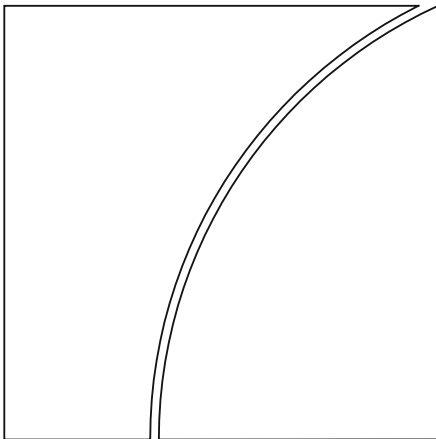


# Basel Committee on Banking Supervision



## High-level considerations on proportionality

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# High-level considerations on proportionality

**Note: this document is for informational purposes only and does not constitute new standards, guidelines or sound practices, nor does it endorse specific approaches. This document is not intended to be used in formal assessments of regulation or supervisory practices, but rather to assist authorities in their own internal discussions on proportionality.**

## Introduction

Proportionality in financial system regulation and supervision may ensure that the applicable rules and supervision practices are consistent with banks' systemic importance and risk profile, and are appropriate for the broader characteristics of a particular financial system. The *Core principles for effective banking supervision* (BCPs),<sup>1</sup> which are applicable to all banks in all jurisdictions, embed proportionality as a principle. The Basel Framework,<sup>2</sup> which sets minimum requirements for internationally active banks in Committee member jurisdictions, also allows for a degree of proportionality by providing options to implement simpler standardised approaches. While the simpler standardised approaches in the Basel Framework may also be suitable for banks that are not internationally active, in some cases regulation might require even further adaptation. These high-level considerations and the accompanying technical annexes aim to provide practical support to authorities seeking to implement proportionality in these situations in their domestic frameworks.

In line with its mandate to strengthen the regulation, supervision and practices of banks worldwide to enhance financial stability, the Committee has conducted work on proportionality over a number of years. In November 2019, the Committee and the Basel Consultative Group (BCG)<sup>3</sup> issued a statement clarifying that proportionality can take different forms, which for non-Committee member jurisdictions may include the implementation of requirements that are broadly consistent with the Basel Framework and compliant with the BCPs.<sup>4</sup> The Committee has discussed proportionality extensively with the broader banking supervisory community, including BCG members and non-members. The Committee also published two global surveys on proportionality, one of them jointly with the World Bank.<sup>5</sup> These surveys demonstrated that proportionality has been widely adopted and implemented in different ways. The surveys and discussions also highlighted that proportionality raises many practical policy challenges, as authorities seek to balance the regulatory requirements in a way that supports financial stability.

<sup>1</sup> The BCPs are available at [www.bis.org/basel\\_framework/standard/BCP.htm](http://www.bis.org/basel_framework/standard/BCP.htm).

<sup>2</sup> The Committee expects full implementation of its standards by Committee members for their internationally active banks, with jurisdictions being free to apply more conservative requirements if deemed necessary. The BCPs are also a Basel standard and form part of the Basel Framework, but are applicable to all jurisdictions and all banks. For simplicity, throughout this document the term Basel Framework is used to refer to those standards applicable only to internationally active banks and does not include the BCPs.

<sup>3</sup> The BCG provides a forum for deepening the Committee's engagement with supervisors around the world on banking supervision issues. BCG membership comprises central banks and supervisory authorities from 28 jurisdictions, as well as supervisory groups, international agencies and other bodies. It facilitates broad supervisory dialogue with non-member jurisdictions by gathering senior representatives from various jurisdictions, international institutions and regional groups of banking supervisors.

<sup>4</sup> Available at [www.bis.org/publ/bcbs\\_n123.htm](http://www.bis.org/publ/bcbs_n123.htm).

<sup>5</sup> Available at [www.bis.org/bcbs/publ/d460.htm](http://www.bis.org/bcbs/publ/d460.htm) and [www.bis.org/bcbs/publ/d523.htm](http://www.bis.org/bcbs/publ/d523.htm).

In response to these findings, these voluntary high-level considerations have been developed by the BCG. They aim to support the decision-making process of proportionality in a broad variety of jurisdictions, in a way that would not undermine financial stability and/or the safety of financial institutions. The accompanying technical annexes offer illustrative elements that authorities may wish to consider as they address the specific policy challenges related to proportionality in their jurisdiction. These considerations and the technical annexes build upon the Committee's work on proportionality, domestic experiences from across the world, international discussions and academic work, and the broad exchange of views across the supervisory community.

Importantly, these high-level considerations and technical annexes are not a standard and do not contain any prescriptive requirements. *They should not be understood as a modification to the Basel Framework, the BCPs or any of the Committee's standards, guidelines or sound practices.* Neither these considerations nor the accompanying technical annexes will be used by the Committee to assess proportionality in member or non-member jurisdictions and will *not* be used in the Committee's Regulatory Consistency Assessment Programme (RCAP).

## High-level considerations

Financial systems are heterogeneous. Characteristics that tend to vary across financial systems include the distribution of banks' size, international activity, level of sophistication and predominance of domestically owned (including government-owned) versus foreign-owned banks. Some financial systems include both large internationally active banks and small banks serving local communities. Other financial systems consist primarily of small local institutions, some of which might undertake bank-like activities without themselves being banks.

The distribution of banks within a financial system may influence the approach to proportionality. In a number of jurisdictions, simpler rules are implemented for less complex banks in banking systems that also include large, internationally active banks subject to the Basel Framework. For some non-Committee members with simple and homogenous banking systems, it might be appropriate to apply simpler rules to all banks. However, simplifications that might be appropriate for small banks in jurisdictions with less complex banking systems are not necessarily appropriate for small banks in more complex financial markets.

Like financial institutions, supervisory authorities also differ across jurisdictions. For example, supervisory authorities may have different legal powers, organisational arrangements, availability of resources and levels of independence. In general, these factors tend to influence the design and implementation of proportionate regulation and supervision frameworks.

In addition to these overarching issues, authorities are invited to bear in mind the following considerations to help ensure the proportionality approach being considered is consistent with financial system robustness, safeguards financial stability and limits regulatory arbitrage opportunities across and within jurisdictions.

- **Proportionality approaches that are consistent with the BCPs preserve financial stability.** The BCPs were designed to be applicable globally, across a range of jurisdictions, financial systems and banking institutions. The BCPs establish the minimum criteria for an effective regulatory and supervisory framework and underpin any proportionate approach. Regardless of the proportionality approach adopted, the BCPs require that all banks have prudent policies and processes to identify, measure, evaluate, monitor, report and control or mitigate risk on a timely basis.
- **The Basel Framework is the standard for internationally active banks.** The Framework already embeds a menu of options with various elements of proportionality and flexibility that could be

authorities' first choice whenever appropriate and possible. Alignment with international standards promotes trust in the financial system and prevents regulatory arbitrage and fragmentation. It also streamlines cross-border supervision and facilitates transparency, comparability and understanding of the regulatory framework by international stakeholders.

- **Depending on local circumstances, it might be appropriate to tailor regulation for non-internationally active banks.** This includes potentially applying the Basel Framework in its current form (ie Basel III), or earlier or modified forms, for jurisdictions that have simpler banking systems, implemented in a way that is consistent with the underlying objective of the international standard. Such proportionate approaches preserve financial stability through bank safety and soundness. For some banks and banking systems, this might be achieved with rules that are even simpler than the Basel Framework while remaining broadly aligned with the international standards.
- **Effective proportionate approaches strive to be both conservative and simple to understand and implement.** The objective of proportionality is to reflect jurisdictions' circumstances and supervisory capacity, not to dilute the robustness of the standards. This means that any simpler proportionate approaches would be more conservative to compensate for their lower risk sensitivity. As the Basel Framework establishes minimum requirements, more conservative requirements and thresholds may be more suitable in some cases.
- **Proportionality can help authorities achieve an appropriate intensity of supervision for all banks.** As per the BCPs, all banks should be subject to supervision commensurate to their risk profile and systemic importance. This is achieved when supervisors maintain sufficient awareness and surveillance of the overall risk profiles, risk management and governance practices of banks, including those that are under simpler proportionate regulatory requirements.
- **Proportionate approaches provide regulatory certainty, without being overly static.** Regulatory stability and predictability tend to create favourable operating environments for both banks and supervisors. As with any other regulation, it may be necessary for authorities to revise the scope and range of proportionate approaches as the financial system evolves, banks' business models change and supervisors' powers, skills and capabilities improve. In any case, it is important that proportionality is seen as a stepping stone in the implementation of international standards, and that the design of a proportionate approach can facilitate potential future implementation of the Basel Framework, where appropriate.
- **Proportionality approaches that include supervisory discretion allow supervisors to respond to bank behaviours and financial system developments.** Supervisors are encouraged to ensure that proportionality approaches do not create opportunities for regulatory arbitrage or particular (dis)incentives for any group of banks. In general, simple segmentation rules work well for most, but not necessarily all, banks. In addition, financial systems may evolve in ways that are not foreseen when a proportionality approach is first designed. These situations can generally be addressed by supervisors if they retain discretions under the proportionality approach.

# Illustrative technical annexes

## 1. Segmentation

### 1.1 Introduction

Authorities that apply proportionality may choose to define groups of banks subject to different elements of regulation. For example, a jurisdiction might consider a proportionality arrangement where all banks are subject to the same set of rules, or one in which different regulations apply to different sets of banks. In jurisdictions where supervisory authorities apply different rules to different sets of banks, key considerations include the definition of segmentation metrics and thresholds, and the role of supervisory judgment. This section outlines operational considerations that may assist authorities which choose to differentiate among banks for proportionality purposes.

