Proportionality in regulation
Brazilian experience

18th Annual International Conference on Policy Challenges for the Financial Sector
Agenda

• Motivation
• Proportionality in International Standards
• Implementation examples
• Brazilian model
• Final remarks
Motivation

- Basel I and Basel II implementation
  - Many jurisdictions opted to apply the standards to all banks
- Basel III implementation
  - Limited scope of banks when implementing some standards due to complexity and increased number of frameworks
- Diversity and complexity of financial systems
- Scarce resources (supervisors and institutions)

Objectives: safety and soundness + level playing field + efficiency
Proportionality in International Standards

- Core Principles for Effective Banking Supervision, Sept. 2012
  - Globally applicable → all banks
  - Flexible implementation
  - Proportional supervisory approach → risk profile and systemic importance
- Basel Minimum Prudential Standards → Basel II & III
  - Internationally active banks
  - Level playing field and risk transmission across borders → safety and soundness of the banking systems
Applying Proportionality

Proportionality is not a new discussion. Supervisors apply a proportional approach, recognising the varying scale, complexity and risk profiles of the institutions.

- Banking supervision → intrinsically proportional
  - Risk-based supervision
- Pressure on supervision is high
  - Narrow scope of some frameworks
  - Increased proportionality in regulation
Applying Proportionality

• Pros
  • Address the differences of the regulated banks, contributing to a more competitive and resilient banking system
  • Require banks to comply with standards that fit their business model, size, systemic significance and complexity
  • Better use of scarce resources (supervisors and institutions)

• Cons
  • Not straightforward
    • How to demarcate small from big banks, simple from complex banks → judgment?
  • Can hamper comparability and level playing field → regulatory relief = higher capital requirements?
Criteria for Applying Proportionality

- **Categorization Approach for Proportionality (CAP)**
  - Categories of banks
    - Qualitative and/or quantitative characteristics
    - Consistent prudential rules for banks sharing similar characteristics
- **Specific Standard Approach for Proportionality (SSAP)**
  - Tailored criteria for application of specific prudential standards to a subset of institutions
    - Disclosure, liquidity ratios, large exposures limits, market risk

* Proportionality in banking regulation: a cross-country comparison. FSI Insights on policy implementation n. 1, Aug 2017.
## Criteria for Applying Proportionality

<table>
<thead>
<tr>
<th>Categorisation approach (CAP)</th>
<th>Specific standard approach (SSAP)</th>
<th>Exceptions in</th>
</tr>
</thead>
<tbody>
<tr>
<td>Classification of banks</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Brazil</strong></td>
<td><strong>European Union</strong></td>
<td>- Trading book</td>
</tr>
<tr>
<td>5 categories</td>
<td></td>
<td>- Disclosure</td>
</tr>
<tr>
<td></td>
<td></td>
<td>- CCR</td>
</tr>
<tr>
<td></td>
<td></td>
<td>- Large exposures</td>
</tr>
<tr>
<td><strong>Japan</strong></td>
<td><strong>Hong Kong</strong></td>
<td>- Credit risk</td>
</tr>
<tr>
<td>2 categories</td>
<td></td>
<td>- Liquidity framework</td>
</tr>
<tr>
<td></td>
<td></td>
<td>- Large exposures</td>
</tr>
<tr>
<td><strong>Switzerland</strong></td>
<td><strong>United States</strong></td>
<td>- Advanced approaches BHC</td>
</tr>
<tr>
<td>5 categories</td>
<td></td>
<td>- CCAR</td>
</tr>
<tr>
<td></td>
<td></td>
<td>- Stress tests</td>
</tr>
<tr>
<td></td>
<td></td>
<td>- Trading book</td>
</tr>
<tr>
<td></td>
<td></td>
<td>- LCR</td>
</tr>
</tbody>
</table>

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

* Proportionality in banking regulation: a cross-country comparison. FSI Insights on policy implementation n. 1, Aug 2017.
• Size is a prominent feature
  • Absolute or relative terms

• Size-related thresholds alone do not capture the full extent of banks’ business models and related risks
  • Complemented by other quantitative or qualitative indicators and definitions

• Structural characteristics of banking sectors play a role in the thresholds definition
Threshold Comparison

