organisations that have US banking operations, each with total consolidated assets of US$ 50 billion or more. The Board's regulations implementing these provisions of the Dodd-Frank Act include an annual supervisory stress test and semiannual company-run stress tests, as well as more stringent capital and liquidity requirements, a risk management framework, a resolution plan framework, and a pending single counterparty credit limit. Certain enhanced prudential standards are tailored to the size and risk characteristics of a firm. For example, a modified minimum liquidity coverage ratio requirement applies to bank holding companies that have US$ 50 billion or more in total consolidated assets that are not advanced approaches banking organisations. Foreign banking organisations with US$ 50 billion or more in US subsidiary assets are required to transfer ownership of virtually all US subsidiaries to an intermediate holding company, which is subject to prudential requirements comparable with those required for domestic US bank holding companies of similar size. Bank holding companies with total assets of at least US$ 10 billion are subject to an annual company-run stress test and risk management requirements.

In January 2017, the Federal Reserve Board released a change in its regulation for the 2017 cycle of capital planning and stress-testing rules. The rule change provided that bank holding companies that are not identified as G-SIBs, with total assets in the range of US$ 50 billion to US$ 250 billion and with total non-bank assets of less than US$ 75 billion, were exempted from the qualitative part of the CCAR review. The Federal Reserve also differentiates its assessment of firms' capital planning and positions based on asset size and risk profile.

Another proportional application of the international standards in the United States is related to the market risk and counterparty credit risk frameworks. Only banking organisations with aggregate trading assets and liabilities equal to or above US$ 1 billion or representing 10% or more of total assets, calculated quarterly, are subject to the US implementation of market risk-based capital requirements, reflecting Basel II.5 standards. In addition, only advanced approaches banking organisations are permitted to apply the internal models methodology for purposes of the counterparty credit risk framework and are required to calculate a credit valuation adjustment (CVA) risk-weighted asset amount; other banking organisations may only apply the current exposure method and do not do a CVA calculation.

40 Depository institution subsidiaries with total assets of less than US$ 10 billion are not subject to the LCR.

References

Basel Committee on Banking Supervision (1988): International convergence of capital measurement and capital standards (Basel I).

——— (1998): International convergence of capital measurement and capital standards, 1988 updated to 1998.

——— (2004): Implementation of Basel II: Practical considerations.

——— (2006): International convergence of capital measurement and capital standards (Basel II).

——— (2011): A global regulatory framework for more resilient banks and banking systems (Basel III, on definition of capital [revised version]).

——— (2012a): Core principles for effective banking supervision.

——— (2012b): A framework for dealing with domestic systemically important banks.

——— (2013a): Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools.

——— (2013b): Global systemically important banks: updated assessment methodology and the higher loss absorbency requirement.

——— (2013c): Fundamental review of the trading book: A revised market risk framework.

——— (2014a): Basel III leverage ratio framework and disclosure requirements.

——— (2014b): The standardised approach for measuring counterparty credit risk exposures.

——— (2014c): Basel III the net stable funding ratio.

——— (2015): Standards: Revised Pillar 3 disclosure requirements.

——— (2016a): Minimum capital requirements for market risk.

——— (2016b): Interest rate in the banking book.

——— (2017): Consultative document on a simplified alternative to the standardised approach to market risk capital requirement.

Board of Governors of the Federal Reserve System (2015): Advanced approaches capital framework implementation.

——— (2017): "Federal Reserve Board announces finalised stress testing rules removing noncomplex firms from qualitative aspect of CCAR effective for 2017", press release.

Central Bank of Brazil (2017): Minimum requirements for the risk management and the capital management framework.

Dombret, A (2017): "Basel should rethink proportionality in banking regulation", *The Banker*, 3 January.

European Banking Authority (2014): Guidelines on common procedures and methodologies for the supervisory review and evaluation process (SREP).

——— (2015): Guidelines On the management of interest rate risk arising from non-trading activities.

——— (2016): Guidelines on ICAAP and ILAAP information.

European Commission (2015): Delegated Regulation (EU) 2015/61 of 10 October 2014 to supplement Regulation (EU) No 575/2013 of the European Parliament and the Council with regard to liquidity coverage requirement for Credit Institutions.

——— (2016a): Regulation of the European parliament and of the Council amending Regulation (EU) No 575/2013.

——— (2016b): Call for evidence – EU regulatory framework for financial services.

European Union (2013): Capital Requirements Regulation and Directive (CRR/CRD IV).

Federal Deposit Insurance Corporation (2016): Interest Rate Risk.

Harada, K, T Hoshi, M Imai, S Koibuchi and A Yasuda (2014): "Japan's financial regulatory responses to the global financial crisis", Journal of Financial Economic Policy, vol 7, no 1, pp 51–67.

Hong Kong Monetary Authority (2006a): Banking (Disclosure) Rules.

——— (2006b): Banking (Capital) Rules.

——— (2015a): Overview of capital adequacy regime for locally incorporated authorized institutions (revised), items 7.2.5 and 7.2.6.

——— (2015b): Implementation of Basel standards relating to counterparty credit risk and banks' equity investment in funds.

——— (2016a): Consultation paper 16.01, Exposure Limits.

——— (2016b): Regulatory framework for supervision of liquidity risk.

——— (2016c): Consultation paper 16.02, Net Stable Funding Ratio.

International Association of Insurance Supervisors (2012): Application Paper on Regulation and Supervision supporting Inclusive Insurance Markets, Section 4.

Swiss Financial Market Supervisory Authority, FINMA (2011): Categorisation of banks and securities dealers.

United States Government Printing Office (2014): Interest rate risk for non-trading activities.