

Proportionality in banking regulation: who, what and how?



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Summary

The Basel Framework sets minimum regulatory requirements for internationally active banks and there is no obligation to apply the Framework to banks that are not internationally active. The introduction of Basel III, which increased the volume, risk sensitivity and complexity of the prudential rule book, has sparked debate on how best to tailor Basel rules in small banks and in smaller jurisdictions with relatively simple banking systems. But how do jurisdictions go about tailoring Basel rules to non-internationally active banks? This policy brief identifies the three key elements needed to develop a coherent proportionality strategy and catalogues the proportionality approaches taken in 100 jurisdictions that are not members of the Basel Committee on Banking Supervision. It also outlines three overarching policy objectives that may be considered as authorities in smaller jurisdictions grapple with constructing an appropriate proportionality regime that meet their country-specific needs.

Authors note: The views expressed in this column are those of the author and do not necessarily represent the views of the Bank for International Settlements or the Basel-based standard setters.

The Basel Framework is technically applicable only to internationally active banks (IABs) in jurisdictions that are members of the Basel Committee on Banking Supervision (BCBS). There is no obligation for authorities to extend its application to smaller banks in their respective jurisdictions or to banks in non-BCBS members. While all jurisdictions oversee at least a subset of banks that are not internationally active, the policy challenge of devising an appropriate regulatory regime is particularly important in smaller, non-BCBS jurisdictions where the vast majority of their banking systems may comprise of non-IABs.

The introduction of Basel III have renewed calls for applying a streamlined regulatory rule book – without undermining its stringency - for banking systems in smaller, non-BCBS member jurisdictions. This is because the risk-based capital (RBC) regime under Basel III unveiled a number of new elements in both the numerator and denominator of the RBC ratio; beyond this, Basel III also established new standards on leverage, liquidity, and large exposures for which a ‘one-sized fits all’ set of rules have been published. In short, there are now many more standards and the components within each standard where a proportionality regime may apply in relation to its predecessor regimes under Basel I or II.

In an earlier publication of the Financial Stability Institute ([Hohl et al. 2018](#)), we examine how 100 non-BCBS member jurisdictions apply proportionality to banking rules. We find that while jurisdictions may have different approaches, all must address three fundamental questions on the ‘*who*’, ‘*what*’ and ‘*how*’ of proportionality to help guide their proportionality architecture. Not surprisingly, the RBC regime (encompassing Basel I, II and III), is the standard most often subject to a proportionate application. Beyond the RBC regime, we also find that the increased volume and added complexity of Basel III is affecting the pace of implementation of other standards on leverage, liquidity and large exposures.

In designing an appropriate regulatory regime, non-BCBS jurisdictions grapple with the need to achieve international recognition of a proportionality framework that by design may deviate from Basel standards – a consideration that BCBS member jurisdictions may often take for granted. This may help to explain our general observation that in several non-BCBS jurisdictions, a proportionate application does not necessarily imply lowering prudential standards: in a number of cases, a streamlined application of one element is accompanied by more stringent treatment of another aspect of the applicable Basel standard.

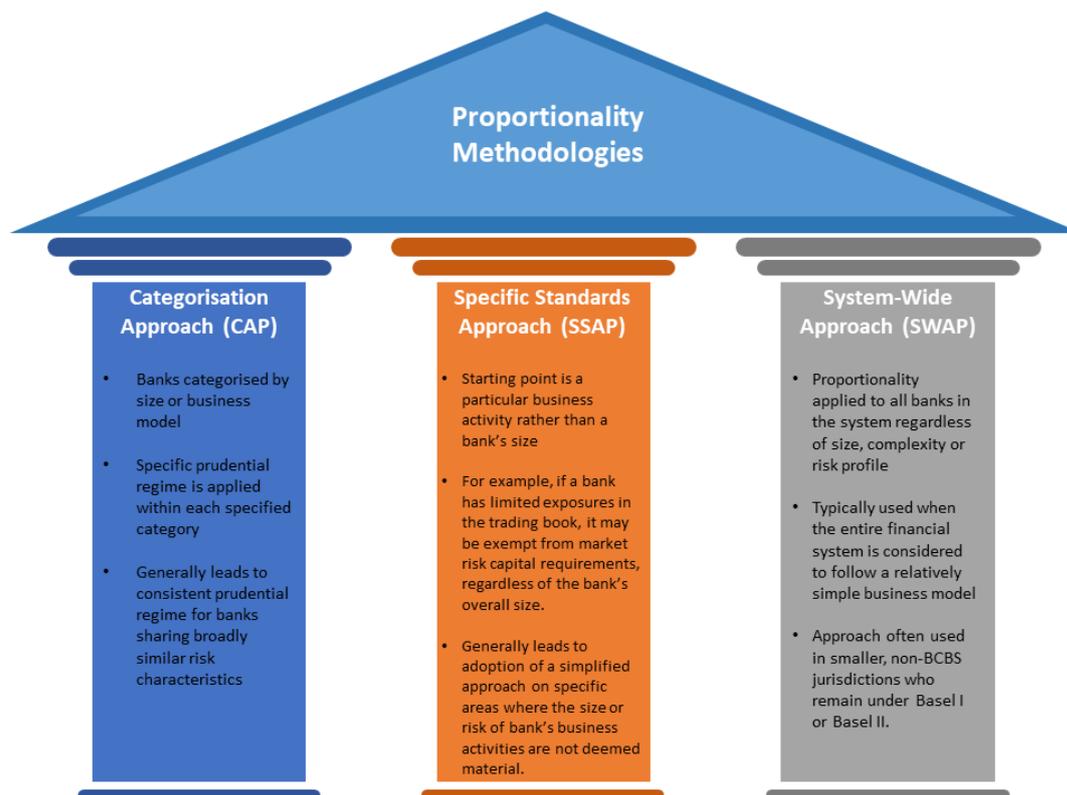
The proportionality architecture

In devising a proportionality strategy, all jurisdictions must answer three fundamental questions:

- **Who:** which banks should be subject to a proportionate approach?
- **What:** once the class of banks are determined, what regulatory standards warrant a proportionate application?
- **How:** how will the standard(s) be modified to reflect a proportionate application? Here, there are at least three possibilities: (a) a full exemption could be granted; (b) some modifications can be made to the applicable global standard; or (c) a domestic rule can be in place in lieu of adopting the applicable Basel standard.