### 1.2 Number of segments

Categorising banks into different segments may help to properly differentiate them when a financial system exhibits significant heterogeneity. This could help authorities that are responsible for supervising a variety of different financial institutions. For example, a regulatory framework with two segments might be suitable for a banking system where a few banks are internationally active or domestic systemically important banks (D-SIBs), while all other banks are smaller, simpler and have a roughly similar business model. In other cases, it may be more appropriate to implement additional segments. In fact, surveys show that jurisdictions with very heterogeneous financial systems have established up to five different segments.

Introducing different segments entails some trade-offs. The benefits of a higher number of segments include allowing supervisory authorities to better match the level of regulatory and supervisory requirements with different types of banks, supporting risk-based supervision and reducing potential cliff effects. Some of the potential disadvantages include reduced comparability between banks of different segments and the practical challenges associated with maintaining multiple approaches. The appropriate number of segments will be jurisdiction-specific, and may also depend on the dispersion of bank sizes and business models.

### 1.3 Metrics for segmentation

Most jurisdictions using proportionality define the different segments with quantitative and qualitative criteria. These criteria generally reflect the nature and magnitude of the risks inherent to different groups of banks and the risks that they can pose to the financial system. Authorities assess banks against these criteria, and allocate banks into one of the segments. Jurisdictions often supplement these metrics with supervisory judgment.

As the segmentation criteria determine the regulatory requirements applicable to each group of banks, alignment with the fundamentals of prudential supervision is advisable. Conceptually, prudential regulation and supervision exist to address the negative externalities that arise from banks' financial intermediation activities. Ideally, the criteria used would be consistent with the scale of these negative externalities, eg according to banks' size, international activity and risk profile.

When the criteria used to categorise banks are simple to understand and to calculate based on audited or publicly available information, segmentation is more effective, robust, transparent and predictable. This allows banks and other stakeholders to better foresee and plan for transition through



segments. Conversely, complex criteria may result in less transparency, increase the potential for arbitrage by banks and lead to distortions.

Authorities in each jurisdiction are likely to consider factors including the size (in absolute terms or as a share of the jurisdiction’s GDP) and the diversity of the banking system in setting segmentation criteria. In some cases, it might make sense to determine one or more specific size thresholds, alongside other qualitative criteria that consider banks’ business models, risk profiles and any activities that may have implications for financial stability. Small banks that rely on complex products and sophisticated business models might be better regulated with a framework that is able to address the related risks. For example, banks whose business models are focused on trading activities may be better allocated to segments that apply commensurate prudential requirements. Over time, as the financial system evolves, authorities may need to re-evaluate which activities should bring banks under a more risk-sensitive regime. Specifically, the qualitative criteria that help distinguish complex banks might need to be adjusted occasionally to consider future innovations, including new financial instruments and business models.

International activity is likely to be an important factor when designing segmentation criteria. For some authorities, indicators such as cross-jurisdictional exposures or foreign consolidated assets directly measure a bank’s exposure to international markets. Depending on the volatility of the domestic currency compared with the main international currencies used by the jurisdiction’s banks, it might make sense to measure the international activity in one of those international currencies. Such an approach could avoid large swings in the international activity metric that would be attributable to exchange rate volatility rather than changes in banks’ actual cross-border exposures.

Some examples of metrics used by different jurisdictions are listed in Table A.1 below.

## Segmentation metrics

Non-exhaustive list of metrics used in practice to define proportionality segments

Table A.1

| Size / systemic importance  | International activity  | Risk profile / business model   |
|---|---|---|
| <ul style="list-style-type: none"> <li>• G-SIB or D-SIB status (yes/no)</li> <li>• Total leverage ratio exposure measure (as a percentage of GDP)</li> <li>• Total assets (in monetary amounts)</li> <li>• Total loans (in monetary amounts)</li> </ul> | <ul style="list-style-type: none"> <li>• Cross-jurisdiction activity (in monetary amounts)</li> <li>• Foreign consolidated assets (in monetary amounts)</li> <li>• Existence of foreign subsidiaries (Boolean indicator)</li> </ul> | <ul style="list-style-type: none"> <li>• Off-balance sheet exposure (in monetary amounts)</li> <li>• Exposure to derivatives (yes/no)</li> <li>• Exposure to stocks (yes/no)</li> <li>• Exposure to securitisation positions (yes/no)</li> <li>• Assets under management (in monetary amounts)</li> <li>• Specific types of deposits (in monetary amounts)</li> </ul> |

Metrics used by Committee member and non-member jurisdictions, according to the Committee’s *Proportionality in bank regulation and supervision – a survey on current practices* (2019), the Committee and World Bank’s *Proportionality in bank regulation and supervision – a joint global survey* (2021) and national proportionality rules.

## 1.4 Setting the threshold values

Authorities that choose to use segmentation will also need to consider the relevant thresholds, ie the specific variable values that will separate banks in each segment. A first step to define these values could be to compile the distribution of the variables of interest over a period sufficient to estimate whether potential thresholds are likely to result in frequent back-and-forth movement of banks, which is generally undesirable. For example, if the size metric is total assets, analyses of the distribution of total assets of each bank might reveal thresholds that separate natural clusters. For some variables, it may be that firms with the highest values are few and dispersed and lower values occur more frequently. If needed,

identification of the threshold values can be complemented by statistical analyses that cluster banks along this dimension. These two steps might inform authorities as to what natural thresholds could be.

For qualitative requirements, authorities could list the main activities and associated risks for banks and check whether the riskiness of a bank matches the ranking according to the main metric. Conversely, authorities could impose restrictions on the activities of those banks allocated to a particular segment – for example, banks in the segment with the simplest requirements could be prohibited from engaging in higher-risk activities.

Effective thresholds would separate different groups of banks, often with a distance between them. Thresholds around which a group of banks tend to cluster may not be ideal, due to the potentially artificial differentiation between banks that would result. In cases where there are multiple segments, having a consistent distance between them may make more sense in terms of risk sensitivity. It may be the case that, depending on whether the metric distribution is log-normal, the distance between thresholds needs to be multiplicative rather than additive. As an example, if size is measured in the local currency and the distribution of bank size appears to be log-normal, possible thresholds could be set to 1 billion, 10 billion and 100 billion in assets – ie each threshold is larger or smaller than the neighbouring ones by the same multiple (in this case, 10).

In cases where the metric is expressed as an absolute monetary value, and not as a percentage of GDP or other relative measure, authorities might have to reassess over time if the thresholds still adequately distribute banks in each segment. Over time, factors like inflation and overall financial system growth might affect the adequacy of thresholds calculated with absolute values.

## 1.5 Migration between segments

Whenever a proportionality framework divides banks into two or more segments, establishing rules governing the migration between segments provides regulatory certainty for changes in size, risk profiles and activities. Migration rules can also be effective backstops against regulatory arbitrage.

Supervisors might find it desirable that requirements applicable to individual banks change only gradually. This helps prevent unnecessary adjustment costs and uncertainty for banks and supervisors, while ensuring that firms are subject to adequate regulation and supervision regardless of where they are in their growth cycle. In practice, supervisors normally define a minimum fixed time (often one year) when a bank must stay in a segment before being eligible to change. Additionally, as migration between segments might affect banks significantly, authorities may consider phasing in requirements when a bank changes tiers, for example by providing a reasonable adaptation time between confirmation of the migration and the actual change in requirements. This could be especially helpful for both banks and supervisors in cases where the bank is migrating to a segment with more risk-sensitive regulation.

Occasionally, newly authorised banks, or banks formed via significant mergers or acquisitions, have not yet generated sufficient data to determine their segment. In practice, the best information that supervisors have to determine the initial allocation of a newcomer bank is that submitted as part of its licensing application. In these cases, supervisors might use the planned size, and other planned variables consistent with the business plan, to establish what the appropriate allocation might be from the first day of operations. Similarly, other changes in a bank's life cycle, such as mergers, acquisitions and spin-offs, might have a significant impact on a bank's segmentation metrics. Where such changes would reasonably lead the pro forma resulting bank(s) to cross thresholds into a different segment, supervisors might consider establishing the destination segment sooner rather than later, to provide regulatory certainty to the new bank(s) and its other stakeholders, including competitors.

## 1.6 Role of supervisory judgment

As outlined above, categories based on size and other quantitative metrics may not be sufficient to capture different risk profiles and different business models at all times. Even in cases where qualitative characteristics are also considered, the supervisory perspective is probably better able to reflect the particularities of banks within each tier. Therefore, it is advisable that supervisors have sufficient powers to move institutions between tiers, beyond the quantitative criteria.

Supervisory judgment is based on the risk-based assessment framework, considering both quantitative and qualitative information. In some jurisdictions, it may be challenging for supervisors to disclose the supervisory judgment aspects considered in classification, given that some of the qualitative information may be confidential.

Some qualitative factors that authorities might consider are activities that are not captured by the simpler metrics listed above. Relevant cross-border activity, interconnections with other institutions, and capacity for complying with new requirements are some examples. Smaller banks whose trading activity and sophisticated risk-taking ability need more intense supervisory scrutiny might be allocated, by supervisory discretion, to a corresponding segment. A well grounded perception by the supervisor that a particular bank is substantially more similar in terms of its risk profile and systemic importance compared with banks in another segment might also trigger the exercise of supervisory judgment. Authorities might consider disclosing publicly, at a high level, a non-exhaustive list of the factors that may inform supervisory judgment, with the goal of managing stakeholders' expectations and facilitating banks' planning process.

Ideally, application of supervisory judgment is subject to a high bar, and only used to override the segmentation rules in limited circumstances. In any case, it is advisable that these segment moves be based on well documented and verifiable quantitative and qualitative information. Over time, the frequency of cases that require supervisory judgment could indicate to authorities whether the definition of segments, the metrics and their thresholds continue or not to be adequate for that particular financial system.

