Proportionality: what’s next?

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Outline

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   - Constraints
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4. What’s next?
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, i.e., 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, replacement 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*

<table>
<thead>
<tr>
<th>Prudential standard</th>
<th>Iteration of Basel standards</th>
<th>Domestic rule</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Risk-based capital</td>
<td>Basel III 60</td>
<td>Basel II 10</td>
<td>Basel I 30</td>
</tr>
<tr>
<td>Leverage</td>
<td>2014 standard 15</td>
<td>2010 standard 1</td>
<td>4</td>
</tr>
<tr>
<td>Large exposures</td>
<td>2014 standard 14</td>
<td>1991 standard 38</td>
<td>39</td>
</tr>
<tr>
<td>LCR</td>
<td>54</td>
<td></td>
<td>27</td>
</tr>
<tr>
<td>NSFR</td>
<td>15</td>
<td></td>
<td>1</td>
</tr>
</tbody>
</table>

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

Pillar I quantitative standards

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

3 – Evidence (2): Supervision

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

<table>
<thead>
<tr>
<th>Supervisory requirements</th>
<th># of jurisdictions in sample</th>
<th>of which imposing requirements on banks</th>
<th>of which applying proportionality in implementation</th>
<th>Methods used to apply proportionality</th>
</tr>
</thead>
</table>
| 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”
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 (e.g., 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 (e.g., 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)