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Proportionality: what's next?

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1 – Context

- Post-crisis regulatory reforms were a major achievement, ensuring a more resilient financial system by enhancing the ability of rules to capture relevant risks and to facilitate crisis management
- But new (necessarily more complex) rules are not meant to be universally applicable
- Jurisdictions face important trade-offs when applying proportionality
  - Advanced economies: how far to implement the Basel framework to entities which are not internationally active
  - EMEs: how to adapt their regulatory framework to national specificities while still being perceived as sufficiently rigorous

2 – Concept (1): Objectives

- Proportionality stems from the need to limit public intervention to what is actually needed to achieve desired policy objectives
- In **regulation**, a proportionate approach means tailoring regulatory requirements to a firm's size, systemic importance, complexity and risk profile
  - aim is to avoid excessive compliance costs for smaller and non-complex banks that could unduly dampen their competitive positions without a clear prudential justification
- In **supervision**, the main aim is to facilitate the efficient allocation of scarce supervisory resources to banks that are either systemically important or considered high risk
  - closely associated with the concept of risk-based supervision
- In bank **resolution**, the aim of proportionality is to adjust the requirements for recovery and resolution planning and resolvability to the potential systemic impact of a bank failure

2 – Concept (2): Constraints

- Applying proportionality means that different entities are subject to a differentiated set of requirements: risks of distorting competition
- Proportionality often entails less risk sensitivity: it may reduce incentives for sound risk management
- Proportionality regimes should meet at least three conditions:
  - respect key prudential safeguards (capital, liquidity, governance…)
  - maintain sufficient control of institutions that benefit from simpler rules
  - avoid overprotection of small or medium-sized firms

3 – Evidence (1): Prudential regulation

- Most jurisdictions around the globe apply proportionality, ie tailor regulatory requirements for non-internationally active institutions that meet specific conditions
- Proportionality regimes vary markedly in different dimensions (FSI Insights nos 1 and 11):
  - Differentiation criteria (size, complexity, risk profiles)
  - Standards (market risk, disclosure/reporting, liquidity, leverage, large exposures)
  - Tools (exemptions, replacecement by domestic rules…)
  - Approach: (specific standards, categorisation, system-wide…)
- The diversity is particularly pronounced for insurance regulation, given the lack of international capital standards (FSI Insights no 14)
- …and for banking regulation in non-G20 jurisdictions: proportionality combined with different iterations of the Basel standards.

3 – Evidence (1): Prudential regulation (cont)

Pillar I quantitative standards – adoption of a variety of prudential regimes*

Prudential standard	Iteration of Basel standards			Domestic rule	Total
Risk-based capital	Basel III 60	Basel II 10	Basel I 30		100
Leverage	2014 standard 15		2010 standard 1	4	20
Large exposures	2014 standard 14		1991 standard 38	39	91
LCR	54			27	81
NSFR	15			1	16

** FSI Insights no 11 (2018): The Basel framework in 100 jurisdictions: implementation status and proportionality practice.*

3 – Evidence (1): Prudential regulation (cont)

Pillar I quantitative standards

Pillar 1 requirements	Countries adopting applicable Basel standard	Countries applying proportionality to adopted Basel standard	Adoption of domestic standards	Total number of countries applying proportionality*
Risk-based capital	100	97		97
Leverage ratio	16	9	4	13
Large exposures (2014 standard)	14	12	39	51
LCR	54	17	27	44
NSFR	15	5	1	6

** FSI Insights no 11 (2018): The Basel framework in 100 jurisdictions: implementation status and proportionality practice.*

3 – Evidence (2): Supervision

Pillar II – implementation of its principle 1 sees numerous proportionality approaches taken

Supervisory requirements	# of jurisdictions in sample	of which imposing requirements on banks	of which applying proportionality in implementation	Methods used to apply proportionality
ICAAP	16	15	15	• 4 jurisdictions exempt subset of banks; and when rules imposed, requirements can be tailored • 11 jurisdictions do not exempt any locally incorporated banks, but can tailor requirements based on size, complexity and risk profile
Stress testing		16	15	• 1 jurisdiction exempts subset of banks; and when rules imposed, requirements can be tailored • 14 jurisdictions – no exemptions provided but requirements can be tailored
Recovery plans		12	12	• 6 jurisdictions exempt subset of banks and when rules are imposed, requirements can be tailored • 6 jurisdictions do not exempt any banks, but can tailor rules

- Proportionality applied in one of two ways:
  - exempt subset of banks: criteria to exempt banks vary
  - tailor rules when applicable: “guided discretion vs principles-based”

3– Evidence (3): Resolution

- Proportionality used in tailoring resolution planning requirements (FSB (2019)):
  - Some require resolution plans for all banks
    - Example: the European Union tailored application of some aspects of resolution planning requirements (eg the frequency of resolution plan review, data reporting and plan content)
  - Some impose requirements only on their G-SIBs and/or D-SIBs
  - Some impose requirements on banks using other thresholds like asset size or tailoring rules for banks on a discretionary basis

3 – Evidence (4): Summing-up

- Post-crisis reforms broadly appreciated as a coherent and comprehensive framework
  - Most jurisdictions are on their way to Basel III adoption, either in full or partially
- However, the variety of proportionality approaches effectively leads to widely heterogeneous regulatory frameworks:
- Benign assessment:
  - International standards should focus only on internationally active firms to achieve a level playing field and protect global stability
  - Differences in domestic regimes could just reflect different financial structures
- Yet:
  - International standards do not guarantee a level playing field (accounting rules, stress test, ring-fencing…)
  - Unlikely that all proportionality approaches taken could deliver the same outcomes (in particular, to ensure a level playing field while protecting financial stability)

4 – What's next?

Possible practical approaches to applying proportionality

- Systemically important banks – regardless of the complexity of their business models – should be subject to the most demanding regulatory, supervisory and resolution policies
- Consider imposing more stringent regulatory requirements on banks that are subject to simpler obligations, as an explicit trade-off for adopting less risk-sensitive methodologies (eg high minimum large leverage ratios for small banks exempted from RBC rules)
- Consider adopting a categorisation (or tiering) approach, where banks are grouped into several classes (Brazil, Switzerland, soon US)
  - Specific prudential rules, supervisory criteria and resolution planning requirements for defined categories

4 – What's next (cont)

Provision of additional international guidance

- Objective
  - EMEs need to ensure that their regulatory framework – particularly if it deviates in some respects from Basel standards – is perceived internationally as being sufficiently rigorous
- Signposts
  - Lowering compliance costs while keeping safety and soundness
  - Contributing to level playing field, maintaining comparability and avoiding fragmentation
- Potential options for international work
  - Range of practices describing existing well developed proportionality approaches (already under way: BCBS, FSI..)
  - Development of high-level principles by the BCBS or IMF/WB (should be the short-term priority)
  - Designing a simplified framework as a signpost (an ambitious and controversial endeavour)