## 2. Definition of capital

**Core Principle 16 (BCP01.100-102) establishes global requirements on this topic and the corresponding standard in the Basel Framework is CAP.**

### 2.1 Introduction

The definition of capital underpins the quality and availability of capital to absorb losses. As the Basel Framework recognises different capital instruments, each with varying degrees of complexity and different loss-absorbency features, there is the potential for individual jurisdictions to introduce proportionality in the definition of capital.

### 2.2 Considerations for the definition of capital

The following elements are important considerations when determining the quality of capital adequacy to be maintained by small and simple banks:

- whether the capital instruments meet the eligibility criteria as set out in the Basel Framework;

- whether and how the eligible components of regulatory capital are available to absorb losses on a going-concern basis (for example, common equity and disclosed reserves) and/or on a gone-concern basis;
- whether the capital base includes going- and gone-concern capital, considering also the tiers in the Basel Framework as a guidance; and
- whether the capital has permanency and certainty.

In small and simple financial systems, where the variety of capital instruments may be limited, it could be appropriate to adopt a simpler definition of capital. For example, in such jurisdictions it may be more practical for both supervisors and banks if the regulatory framework defines a simpler capital structure comprising fewer tiers or capital elements, or simpler eligibility criteria for those tiers of capital, provided these do not undermine the quality of bank capital. In jurisdictions with a limited variety of capital instruments, a capital regime that has an enhanced focus on CET1 could also help compensate for any risks arising from other, unrelated adjustments made to simplify the regime for smaller and simpler banks, since the average quality of capital would be higher.

The capital definition could also be simplified by, for example:

- Setting simpler approaches for including retained earnings and unrealised gains and losses in CET1 capital.
- Setting simpler approaches for making regulatory adjustments, since these adjustments, thresholds and waivers for deductions have detailed rules that may not be relevant in simpler financial systems. For example, adjustments could be made to only one level of capital, or those items that are subject to a deduction threshold approach could be fully deducted from capital.
- Reducing the scope of regulatory adjustments and deductions to exposures that are more material to the particular banking system or group of banks within that jurisdiction.
- When the denominator in risk-based capital ratios or the leverage ratio is simplified, the exposures that are typically risk weighted at 1,250% but are not captured in the denominator could be deducted from capital instead.
- Setting simpler rules for determining non-viability in the context of conversion of Tier 2 instruments into common equity or writedown.

## 2.3 Conservative calibration

Authorities might use historical experience to assess whether the minimum capital levels in the Basel Framework are sufficient for small and simple banks given the characteristics of their economies and banking systems. Historical experience includes both the loss history of banks and general macroeconomic developments. The larger the historical losses and the more volatile the macroeconomy, the higher the capital requirements.

More conservative capital requirements could also reflect domestic regulation and the capacity of supervisors. If authorities implement a simple framework, capital requirements may need to be higher to mitigate the risk of the framework having lower risk sensitivities or not covering specific risks. However, this may not be the case if the simplification is accompanied by, for example, higher risk weights, conservative regulatory adjustments or deductions, and/or limits on certain activities.

The Basel Framework also includes a number of regulatory capital buffers that authorities could choose to replace with higher capital requirements. Such an approach may be particularly useful in jurisdictions that lack the legal or regulatory capacity to activate and/or release capital buffers and constraints on the distribution of earnings. Given that some of the regulatory capital buffers, such as the

countercyclical capital buffer (CCyB), are also important macroprudential policy tools, jurisdictions may choose to implement buffers adjusted as appropriate for the particular circumstances of the jurisdiction.

## 2.4 Self-guided itinerary

Table A.2 contains questions that authorities might discuss internally when considering how to implement proportionality in the definition of capital and its calibration.

| Definition of capital  | Table A.2 |
|--|-----------|
| Questions guiding a proportional approach  | Table A.2 |
| <p>Components of capital (CAP10)</p> <ul style="list-style-type: none"> <li>• What types of capital instruments are used by the banks in your jurisdiction? To what extent and by which types of banks?</li> <li>• What do you see as the respective qualities of the different capital instruments and other risks posed by the instruments? What impediments to conversion or writedown may exist in the broader legal and investor protection framework?</li> <li>• Are the components of capital (CET1, AT1 and Tier 2) allowed in your local regulatory framework aligned with or more conservative than the applicable Basel capital framework?</li> <li>• Does the added complexity of using AT1 instruments compared with CET1 justify their use?</li> <li>• Does the added complexity of using Tier 2 instruments justify their use?</li> <li>• What is the nature (eg maturity, depth, liquidity) of capital markets in your jurisdiction? Are certain capital instruments more conducive to banks achieving deep and reliable access to capital in good times and in stressed times?</li> </ul> <p>Eligibility criteria (CAP10)</p> <ul style="list-style-type: none"> <li>• Do local rules explicitly prescribe the eligibility criteria for each type of regulatory capital category (ie CET1, AT1 and Tier 2 capital)?</li> <li>• If yes, what are the permitted forms or components for each tier of capital?</li> <li>• Also, if yes, do these criteria deviate from the applicable Basel capital framework(s)? How and why?</li> <li>• Does the deviation improve the quality and availability of capital to absorb losses on a going- and/or gone-concern basis?</li> <li>• Do local rules, laws or regulations explicitly allow certain legal forms of regulatory capital instruments or elements for eligible capital components without providing detailed eligibility criteria? If yes, what are the permitted components for each capital component (ie CET1, AT1 and Tier 2)?</li> <li>• What is the historical experience in the enforcement of creditors' rights and dispute resolution in the event of default?</li> <li>• Are there any components that need prior supervisory approval before inclusion in regulatory capital?</li> <li>• Are there any components that do not need prior supervisory approval when the bank repays the investors before maturity or purchases the instruments from the investors? If yes, how are these components seen as available to absorb losses on a going- and/or gone-concern basis?</li> </ul> <p>Deductions / regulatory adjustments (CAP 30)</p> <ul style="list-style-type: none"> <li>• What are the major deductions and adjustments to capital in your jurisdiction? For which types of banks are they material?</li> <li>• Are the deductions adequate and the adjustments justified? Why? Are all regulatory adjustments in the applicable Basel capital framework(s) applied? If not, why not?</li> <li>• How are regulatory adjustments applied? Are regulatory adjustments applied to each capital category or are deductions made from a particular tier or level of capital or specific CET1 capital only?</li> <li>• Do these deviations improve the quality and availability of capital for absorbing losses on a going- and/or gone-concern basis?</li> <li>• Does the added complexity justify the deductions and adjustments? For all banks?</li> </ul> |           |

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#### Prudent valuation guidance (CAP50)

- What risks do you see in relation to the valuation framework in your jurisdiction? What implications does the valuation framework have for the supervisory assessment of banks and the components of eligible capital?
- What valuation practices are applied in your jurisdiction? What positions cannot be valued by using market values due to the absence of market(s) or absence of liquid markets? What inputs are used in valuing these positions? Are there any less liquid positions for which the market values used may not be representative? Do you establish and maintain procedures for considering valuation adjustments, including for less liquid positions, in accordance with the Basel Framework?
- Do you have the systems and controls prescribed by the Basel Framework? Do you apply the valuation methodologies prescribed by the Basel Framework?
- Would prohibiting certain positions or valuation practices make it possible to have simpler regulations?
- Would disallowing some or all of such revaluation gains from inclusion in eligible components of capital improve the availability and loss-absorbing capacity and simplify regulations?
- Does your jurisdiction currently prescribe or limit valuation practices? If so, why?

#### Levels of capital requirements (RBC20)

- What are the minimum levels for CET1, Tier 1 and total capital (as a percentage of risk-weighted assets)? Are these levels aligned with the requirements in the applicable Basel capital framework(s)? Do different levels apply to different banks? If so, why? Are capital floors used? Are they more conservative than the Basel Framework?
- What is the proportion of total regulatory capital maintained as Pillar 2 capital and in what form of capital instrument?
- Is there any historical experience on what level of capital is required to absorb losses when a bank fails? What do stress tests suggest?
- Are the limits (ie caps) on the permitted components share in regulatory capital aligned with or more conservative than the relevant Basel capital framework(s)?

#### Buffers (RBC30)

- If you are implementing Basel III in your jurisdiction, what are the existing regulatory buffers in your capital framework? Are the types and sizes aligned with or more conservative than the Basel Framework?
- Can you impose limits on profit distributions if banks make use of buffers? Are the restrictions on distributions in case of buffer breach automatic, or discretionary for the supervisory authority? And are the restrictions gradual (eg a percentage increasing with the size of the breach) or non-gradual (eg outright restriction/prohibition in case of breach regardless of the size of the breach)?
- If you are implementing countercyclical buffers, what would you consider to be excessive aggregate credit growth? What would be the impact of downturns after such periods of excessive credit growth on bank earnings and solvency?
- For simplification, can an increase in minimum capital requirements for the simplest and smallest banks be an alternative to buffers?

#### Exemptions, deviations and disclosures

- Are the deviations, if any, from the applicable Basel capital framework available to all banks?
- If they are available only to select banks, what factors support such selective deviation?
- Are there any exemptions from local requirements?
- In case of exemptions or selective deviations, are these disclosed publicly by either the bank or the supervisor? If not, what factors are preventing public disclosures?
- Are banks required to make periodic (at least annual) public disclosures of the key terms and conditions of the components of capital? If not, what factors prevent requiring such disclosures?

