FSI Insights on Proportionality
Global Symposium on Development Financial Institutions

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The principle of proportionality is not a new concept in the banking regulation, but it has become a hot topic just recently

- The need for a cross-border level playing field for banks has led to the introduction of harmonised **global regulatory frameworks**: Basel I (1988), Basel II (2005) and Basel III (2010).

- The rules are meant to be applied to **large and internationally active** banks.

- In many countries, however, these rules have become binding for a **wider set of institutions, for a variety of reasons**.

- Basel II offered options for small and large banks.

- The **regulatory reforms** since the financial crisis **have become more complex**.

- As a result, if regulations are applied widely, small banks are left especially with the **administrative burden** of complying with more rules without having the advantages of economies of scale that come with the size of an institution.
Depending on the characteristics of the banking sector, there is more than one way to applying proportionality

- The FSI Insight Paper on Proportionality compares the proportionality approaches in selected countries: Brazil, the European Union, Hong Kong (SAR), Japan, Switzerland and the United States.

- Three major decisions need to be made for the application of the proportionality principle:
  1. Choosing the strategy?
  2. Designing the adequate scope of application?
  3. Which parts of the regulation should be targeted?
Both of the observed strategies, the CAP and the SSAP, have their advantages and disadvantages

**Option 1: Categorisation approach (CAP)**
- A specific regulatory regime (e.g. simplifications of existing rules) is applied to certain predefined categories of banks.
- **Example**: simplified ICAAP for category 2 banks in Brazil.
- **Analysed countries**: Brazil, Japan, Switzerland

**Option 2: Specific standard approach (SSAP)**
- Regulatory requirements are tailored on specific prudential issues (e.g. exemptions for banks with no or negligible activities in certain areas).
- **Example**: simplified calculations of market risk in banks with a small trading book in the EU.
- **Analysed countries**: EU, Hong Kong SAR, USA

- More simple to implement
- Facilitates consistency and transparency
- Potential competitive distortions and cliff-effects

- Permits a more granular tailoring of regulatory requirements
- Provides more risk-sensitivity (no regulatory arbitrage)
- Regulatory „rag rug“
- And More difficult to supervise
Besides sharing some main features, every observed regulatory regime has unique elements.

- Only large banks are required to conduct annual company-run stress tests.
- Substance and frequency of disclosure requirements depend on a bank’s size and complexity¹.
- Less stringent capital requirements apply to non-internationally active banks.
- Pillar 2 requirements are set degressively depending on a bank’s size and complexity.
- A relative size threshold is used for the categorisation of banks.
- Local liquidity standard (instead of LCR²) for category-2 institutions.

¹ Planned ² Liquidity Coverage Ratio

Categorisation approach (CAP)
Specific standard approach (SSAP)

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Although a strict and coherent banking regulation is important, it should not become overly burdensome for small and medium-sized banks.

Many jurisdictions have extended the scope of the Basel standards to medium-sized and small banks, even though the framework was meant to be applied to large and internationally active banks.

In response to the great financial crisis, banking regulation has become more complex, leading to an unproportionate raise in compliance costs for small banks.

As a result, enhancing proportionality has recently become a priority in several jurisdictions.

Regardless of which strategy is chosen, financial stability and the resilience of individual banks must not be put at risk when designing proportional regulations.
Thank you very much for your attention.