BANCO CENTRAL DO BRASIL

# 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 *

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

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

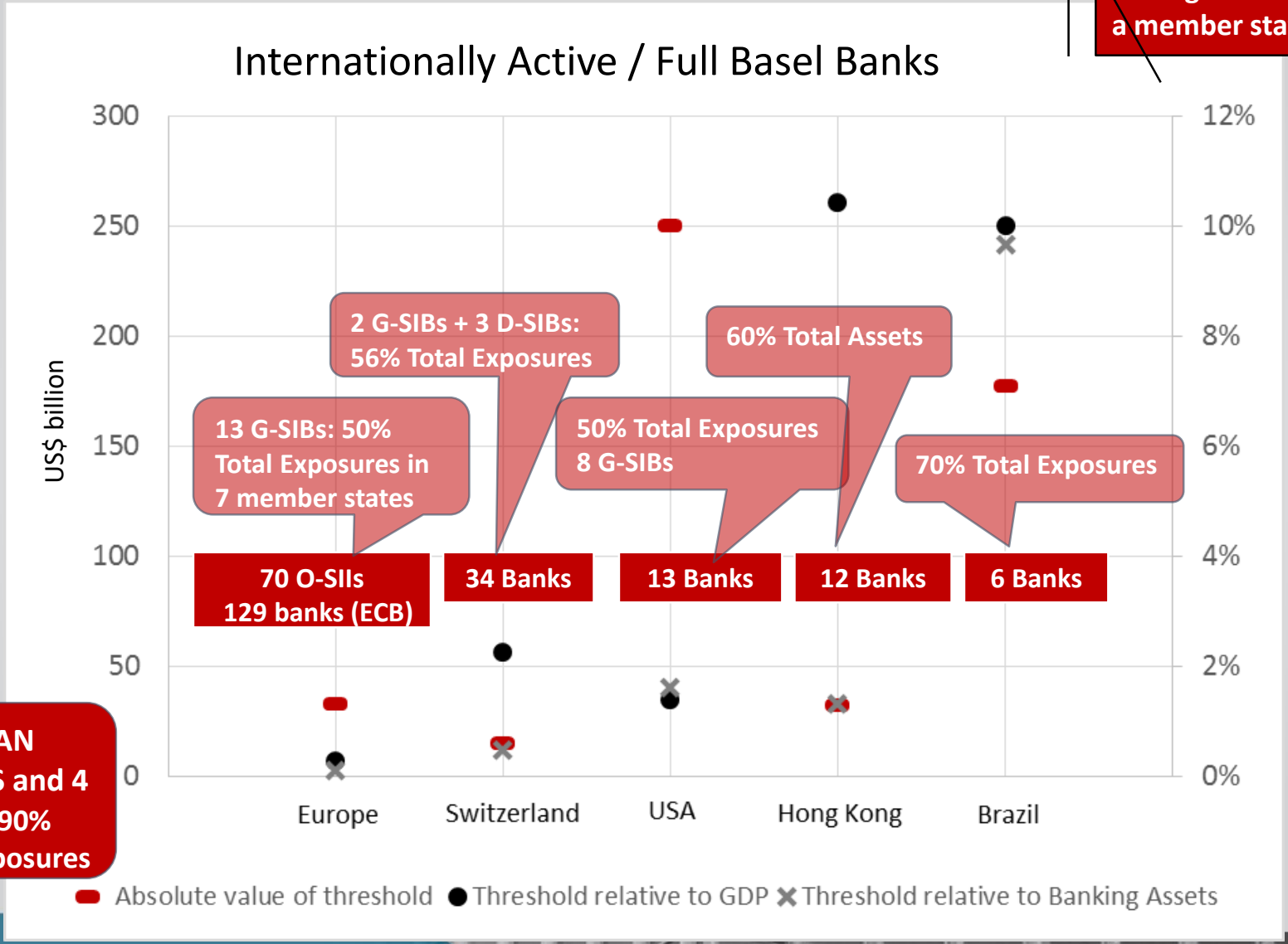
* Proportionality in banking regulation: a cross-country comparison. FSI Insights on policy implementation n. 1, Aug 2017.

# Criteria for Applying Proportionality

- 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

**EUROPE**
**20% GDP threshold to be large institution in a member state**




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

# 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 where 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

# Brazil - Proportionality

## New approach from Basel III onwards

| Segment | Size Ratio Threshold (Total Exposure/GDP) | Internationally Active (Total Consolidated Assets Abroad ≥ US$ 10 bn) | 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 | business model of non-banks | No | 989 non-banks |

Regulatory Proportionality

**Full Basel**
70% of total exposures

**Simplified Approaches**
1% 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)

# Brazil - Proportionality

- 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

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# Thank you!

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