#### Reporting requirements

- Are banks required to submit any ad hoc (not periodic) reports to the supervisor on: (i) changes to CET1, T1 and total capital adequacy ratios; (ii) changes to the components of capital; (iii) issuances of new eligible capital instruments; or (iv) repayment or buyback of issued eligible capital instruments? Are these reports required to be submitted before the event or after?
  - How frequently are the banks required to report their capital requirements?
-

### 3. Calculation of risk-weighted assets

**Core Principles 16, 17, 22 and 25 (BCP01.100–104; 114; 122–124) establish global requirements on this topic, and the corresponding standards in the Basel Framework are RBC, CRE, MAR and OPE.**

#### 3.1 Introduction

Risk-weighted assets (RWA) are a key input in determining banks' capital adequacy ratios. This technical annex outlines considerations to support the use of proportionality for the calculation of RWA in a manner that comprehends all material risks.

#### 3.2 Calculation of risk-weighted assets

The Basel Framework contains different approaches for calculating RWA, including both standardised approaches and internal model-based approaches for some risk categories. To promote international comparability and consistency, jurisdictions with simpler financial systems and smaller and simpler banks might consider implementing the simplest approaches available for each risk category.

However, even the simplest approaches may be too detailed for some banks or, in the case of non-Committee member jurisdictions, for some banking systems. In these circumstances, simplifications beyond the simplest version of the international rules may be warranted, to help lower costs for banks and supervisors while still maintaining sufficient risk sensitivity and an adequate amount of capital in each bank and across the banking system. To achieve a balance between simplicity and prudence, some jurisdictions may deem it necessary to include a degree of conservatism in the proportionate rules, eg by requiring an overall higher amount of capital for Pillar 1 or by adopting more conservative risk weight calibrations.

This annex illustrates situations where the calculation of RWA components might be made simpler than the existing Basel Framework.

##### 3.2.1 Credit risk

The Basel III framework for credit risk includes two main approaches for calculating credit risk RWA: a standardised approach and an internal ratings-based approach. Within the standardised approach, there are further options for calculating RWA for specific asset classes (eg for bank and corporate exposures, RWA may be calculated based on whether or not the use of external ratings is permitted). To increase comparability and reduce variability across banks' RWAs, the Basel III framework limits the scope of internal models, while deliberately increasing the risk sensitivity of the standardised approach.

Simpler rules might be considered, particularly for jurisdictions with smaller and simpler banking systems. The calculation of credit risk RWA under the standardised approach could be simplified by establishing less granular definitions of (sub)asset classes and exposures compared with the Basel Framework. For example, a conservative uniform risk weight could be applied to all corporate exposures instead of distinguishing between small and medium-sized enterprises (SMEs), externally rated corporates or specialised lending, with a conservatively higher uniform risk weight also applicable to defaulted exposures. Similarly, for retail exposures a conservative uniform risk weight could be applied to all unsecured loans and loans secured by assets other than real estate. For exposures secured by real estate, one possibility in the absence of further data could be to differentiate at least between loans secured by residential vs commercial real estate, with a more conservative prudential treatment applied to the latter.

Where data are available, jurisdictions could consider using objective drivers of risk to differentiate exposures in the retail (eg characteristics of the borrowers, or characteristics of certain types of collateral), corporate (eg revenues and leverage) and bank (eg CET1 ratio and non-performing loan

ratio) asset classes. Where such data are not available, it may be more prudent to adopt more conservative uniform risk weights. Further, where external ratings are not available (or limited) for exposures to banks and corporates, authorities could, for example, instead require that the risk weight for unrated exposures be assigned to the entire asset class. For the smallest and simplest banks, particularly those in less developed financial systems, it might make sense to consider the granularity required for the compilation of financial statements as a guidepost – supervisors could take advantage of banks' bookkeeping processes and require the application of risk weights at the balance sheet item level, with a sufficiently conservative risk weight to compensate for the coarser risk sensitivity.

For some smaller jurisdictions, a proportionate calculation of credit risk RWA might focus only on those exposures that are material for banks operating in that jurisdiction. Provided all material risks are covered, and the resulting capital framework is sufficiently conservative, this could be a viable option for implementing proportionality. For example, in jurisdictions where banks do not have exposures to securitisation or equity-like financial instruments, authorities could consider not implementing specific RWA calculations for these exposures. However, authorities might consider monitoring financial innovations and introducing requirements for these specific exposures as the structure and sophistication of local financial markets evolve. Where banks do have material exposure to equity instruments, a differentiation could be made between unlisted companies and all other equity holdings if the risk profile of these companies justifies this differentiation, since information on listing status is publicly available. In some cases, exposures of simple and small banks to these and other more complex credit instruments may be prohibited, or a conservative capital requirement such as a deduction from capital (or a risk weight treatment equivalent to deduction) could apply. Similarly, if exposures to derivatives are immaterial, banks could, for example, be allowed to use the current exposure method (CEM, which was used in the context of counterparty credit risk within the Basel II framework) to calculate capital requirements for derivative exposures.

For off-balance sheet exposures, authorities may also choose to focus only on those exposures that are material for banks operating in that jurisdiction and limit the granularity of exposure categories. Such an approach could be supported by a more conservative off-balance sheet capital requirement. Other aspects of the Basel III framework may be appropriate for many non-member jurisdictions and could be considered even for simpler banking systems, such as higher credit conversion factors for some off-balance sheet exposures. For example, where there is uncertainty as to banks' ability to control drawdown or cancel commitments in practice (eg for unconditionally cancellable exposures) supervisors may consider applying higher credit conversion factors.

Authorities could also simplify the recognition of eligible credit risk mitigation techniques by considering for lower capital requirements only those techniques that are most relevant and can be legally enforced. For many smaller and simpler banks, deposits and government bonds are likely to be a common form of financial collateral. Where authorities allow banks to recognise other types of more volatile collateral such as equities, consideration could be given to requiring the application of conservative supervisory haircuts. Authorities may also elect to only permit banks to use a simple approach to the recognition of eligible financial collateral, rather than the more detailed comprehensive approach.

### 3.2.2 Market risk

The Basel III Framework for market risk includes a menu of approaches: simplified standardised, standardised and internal models.<sup>6</sup> The simplified standardised approach was specifically created as an option for banks with smaller or less complex trading portfolios. The internal models, and to some extent the standardised, approaches are more detailed and may require significant human and technical resources including specialised training of personnel, sophisticated IT systems, and internal and external

<sup>6</sup> Simplified approaches were also designed by the Committee to determine the exposure amount of derivatives under the counterparty credit risk (CCR) and under the credit valuation adjustment (CVA) frameworks.



information databases. The implementation of the market risk framework may be challenging for banks in jurisdictions with simpler financial systems.

In these jurisdictions, trading activity can be minimal: the number of issuers of stocks or fixed-income instruments may be limited, and securities markets may be incipient or in some cases non-existent. Derivative instruments might also be absent or immaterial. In such cases, even the simplified standardised approach may be challenging for some jurisdictions to implement, and authorities might seek further paths for simplification. For example, one alternative is to implement a flat surcharge that increases capital requirements by a fixed amount relative to the bank's RWA for other risks or total assets. Such a simplification could be replaced by a market risk RWA calculation if the trading books of these smaller banks begin to grow in size and complexity. A flat surcharge approach may be appropriate if the materiality of market risk inherent within the jurisdiction's banking system or banks' activities and business models is small, and the supervisors and banks still have sufficient information and processes to identify and monitor market risk. For small banks where exposure to market risk is not immaterial, supervisors could also consider treating this risk on a Pillar 2 basis in addition to a Pillar 1 flat surcharge.

For most emerging and developing economies, FX risk might be the predominant source of market risk under Pillar 1. In these cases, it could be advisable to establish a more risk-sensitive approach to FX risk, such as by applying only the FX component of the simplified standardised approach or taking advantage of data already produced by banks (eg for accounting statements). One example would be to use relevant balance sheet lines to calculate a measure of banks' open FX position, and apply risk weights to that amount.

In some cases, it may be appropriate to combine the simplified standardised approach under Basel III for less material portfolios with the standardised approach for relevant risks such as FX. Regardless of the implementation of the simplified standardised approach, jurisdictions could choose to still apply to small and simpler banks some, or all, of the new definitions for the trading and banking books, which are more helpful in risk identification and management, and limit opportunities for regulatory arbitrage.

### 3.2.3 Operational risk

The Basel framework for operational risk takes into account each bank's business volume and unique operational risk profile. Under the Basel III standard, banks are required to use the standardised approach to calculate operational risk RWA. The most significant elements driving this calculation that introduce a degree of differentiation are the business indicator component's (BIC) application of multipliers (marginal coefficients) based on business volume, and the use of the internal loss multiplier (ILM) that may reduce or increase capital requirements for operational risk. The use of the ILM by banks in bucket 1 (generally smaller banks) is subject to national discretion. While the use of the ILM – which requires 10 years of high-quality annual loss data – is not mandatory for banks in bucket 1, jurisdictions may benefit from banks' development of internal operational loss databases, which is an important step towards robust and sound operational risk management regardless of whether the full Basel Framework is adopted.

When implementing Basel III, jurisdictions with smaller and less complex banking systems may find it appropriate to recalibrate the business indicator (BI) buckets so that thresholds reflect domestic conditions. The thresholds in the Basel III standard may be too large for application for jurisdictions with smaller banking systems. If recalibration is not feasible, smaller jurisdictions could set a single marginal coefficient for all banks in a conservative manner. A simpler approach would be to set a flat surcharge for operational risk based on the bank's RWA for other risks or total assets.

Jurisdictions with smaller and simpler banking systems may also benefit from encouraging their banks to improve their operational risk management frameworks, in line with the Committee's revised *Principles for the sound management of operational risk*<sup>7</sup> and the *Principles for operational resilience*<sup>8</sup>.