Internationally Active / Full Basel Banks

- **Europe**: 20% GDP threshold to be a large institution in a member state

- **70 O-SIls**: 56% Total Exposures
- **2 G-SIBs + 3 D-SIBs**: 56% Total Exposures
- **60% Total Assets**: 70% Total Exposures
- **50% Total Exposures**: 8 G-SIBs
- **13 G-SIBs**: 50% Total Exposures in 7 member states
- **50% Total Exposures**: 8 G-SIBs
- **70% Total Exposures**: 8 G-SIBs

- **JAPAN**: 3 G-SIBS and 4 D-SIBS: 90% Total Exposures

**Legend**:
- Red square: Absolute value of threshold
- Black circle: Threshold relative to GDP
- Black cross: Threshold relative to Banking Assets

**Countries**:
- Europe
- Switzerland
- USA
- Hong Kong
- Brazil
Brazil - Proportionality

Basel II and Basel II.5

- Prudential standards applicable to the whole financial system
  - 1,400 institutions
  - Big and complex banks, credit cooperatives, securities dealers
    - Stability of the financial system
    - Reputation
  - Challenges of the one-size-fits-all approach
    - Judgment in applying the rules
    - Some areas where standards were not applicable to all institutions
Brazil - Proportionality

New approach from Basel III onwards

- Since 2017, categorization of the Brazilian financial system in 5 segments, based on:
  - Size (as % of GDP)
  - International activity (to ensure level-playing field with global standards)
  - Risk profile
- Segments as drivers → proportional/different regulatory requirements
  - Suitable for different regulatory subjects: prudential supervision to recovery and resolution issues
New approach from Basel III onwards

<table>
<thead>
<tr>
<th>Segment</th>
<th>Size Ratio Threshold (Total Exposure/GDP)</th>
<th>Internationally Active (Total Consolidated Assets Abroad ≥ US$ 10 bn)</th>
<th>Number of institutions (June 2016)</th>
</tr>
</thead>
<tbody>
<tr>
<td>S1</td>
<td>Size Ratio ≥ 10%</td>
<td>Yes</td>
<td>6 banks</td>
</tr>
<tr>
<td>S2</td>
<td>1% ≤ Size Ratio &lt; 10%</td>
<td>No</td>
<td>7 banks</td>
</tr>
<tr>
<td>S3</td>
<td>0.1% ≤ Size Ratio &lt; 1%</td>
<td>No</td>
<td>39, including 36 banks</td>
</tr>
<tr>
<td>S4</td>
<td>Size Ratio &lt; 0.1%</td>
<td>No</td>
<td>422, including 83 banks</td>
</tr>
<tr>
<td>S5</td>
<td>business model of non-banks</td>
<td>No</td>
<td>989 non-banks</td>
</tr>
</tbody>
</table>

Simplified Approaches 1% of total exposures

Full Basel 70% of total exposures

LCR and NSFR: S1
Leverage Ratio: S1, S2
IRRBB: - full: S1, S2 - simplified: S3, S4
ICAAP: - full: S1 - simplified: S2
Others in future: - Recovery plan: S1 - Basel III – S1, S2-S4 (?)
Brazil - Proportionality

S5 Simplified Approach – an option for S4 institutions

• Prescriptive requirements instead of principles
• Calculation of capital limits and requirements based on accounting balance information (reduction of reporting)
• Focus on main risks: credit, FX (just for dealers) and operational
• Restricted business model:
  • Only non-banks
  • No market risk, derivatives or securitization
  • Only equity (capital base)
• Higher capital requirements (17% > 8%)
• Intense off-site supervision (data)
Brazil - Proportionality

• Premises for segmentation
  • Clear, objective and transparent rules
  • Categorization based on individual results, not on market-wide figures
  • Stability of the categorization, and possibility of adjustment by the BCB

• Premises for proportionality
  • Full compliant with Basel regulation
  • Strict capital requirement for smaller/simpler institutions
  • Structured information (off-site supervision)
Expected benefits of a proportional regulation

- Higher competitiveness of smaller and simple financial institutions, without compromising their individual soundness
- Higher contestability in the financial system
- Regulatory process is more streamlined
- Macroprudential “externality”
Final remarks

- Proportionality has always been important
- After the crisis:
  - More complex regulatory framework and financial markets and services
  - More reporting requirements
  - Calibrate regulation and supervision
  - Not over burden small and non-complex banks
  - Minimize distorted incentives

safety and soundness + level playing field + efficiency
Thank you!

João André C.M. Pereira
joao.andre@bcb.gov.br