In regards to the *who* and *what*, our study suggests that jurisdictions take one of three approaches (sometimes used in combination) - which we have classified respectively as the ‘categorisation approach’, ‘specific standards approach’ and the ‘system-wide approach’ - in determining the contours of their proportionality regime.

Chart 1: Proportionality methodologies



Proportionality in non-BCBS jurisdictions

As difficult as it may be to determine the *who* and *what* of proportionality, an even bigger challenge may be to operationalise the *how*. In this context, our study found that all 100 surveyed non-BCBS jurisdictions have adopted some iteration of the RBC regime under the Basel Framework (Basel I, II or III) but apply different proportionality strategies (Table 1).

Table 1: Risk-based capital regime and proportionality strategy applied

Applicable RBC regime	# of jurisdictions	# of jurisdictions applying proportionality	CAP strategy	SSAP strategy	SWAP strategy	Mix of strategies
Basel I	30	30	-	-	29	1
Basel II	10	10	-	-	7	3
Basel III	60	57	5	24	19	9

Basel I and II RBC Jurisdictions

Countries that remain under Basel I and Basel II overwhelmingly follow a SWAP strategy: that is, when prudential rules are modified, those modifications are applied to all banks in the system. This reflects the relative simplicity of both standards, particularly when the standardised approaches to capital measurement are applied. In regards to the *'how'*, the two most common modifications entail imposing higher than the minimum RBC requirements to all banks (ranging from 9%-15%, as opposed to the Basel I/II minimum of 8%), while exempting banks from market risk capital requirements.

Basel III RBC jurisdictions

When jurisdictions migrate to Basel III, multi-faceted proportionality strategies are often applied and efforts are made to differentiate which rules apply to which banks. This reflects the greater number of components in the numerator and denominator within the RBC framework that may be subject to a proportionate application. The most common proportionality strategy taken is to exempt a subset of banks from market risk capital requirements based on the size of the trading book (with a 5% of total assets threshold often used in conjunction with an absolute minimum). Similar to Basel I and II jurisdictions, a number of countries also impose minimum RBC ratios above the Basel minimum (ranging from 9%-13%) across all banks in their system.

Dual nature of proportionality

In contrast to the general assumption that proportionality is synonymous with easing regulatory rules, the evidence in a number of non-BCBS jurisdictions indicates that the realities on the ground are more nuanced. Often times, an exemption or a simplification of one aspect of a rule (e.g., market risk) is accompanied by a more stringent application of another component of the same standard (higher RBC ratio requirements).

Adoption of and proportionality in other Basel rules

Beyond the RBC regime, the adoption of other Basel III standards, such as the two quantitative Liquidity Standards, the Leverage Ratio and the Large Exposures standard have been lagging in non-BCBS jurisdictions. This may reflect two inter-related factors: the resources needed to determine a proportionate approach to the RBC regime is daunting, let alone the challenges involved in implementing other quantitative rules under Basel III where there are no menu of approaches to choose from.

Nevertheless, a number of non-BCBS jurisdictions have adopted domestic rules in lieu of implementing applicable Basel standards. For example, some countries have applied their own quantitative liquidity rules – even before the introduction of Basel III’s liquidity coverage ratio - that require banks to hold a baseline level of liquid assets in relation to short-term liabilities in the form of ratio requirements. Conceptually, such requirements can be viewed as simplified versions of a non-stressed liquidity coverage ratio under Basel III. Domestic rules are also frequently applied to the Large Exposures (LE) regime in lieu of adopting Basel III’s LE standard.

Policy Implications

Our study provides insights on the key building blocks needed to develop a tailored regulatory regime to fit jurisdiction-specific circumstances. At the same time, if non-BCBS jurisdictions are expected to cut through the maze of the Basel III reforms and to distil the core elements that may be universally applicable, it may be helpful for standard-setting bodies to provide further guidance on proportionality. Such guidance may assist non-BCBS jurisdictions to work within an established framework to achieve their desired trifecta of developing a simpler regulatory regime that:

- maintains a sufficient level of stringency
- avoids excessive regulatory burden on less complex banks and banking systems; and
- achieves a baseline level of international recognition of their prudential regime.

The Irish playwright, Oscar Wilde once said: *“It is the essence of genius to make use of the simplest ideas.”* The time has come for the global supervisory community to develop a simpler, yet suitably rigorous prudential regime for smaller, non-BCBS jurisdictions. ■

About the author

Raihan Zamil is a Senior Advisor at the Financial Stability Institute (FSI) of the Bank for International Settlements (BIS) and currently oversees its banking supervision dissemination programme and outreach activities to central banks and supervisory authorities in the Asia-Pacific region. He represents the FSI in senior groups of the Basel Committee on Banking Supervision, including the Basel Consultative Group and the Accounting Experts Group.

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