### 3.3 Self-guided itinerary

Table A.3 below contains a set of questions that may be useful as a starting point for internal discussion in individual authorities when considering proportionality in relation to the calculation of RWA.

| Credit risk, market risk and operational risk  | Table A.3 |
|--|-----------|
| Questions guiding a proportional approach  |           |
| Credit risk (CRE20)  |           |
| <ul style="list-style-type: none"> <li>• What type of credit exposures do smaller banks tend to have?</li> <li>• What is your experience with credit risk? What is the level of past due loans? What exposures have historically given rise to the biggest losses? What exposures have a particularly volatile history in terms of default rates or asset valuation? What does your domestic experience suggest regarding the correlation of losses between borrowers in the same asset class and across asset classes? How strong is creditor protection in your domestic legislation and in practice? Do you have a history of your sovereign defaulting, on foreign currency debt, on domestic currency debt? Do you have a history of regional governments or public sector entities defaulting? Are credit commitments substantial?</li> <li>• What proportion of banks and bank assets in your jurisdiction follow the standardised approach for credit risk or some simpler approach?</li> <li>• Do you have data on probability of default, loss given default and conversion factors for particular kinds of exposures? If yes, what do they suggest? What is your experience with realising collateral, and does it justify having lower loss given default for secured exposures?</li> <li>• Are some exposures not risk-weighted in proportion to their inherent risk as prescribed by the Basel Framework? If not, could these alternative approaches provide wrong incentives to the banks, leading to underpricing of risks and higher risk-profiles? What other risks could arise to individual banks or to the banking system from applying a different treatment?</li> <li>• Do you apply different risk weights to some or all exposures in your jurisdiction when compared with the Basel Framework? If so, what is the underlying reason? What options do you use for non-central public sector entities, banks and corporates? Do you base any risk weights on external credit ratings? Which items are presently subject to a risk weight above 100%? How do you define and treat past due loans?</li> <li>• Have you considered treating credit commitments as fully drawn facilities, avoiding the use of credit conversion factors?</li> </ul> |           |
| Use of external ratings (CRE21)  |           |
| <ul style="list-style-type: none"> <li>• What external credit assessment institutions (ECAIs) are active in your jurisdiction? What is their track record?</li> <li>• What risks do you see in relying on ratings by ECAIs? Are you comfortable with their assessments?</li> <li>• What criteria do you use to assess ECAIs? How do you map their assessments into risk weights? Do you use issue-specific ratings, or only issuer-specific ratings? Do you distinguish between ratings on local currency exposures and foreign currency exposures? Do you distinguish between short-term and long-term claims? Do you distinguish between international and national rating scales? What risk weights are used for domestic exposures without an international rating?</li> <li>• Have you considered not using ECAIs? What would be an adequately conservative risk weight for these exposures? Are there data available to identify objective drivers of risk?</li> </ul>   |           |

<sup>7</sup> [www.bis.org/bcbs/publ/d515.htm](http://www.bis.org/bcbs/publ/d515.htm).

<sup>8</sup> [www.bis.org/bcbs/publ/d516.htm](http://www.bis.org/bcbs/publ/d516.htm).

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#### Credit risk mitigation (CRE22)

- To what extent are credit risk mitigation techniques used by different banks within your jurisdiction? What techniques are used? Do your banks actively manage the techniques they use, eg by monitoring margins?
- What valuation methods are used for real estate collateral, and do they sufficiently distinguish between residential and commercial property collateral?
- What risks do you see in relation to the use of credit risk mitigation techniques? What residual risks could the instruments create? What degree of legal certainty applies?
- Are the simple and/or the comprehensive approaches for the recognition of eligible collateral implemented in your jurisdiction? What haircuts are required? Is the use of credit derivatives allowed? What collateral is accepted?
- Are all of the Basel Framework credit risk mitigation techniques relevant in your jurisdiction? Do you recognise all credit mitigation techniques, or can you limit the recognition to a few (or none), as relevant for your jurisdiction?
- When the use of credit mitigation techniques is directly embedded in lower risk weights (eg for residential mortgages secured by collateral), does the experience in your jurisdiction with realising collateral and foreclosing on residential real estate justify that?

#### Market risk (MAR40)

- What types of market risks are banks materially exposed to in your jurisdiction? What are the most relevant types of market risk, eg interest rate risk, equity price risk, foreign exchange risk and commodity price risk? What type(s) of market risk(s) have historically given rise to the biggest losses? How volatile are these risks? Which instruments subject to market risk are materially relevant in your jurisdiction? Are your banks exposed to price risks on options or other more complicated instruments? Are banks predominantly subject to long risks? Do they use derivatives? Do they have securitisation positions? What risks do you see in relation to commodity positions? Are they overly exposed to a single asset-type?
- How large a proportion of banks and bank assets in your jurisdiction follow the simplified standardised approach for market risk or some simpler approach? Would a higher proportion enhance the soundness of the banking system? How do you distinguish between the banking book and the trading book? If you apply a version of the simplified approach, which scaling factors do you use? Do you distinguish between specific risk and general market risk? How do you net positions? Do you include vertical and horizontal disallowance? Do you use the maturity or duration method? What maturity ladders do you use? Do you allow offsetting? How do you treat futures and swap positions? How do you calculate net open currency positions? What method do you use for measuring commodities position risk? Do you include in the simplified approach for commodity price risk an additional requirement linked to the gross position? What approach do you use for options?
- Are some exposures not weighted according to the risk capital requirements as prescribed by the Basel Framework? What risks could arise from a different treatment? How do you treat banks' position in their own capital instruments? How do you calculate the overall net position?
- Do you apply lower or higher risk capital requirements and time bands than prescribed by the simplified standard method to some or all market risk exposures in your jurisdiction?
- Are options treated according to the simplified approach? Are there banks in your jurisdiction that write options? Would the simplified approach be adequate for those banks? Can you limit exposure to certain market risks and thereby also use a simpler regulatory framework? Can you simplify the split between the banking book and the trading book, eg limiting the banking book to assets where market prices truly do not exist? Can higher scaling factors substitute for simplifications?

#### Banking book and trading book (RBC25)

- Are holdings of financial instruments in your banks split into a trading book and a banking book? How do you distinguish between the banking book and the trading book? What are the respective sizes in different banks?
  - What risks or problems does any split give rise to? What do you see as the advantages/disadvantages of the two approaches?
  - Can you clearly determine which exposures to include in and to exclude from the trading book? How do you do it?
  - Could you decide that allocation in either book is determined by the position purpose, in a way that does not allow positions with the same purpose of positions to be split between the banking and trading book?
-

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Operational risk (OPE10 and 20)

- How do you define operational losses? What specific categories do you include? What operational risks have your banks been exposed to historically? Do banks maintain a log of operational incidents, and does it include near misses? What information, communication and technology risks, including cyber risks, are your banks exposed to? What legal risks, both domestic and international, are your banks exposed to? Do banks in your jurisdiction have good operational loss collection practices?
  - Do you apply higher or lower coefficients in your jurisdiction than those prescribed by the Basel Framework? Do you apply lower or higher risk weights for operational risk? Are different values justified? What risks could arise from a different treatment? How do you define gross income?
  - Are the elements of the standardised approach's business indicator (BI) generally reflected in banks' financial statements in your jurisdiction?
  - If the elements to calculate the Basel III standardised approach are available to banks in your jurisdiction (ie elements of the BI calculation and historical operational losses), how do estimated capital requirements under the Basel III standardised approach compare with those under the existing approaches for operational risk capital? Are any increases or reductions in capital requirements justified given what you know about your banks' operational risk exposures?
  - Are banks' practices consistent with the Committee's *Principles for the sound management of operational risk* and the *Principles for operational resilience*?
- 

## 4. Leverage ratio

**The corresponding standard in the Basel Framework is LEV.**

### 4.1 Introduction

The Basel III leverage ratio complements risk-based capital requirements by providing a safeguard against excessive leverage and model risk. The leverage ratio is calculated as a measure of Tier 1 capital over a bank's total exposures. In some cases, jurisdictions might choose to implement a simpler version of the leverage ratio for banks.

The implementation of a simpler version of the leverage ratio can help preserve the safety and soundness of small and simple banks, while limiting the operational burden of calculating the exposure measure. It can also be beneficial in situations that are not addressed by the calculation of RWA, such as concentrated exposures to assets with low risk weights. Before implementing a leverage ratio as a Pillar 1 requirement, some jurisdictions might instead choose to introduce this measure as a means to monitor leverage in small and simple banks.

### 4.2 Calculation of the leverage ratio exposure measure

Authorities may choose to adopt a simplified calculation for the leverage ratio exposure measure. This could be achieved by simplifying the calculation of individual components of the measure, particularly those that are not material for small and simple banks. It can be done by, for example: replacing the calculation of derivatives or securities financing transaction exposures with the values already calculated for credit risk RWA purposes or using a more simplified approach; adopting simplifications for other off-balance sheet exposures (including higher credit conversion factors for some exposures) that are applied for the purpose of calculating credit RWA; or relying as much as possible on values used by banks for their usual financial statements or other regulatory reporting. When identifying potential areas for simplification, authorities may consider assessing which simplifications would lead to an undesirable level of risk sensitivity, which by itself could undermine the leverage ratio's role as a backstop to risk-weighted

capital requirements. Supervisors might decide to adjust for any material level of risk sensitivity in this adjusted leverage ratio by, for example, setting a more conservative calibration.

### 4.3 Capital used in the leverage ratio

Authorities that choose to implement simpler definitions of capital (see Annex Section 2) might decide to use the same definition in the calculation of the leverage ratio, including all regulatory adjustments. If appropriate, jurisdictions adopting a simpler method for calculating the leverage ratio may also choose to apply a higher minimum requirement than the 3% required under the Basel Framework.

### 4.4 Self-guided itinerary

Table A.4 below contains a set of questions that may be useful as a starting point for internal discussion in individual authorities when considering proportionality in relation to the leverage ratio.

| Leverage ratio   |           |
|--|-----------|
| Questions guiding a proportional approach  | Table A.4 |
| Definition and application (LEV10)   |           |
| <ul style="list-style-type: none"> <li>• What is the leverage ratio of banks in your jurisdiction? Is there a minimum requirement in place?</li> <li>• Do you have the legal authority to develop and to implement a leverage ratio requirement in your jurisdiction? Is the definition of the leverage ratio clear, comprehensive, meaningful to users, consistent over time and comparable across banks?</li> <li>• Are risk weights and associated capital requirements calibrated such that a leverage ratio will mostly never be relevant as a backstop? If it is not serving as a backstop, what is the purpose of implementing the calibrated leverage ratio?</li> </ul>  |           |
| Exposure measurement (LEV30)   |           |
| <ul style="list-style-type: none"> <li>• Do your banks use: (i) securitisations; (ii) derivatives; (iii) netting; (iv) eligible financial collateral; (v) clearing arrangements; (vi) securities financing transactions; and (vii) other off-balance sheet items? If yes, what are the amounts?</li> <li>• When calculating the leverage ratio, how do you treat: (i) securitisations; (ii) derivatives; (iii) netting; (iv) eligible financial collateral; (v) clearing arrangements; (vi) securities financing transactions; and (vii) other off-balance sheet items?</li> <li>• Are some of these aspects not relevant for your banks, eg because they are prohibited from having derivative exposures, securities financing transaction exposures or other off-balance sheet exposures?</li> </ul> |           |

## 5. Liquidity requirements

**Core Principle 24 (BCP01.119-121) establishes global requirements on this topic, and the corresponding standards in the Basel Framework are LCR and NSF.**

### 5.1 Introduction

The Basel Framework includes two liquidity requirements: the Liquidity Coverage Ratio (LCR), a measure which promotes short-term resilience, and the Net Stable Funding Ratio (NSFR), which requires banks to maintain a stable funding profile in relation to the composition of their assets and off-balance sheet activities. Implementation of the LCR and NSFR requirements are not a prerequisite for compliance with the BCPs for jurisdictions that are not Committee members. However, some jurisdictions have introduced

domestic liquidity rules requiring banks to hold a baseline level of liquid assets to cover potential short-term funding outflows.

Some jurisdictions that have adopted the LCR and NSFR took a proportionate approach to the calculation methodology, while others have adopted an alternative domestic rule, such as liquid assets ratios (stock measure), gap ratios (flow measure) and concentration ratios. Considering that the LCR and NSFR are likely to be more risk-sensitive than other simpler ratios, proportionate domestic liquidity requirements could be set more conservatively to compensate for lesser accuracy.

## 5.2 Definitions

The Basel Framework itself presents some possibilities for a proportionate approach. For example, in some small and simple financial systems, the most challenging issue might be the limited range of high-quality liquid assets (HQLA) available in local markets. To qualify as HQLA, assets must meet liquidity characteristics and operational requirements. Some potential options for simplifying HQLA requirements include:

- Simplifying the definition of HQLA by, for example, recognising only level 1 assets – although that might have limited practical impact if the jurisdiction does not have an active market for level 2 assets.
- Aligning, to the extent possible, the HQLA definitions with balance sheet statement lines or other supervisory reporting requirements while keeping the same level of conservativeness.

Other definitions could also be simplified when applied to small and simpler institutions, and categories can be merged. For example, stable and less stable deposits could be considered as a single category; and the same with level 2a and 2b assets or with operational and non-operational deposits. Another potential simplification could be limiting the NSFR time horizon to two buckets, such as “less than one year” and “one year or longer”. The supervisor might also consider establishing a lower reporting frequency for these banks.

## 5.3 Conservative calibration

Another issue for consideration during a proportional implementation of the LCR and NSFR could be the calibration of runoff rates and availability factors. Individual banks may experience different flows during times of stress, and smaller banks could in some cases have different stressed flows compared with larger banks. For this reason, the cash inflow/outflow and the available and required stable funding (ASF and RSF, respectively) assumptions might be adjusted in a conservative manner by supervisory authorities based on jurisdiction-specific circumstances, as well as historical and behavioural analyses. For example, authorities could use more conservative outflow rates for retail deposits in the LCR and lower stability factors for the NSFR calculations. This could be combined with a less detailed classification of inflow and outflow components.

The Basel Framework assumes that retail deposits are a stable source of funding even in stressed conditions, which might not be the case in all jurisdictions. In jurisdictions without deposit protection schemes, outflows of retail deposits could be significant in times of crisis. Bank exposures may also be more concentrated and banks more dependent on large depositors, which could call for more conservative outflow rates for large deposits.

Further, if banks are more dependent on cross-border funding and it is likely that non-residents would withdraw funding during periods of financial stress, authorities could consider applying more conservative outflow rates when the funds are provided by non-residents. Similar considerations may be relevant for wholesale funding. Authorities could also consider simplifying the treatment of off-balance

sheet items for banks that have insignificant off-balance sheet operations; or merging categories of assets and liabilities in the NSFR that have similar funding characteristics, to simplify compliance.

## 5.4 Self-guided itinerary

Table A.5 below contains a set of questions that may be useful as a starting point for internal discussion in individual authorities when considering proportionality in relation to the liquidity standards.

| Liquidity standards   | Table A.5 |
|---|-----------|
| Questions guiding a proportional approach   |           |
| Liquidity requirements (LCR10 and NSF10)  |           |
| <ul style="list-style-type: none"> <li>• How are banks in your jurisdiction funded? What liquid assets do they rely on? What is the balance between long-term assets and long-term funding?</li> <li>• What short-term risks exist in relation to funding? What more structural funding risks are banks exposed to? What experience have you had in relation to bank runs? What liabilities were most subject to runs?</li> <li>• Are the liquidity requirements applicable to the banks operating in your jurisdiction aligned with or more conservative than the Basel liquidity framework?</li> <li>• Are both LCR and NSFR ratios implemented? If either ratio is not implemented, do you have clear timeline for their implementation?</li> <li>• If the LCR and NSFR are not implemented, do you have alternative liquidity requirements to cover liquidity risk? Are these requirements in line with the Basel Core Principles?</li> <li>• Is there a need to consider liquidity needs per currency?</li> <li>• Should currency play a significant role, how will transferability (across jurisdictions) and convertibility (between currencies) be assessed/addressed?</li> </ul> |           |
| Calculation of LCR (LCR20)  |           |
| <ul style="list-style-type: none"> <li>• What knowledge do you have of idiosyncratic as well as market-wide liquidity shocks?</li> <li>• What on- and off-balance sheet items impose the largest liquidity risks?</li> <li>• What time horizon do you use for the calculation of your short-term liquidity requirement? What are the components in the calculation? What are the numeric requirements? Under what conditions do you allow banks to use their short-term liquidity buffer?</li> <li>• What is the simplest relevant indicator of short-term liquidity risks that would provide value in assessing your banks?</li> <li>• Are the correct data feeds available to banks (eg typically data feeds have not been set up to map to the way the LCR and NSFR evaluate funding)? Are off-balance sheet commitments tracked regularly?</li> </ul>   |           |
| Calculation of NSFR (NSF20)   |           |
| <ul style="list-style-type: none"> <li>• How stable are the various funding sources used by banks?</li> <li>• How easy is it to terminate or exit the various commitments the banks have funded?</li> </ul>   |           |

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#### HQLA in LCR (LCR30 and LCR31)

- What assets on their balance sheets do banks consider to be highly liquid? How much of these assets do the banks hold? How much of these assets are available for banks to hold in your jurisdiction? How do these numbers move over time, eg as a result of developments on the balance sheet of the central bank or the government? How do these numbers compare with the possible stressed outflow of banks?
- What risks do you see in relation to the assets that are considered highly liquid? What do previous periods of stress in financial markets suggest in terms of the possibility to convert these assets into cash? What alternative assets could be considered liquid assets?
- Do laws or regulations explicitly lay down the criteria for HQLA components? Do you have different levels of liquid assets, and are there rules on the composition of the pool of liquid assets? Is there a need to address issues such as encumbered assets? Do you apply any of the alternative liquidity approaches? If yes, how?
- Is your jurisdiction in the position that claims on central banks and available government bonds are more than sufficient to cover all needs for HQLA?
- Is there a standard formula in your jurisdiction to value HQLA?
- If the HQLA market is highly concentrated, what mitigating factor could be put in place should there be large HQLA sell-offs?

#### Outflow/inflow rates in LCR and ASF/RSF rates in NSFR (LCR40 and NSF30)

- How do banks forecast their liquidity positions? What is the experience in your jurisdiction with idiosyncratic liquidity shocks, and market-wide liquidity shocks? What has been the impact on the most important assets, liabilities and off-balance sheet items? Do you have a well functioning deposit insurance system that would ensure stable retail deposits?
- What do you see as the major risks to outflows and inflows, if banks are hit by idiosyncratic or market-wide shocks? What is the possibility for the central bank to counter such shocks?
- What is considered stable retail deposits? What runoff rates do you apply to different liabilities? What do you assume in relation to derivatives, requirements to post collateral, drawdowns on credit facilities and other more specific items? What do you assume in relation to inflows? Do you have a cap on inflows relative to outflows? Would banks be able to identify operational deposits and the related excess amounts? How are SMEs defined and identified in your jurisdiction?
- What assumptions do you use for calculating ASF and RSF? How do you treat encumbered assets? How do you treat off-balance sheet exposures? Do you have interdependent assets and liabilities, and how do you treat them?
- Are there any elements in the standards that are not relevant in your jurisdiction, eg because banks are not allowed to use the related instruments?

#### Reporting requirements (DIS85)

- What is the capacity of banks to calculate liquidity ratios? Are they calculated on a daily, weekly or monthly basis?
  - Do you feel comfortable that the banks can calculate the LCR and the NSFR in a way that provides them with adequate time to react? Do you feel comfortable that you receive the information on a timely enough basis for you to react?
  - What are the reporting requirements?
  - Are LCR reports submitted on a daily, weekly or monthly basis?
  - Are NSFR reports submitted on a monthly or quarterly basis?
  - Are banks required to submit any ad hoc (not periodic) reports to the supervisor on the major changes to the components of HQLA or composition/structure of assets, liabilities? Are these reports required to be submitted before the event or after?
  - Are there any data points that could be left out, either because they are not relevant in your jurisdiction, eg because banks are not allowed to use the related instruments, or because they are quantitatively insignificant?
-



## 6. Large exposures

**Core Principle 19 (BCP01.107–121) establishes global requirements on this topic; and the corresponding standard in the Basel Framework is LEX.**

### 6.1 Introduction

Large exposures regulation limits the maximum loss that a bank could face in the event of a sudden counterparty failure. This standard requires banks to measure their exposures to a single counterparty, or a group of connected counterparties, and limit the size of large exposures as a proportion of their capital, based on definitions that follow, where practical, existing concepts in the Basel Framework.

Large exposures are an important risk particularly in less diversified economies. Historically, many banks have failed because of excessive exposure to a single counterparty, or a few counterparties exposed to the same underlying risk. As a consequence, the scope for a proportional approach which leads to a less comprehensive view of total exposure is likely to be limited.

The Basel Framework requires that the sum of all the exposure values of a bank to a single counterparty, or to a group of connected counterparties, must not be higher than 25% of the bank's Tier 1 capital at all times. The BCPs require that off-balance sheet and contingent liabilities be captured, and that the supervisor have the power to define a group of connected counterparties. The additional criteria include the same limits and quantitative definitions as the Basel Framework.

### 6.2 Definition of connected counterparties

The importance of identifying connected counterparties cannot be underestimated. Identifying groups of connected counterparties is a crucial part of managing concentration risk, but it can be a challenge for simpler and smaller banks due to the lack of information and data. In jurisdictions where concentration risk is particularly relevant, supervisors could consider establishing more prescriptive guidelines on the identification of control relationships and economic interdependencies. This could simplify compliance for small and simpler banks, by facilitating the task of analysing these complex organisational structures to identify connected entities.

Another challenge for small and simpler banks that could be addressed by proportionality is the measurement of exposures, including those exposures that are not typically observed in these banks, such as: counterparty credit risk from derivatives transactions, indirect exposures to underlying of derivatives transactions, trading book exposures and the treatment of specific exposure types such as underlying exposures to structures (eg securitisation vehicles). An additional challenge is the consideration of credit risk mitigation techniques in the definition of connected counterparties, due to the need to also recognise an exposure to the credit risk mitigation provider. One possibility could be to allow small and simple banks to consider gross exposure, ie without recognising the mitigation. Where authorities apply simpler requirements to the measurement and calculation of risk-weighted assets (see Annex Section 3), the same approach could be applied to large exposure calculations. Potential simplifications across both frameworks could relate to the measurement of certain off-balance sheet exposures and the recognition of credit risk mitigation techniques.

### 6.3 Conservative calibration

Due to their more limited size or market reach, smaller banks may be more vulnerable to large exposures. Authorities might consider setting a more conservative limit to identify large exposures.

## 6.4 Self-guided itinerary

Table A.6 below contains a set of questions that may be useful as a starting point for internal discussion in individual authorities when considering proportionality in relation to large exposure limits.

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### Large exposures

Questions guiding a proportional approach

Table A.6

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#### Definition and application (LEX10)

- How material are large exposures in your jurisdiction? What are their characteristics, eg in terms of credit risk and credit risk correlation? What is your experience with losses coming from large exposures?
- What risks do you see in relation to large exposures? Is there a risk that large counterparties to banks are economically interdependent?
- What is the scope of the organisation that you apply the large exposure framework to? How do you assess whether counterparties are economically interdependent?
- Can you limit the investigation of economic interdependence to a limited set of significant exposures?

#### Requirements (LEX20)

- What is the consequence for banks in your jurisdiction if their largest counterparty fails? If, say, the five largest counterparties fail?
- How do you assess the risk that this will happen? Are there underlying economic factors, eg the price of one or more commodities, that could drive failures?
- What limits do you apply to single large exposures? To the sum of a certain number of exposures?
- Can you ease reporting requirements for institutions that have historically operated well below legal requirements?

#### Exposure measurement (LEX30)

- What kind of exposures, in addition to normal credits, do your banks have to counterparties?
  - Are there any kinds of exposures that you consider particularly risky? Are there any kinds of exposures that in particular situations could suddenly become much larger?
  - Do you include both on- and off-balance sheet exposures? How do you define an exposure? What credit risk mitigation techniques do you recognise? How do you include trading book exposures, including offsetting long and short positions? How do you treat covered bonds, collective investment vehicles and other structures? Are any exposures exempted? What credit conversion factors are used?
  - Are some of these aspects less relevant for your banks, eg because they are prohibited from having these exposures?
- 

## 7. Pillar 2

**Core Principles 1, 2, 8, 11 and 16 (BCP01.64–67, 86–88, 100–102, 105–106) establish global requirements on this topic, and the corresponding standard in the Basel Framework is SRP.**

### 7.1 Introduction

The Pillar 2 supervisory review process ensures that banks have adequate capital and liquidity to support all material risks in their business, especially with respect to risks not fully captured by the Pillar 1 process. It also encourages sound risk management and a holistic risk-based perspective by both banks and supervisors.

While implementation of the Basel three-pillar framework is not mandatory for compliance with the BCPs for non-Committee members, the BCPs comprise several essential criteria that are significant and equivalent to essential elements of Pillar 2. For example, Core Principles 2 and 16 concern supervisors' independence and ability to impose capital on individual banks according to their risk profile and that all

material risks are covered by capital or mitigated accordingly; Core Principle 8 mentions that supervisors' methodology for assessing bank risk should address, among other things, the business focus, group structure, risk profile and other qualitative aspects; Core Principle 11 concerns forward-looking corrective actions by supervisors. Other principles lay out other elements of Pillar 2, such as (but not limited to) interest rate risk in the banking book, concentration risk, and governance and risk management requirements, as described below.

## 7.2 Considerations in relation to Pillar 2

The Pillar 2 principles in SRP can be met in several ways. Authorities can use a proportional approach that reflects their assessment of relevant risks, provided it meets the requirements under the BCP. Most supervisors will consider how to apply proportionality in the SRP, when they decide on the level of granularity of requirements. Authorities can also consider proportionality, when they decide on the breadth of coverage of the specific Pillar 2 components. In addition, Pillar 2 is a possible place to address risks which are only relevant for specific institutions in the jurisdiction.

When implemented by authorities, internal capital adequacy assessment process (ICAAP) requirements could be met by simple and small banks with simpler methodologies. For example, these banks could conduct sensitivity analyses to harness the value of a forward-looking risk management tool, without incurring disproportionate costs by running a fully fledged suite of stress tests (see Annex Section 8). Further simplification could be achieved by requiring ICAAP reports to cover only the key risks for small and simple banks and banking systems. For example, for banks that are not active in securitisations and only have limited market operations, the ICAAP reports would not need to consider these areas. In some cases, banks may provide reports endorsed by its Board describing risk management and internal control frameworks in place as well as a description of measurement and assessment of risks. Small banks could assess the impact of external conditions, including business cycle effects and the macroeconomic environment, on their business and future capital adequacy using methodologies that are not necessarily sophisticated.

Authorities with small banks and non-complex banking systems may wish to focus on aspects of Pillar 2 that are particularly relevant for their banks and banking systems. It is important to note that Pillar 2 actions may include not only higher capital requirements, but also timely actions to reduce risk or restore capital. Further, strengthening risk management, internal limits, provisions and reserves, and better internal controls, are other tools that address bank risks.

While there are some risks covered under Pillar 2 that are likely to be relevant in most banking systems, some risks are likely to be particularly relevant for smaller banks and less diversified financial systems, such as:

- Interest rate risk in the banking book (IRRBB): the use of sophisticated models is not a requirement. If the exposure to IRRBB is material, supervisors might choose to address these using the appropriate choices from the options articulated above (eg higher capital requirements or de-risking). If the banks and banking system are not sophisticated, it may be simpler to require a standardised risk charge.
- Concentration risk: concentration risk could include not only credit concentration (direct and indirect) to the same counterparties but also to counterparties whose financial performance is dependent on the same activity or commodity. If relevant, supervisors could also consider other risk concentrations to asset classes, products, collateral or currencies. Concentration risk may be difficult to avoid in some economies, and Pillar 2 actions are therefore key in addressing it.
- Exposures to related parties: in some jurisdictions, diversification of counterparties may be challenging, and exposures to related parties – including through service contracts, asset purchases and sales – may be a source of risk. Pillar 2 actions would therefore be proportionately

more relevant to these jurisdictions. Pillar 2 actions could include, for instance, limits for exposures that are more conservative than the limits for a single counterparty or group of connected counterparties, deduction from capital, requiring collateralisation of such exposures, or higher capital requirements.

There are several means available to supervisors for ensuring that individual banks are operating with adequate levels of capital. Among other methods, the supervisor may set trigger and target capital ratios or define categories above minimum ratios (eg well capitalised and adequately capitalised) for identifying the capitalisation level of the bank. Consideration could be given by authorities implementing Pillar 2 add-ons to small and simple banks as to the hierarchy of loss absorbency of this add-on. Regardless of the approach, authorities should have and retain the means to set minimum prudential requirements for individual banks based on their risk profile and systemic importance.

### 7.3 Self-guided itinerary

Table A.7 below contains a set of questions that may be useful as a starting point for internal discussion in individual authorities when considering proportionality in relation to the Pillar 2 supervisory review process.

| Pillar 2 – supervisory review process  | Table A.7 |
|--|-----------|
| Questions guiding a proportional approach  |           |
| Objectives and four key principles (SRP10 and SRP20)   |           |
| <ul style="list-style-type: none"> <li>• What risks are banks in your jurisdiction exposed to that may not be adequately covered in Pillar 1 capital requirements? Are there relevant external factors in your jurisdiction that you should take into account? Are there issues of insufficient compliance or disclosure that you should take into account? Is bank management effective in identifying, measuring and evaluating risks and clarifying them in the bank’s ICAAP (or other equivalent document)? Is this supported by effective corporate governance and risk management standards?</li> <li>• How is the SRP carried out in your jurisdiction? Do the banks cover the five main features in their processes for assessing capital adequacy stipulated in the Basel standards? What levels of additional capital do banks consider that they need in your jurisdiction? Do you have the power and skills to require banks to hold excess capital, and do you use them? Do you have the powers to intervene early, and do you use them? Could the SRP be simplified if there were a standard requirement for additional capital? What risks and benefits might that bring?</li> <li>• Is it necessary for all banks in your jurisdiction to do complete ICAAP reports? Could they be simplified? Are there other ways to address risks than through extra capital?</li> <li>• Are there any red lines (eg around topics such as cyber security, AML/CFT), and how would you avoid diminishing the capabilities for prudential supervision associated with granting waivers of simplifying reporting requirements?</li> </ul> |           |

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#### Risk management (SRP30 to SRP36)

- What are the most likely deficiencies in the risk management approach by banks in your jurisdiction? Do your banks have complex on-balance sheet or off-balance sheet exposures? What interaction of risks could occur under stressed conditions? What are the most likely reputational risks, and what are their potential impact? Are your banks exposed to difficult valuation issues? Are your banks exposed to IRRBB? What is the capacity of capital instruments in your jurisdiction to absorb risks? Are there differences between the conclusions of SRP and the ICAAP? Do banks build capital buffers during good times, and are they sufficient to absorb losses during a prolonged downturn?
- Do you assess banks' risk management frameworks? How? Do you ensure that there is adequate firm-wide risk oversight? How? What standards and features do you require for the risk management system? Does your review of risk management in banks in your jurisdiction adhere to the Basel Framework? Is it comprehensive and suitable to cover all the relevant risks to which firms are exposed? Do you and your banks use stress tests? How are they designed? What kind of stress tests would balance the costs and benefits for the smallest and simplest banks? How do you address difficult valuation issues, if any?
- Is IRRBB managed as prescribed in the 12 principles in SRP31 of the Basel Framework? If not, what risk might that imply? Could you consider mandating banks to follow the standardised Basel rules for IRRBB? Is there a more proportional approach to manage these risks?
- Do banks in your jurisdiction have sufficient and clear policies in place to manage residual, credit concentration and counterparty credit risk? Could the requirements be introduced in a more proportional manner?
- Is your review of market and operational risk as well as compensation practices in your jurisdiction as prescribed in standard SRP of the Basel Framework? Could they be simplified?
- Do banks in your jurisdiction follow the Committee's *Principles for effective risk data aggregation and risk reporting*? If not, what risk might that imply? Could some of the current requirements be simplified?

#### Liquidity monitoring metrics (SRP50)

- What liquidity risks are particularly relevant to monitor in your jurisdiction? Which types of tools for monitoring purposes do you apply to banks in your jurisdiction?
  - Are some types of liquidity reporting less relevant in your jurisdiction? Should this specific reporting be limited? What risk might that bring?
- 

## 8. Disclosure requirements

**Core Principle 28 (BCP01.130–132) establishes global requirements on this topic, and the corresponding standard in the Basel Framework is DIS.**

### 8.1 Introduction

The scope and content of information disclosed publicly, and the level of disaggregation and detail, is commensurate with the risk profile and systemic importance of the bank. Disclosure is therefore proportional by design.

### 8.2 Provision of information

The provision of meaningful information about common key risk metrics to market participants is a fundamental principle of a sound banking system. Pillar 3 disclosures serve the objective of promoting market discipline, reducing information asymmetry and helping to promote comparability of banks' risk profiles within and across jurisdictions. While markets are likely to have less capacity to exert market discipline on smaller banks or banks in simpler banking systems, disclosure is still important to reduce information asymmetry and promote comparability.

Pillar 3 requires firms to disclose publicly information related to their risks, capital adequacy and policies for managing risk. Disclosure requirements apply to internationally active banks at the top

consolidated level. The frequency of disclosure varies between quarterly, semiannual and annual reporting, including quantitative and qualitative information. While not all Pillar 3 templates will be applicable to all banks, the five guiding principles for disclosures are generally applicable: disclosures should be clear, comprehensive, meaningful to users, consistent over time and comparable across banks.

For small banks or banks in less complex financial systems, the full set of Pillar 3 disclosures may require excessive resources. Although implementation of Pillar 3 requirements is not mandatory for non-BCBS jurisdictions, disclosure of information by banks is a requirement under the BCPs. Proportionality can play a role in ensuring that the rules and regulations meant to strengthen market discipline are adapted to different jurisdictions with different institutional environments. To the extent that supervisors apply proportionality to the other Pillars, Pillar 3 disclosure templates applicable to banks could consequently be simplified. Supervisors may still need to clarify how banks can apply proportionality to disclosure requirements.

Strategies to adopt proportional disclosure requirements include adopting less detailed requirements in terms of required templates and data points, provided that the disclosures mentioned by Core Principle 18 are included and reducing submission frequencies according to the size, risk profile, nature and complexity of the institution. It would likely be advisable to maintain to the extent possible the definitions used in the Basel Framework to allow comparison with international and domestic peers.

Other ways for authorities to apply a proportional approach include:

- The smallest and simplest institutions could be required to disclose only a very limited set of templates at a lower frequency (eg only to disclose the KM1 – Key metrics and OV1 – Overview templates annually), with progressively more disclosure (ie more templates and at a higher frequency) as banks increase in size and risk profile.
- Authorities could consider which data systems for reporting quantitative information are already in place. It is likely to be less costly for banks to comply with the disclosure requirements if they can use existing reporting systems. For qualitative information, reducing the frequency may save costs. Supervisors may wish to combine this approach with a safeguard that allows the supervisor to require additional disclosures as part of ongoing supervision as needed.

Another option is for the supervisor to disclose, on behalf of the bank, some of the bank-level information obtained through supervisory reporting, while recognising that responsibility for data accuracy remains with the institution. Authorities may consider maximising the integration with supervisory reporting requirements, given the commonalities of the information that institutions may have to report to their supervisors and to disclose publicly. This could include a mapping between the quantitative disclosure templates and supervisory reporting. This may be an option only for the smallest and simplest segment of institutions, as the governance of data and the quality of reporting is ultimately the responsibility of bank management, not supervisors.

### 8.3 Self-guided itinerary

Table A.8 below contains a set of questions that may be useful as a starting point for internal discussion in individual authorities when considering proportionality in relation to Pillar 3 disclosures.

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## Disclosure requirements

Questions guiding a proportional approach

Table A.8

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### Definitions and applications (DIS10)

- How and which information do banks disclose in your jurisdiction?
- Can the financial market exert and promote discipline over banks? Could it be improved?
- Should banks publish disclosure information in a standalone document that is easily identifiable to users? Can you make available on your website an archive of individual banks' disclosure reports relating to prior reporting periods?

### Disclosure templates (DIS20 to DIS85)

- Does an institution's size, risk profile and complexity create the conditions for it to be exempted from, or subject to minimal, specific disclosure requirements?
  - How frequent should disclosures be (quarterly, semiannual or annual)? Which disclosure requirements require different frequencies? If there is one standalone report document for the Pillar 3 report, should it be published concurrently with the bank's financial report for the corresponding period?
  - Do banks have an effective internal control structure over the disclosure of financial information?
  - Are disclosures clear, comprehensive, meaningful to users, consistent over time and comparable across banks? Do they follow the five guiding Basel principles?
  - Should templates be used and completed with quantitative data in accordance with the definitions provided in the Basel DIS standard templates? Is there a common electronic format that can be used to facilitate the use of the data? Should tables be used and completed with mainly qualitative information?
  - Could some disclosure templates be simplified? Is some information of lesser importance?
  - Is there any content analogous to Pillar 3 disclosures that is already disclosed by banks as per other existing requirements in your jurisdictions?
- 

## 9. Corporate governance and risk management

**Core Principles 14, 15 and 26 (BCP01.94–99 and BCP01.125–126) establish global requirements on these topics, and the corresponding Committee guidance is the *Corporate governance principles for banks (CGPB) (BCBS, 2015)***

### 9.1 Introduction

Banks and banking groups are required by the supervisor to have robust corporate governance policies and processes covering, for example, strategic direction, group and organisational structure, control environment, responsibilities of the banks' boards and senior management, and compensation. Supervisors may need to consider proportionality for differentiating qualitative requirements applicable across a range of banks, particularly those related to corporate governance and risk management.

### 9.2 Corporate governance requirements

In some cases, supervisors may find it difficult to address specific governance challenges arising from various ownership structures in smaller banks with a "one size fits all" regulatory guidance.

The number and nature of the board-level committees recommended by the corporate governance principles depend on the size of the bank, the size of the board, the business areas, the risk profile and the systemic importance. Consistent with the proportionality principle, authorities may require complex or systemically important banks to constitute, at a minimum: (i) an audit; (ii) risk oversight; and (iii) remuneration committees with experienced non-executive members. For example, though the option



of a remuneration committee may depend on the size, complexities and nature of the bank, supervisory authorities might ensure that banks have in place appropriate remuneration systems that are aligned with prudent risk-taking. Supervisors might prescribe the creation of other board committees depending on the assessment of the risk exposures of potential vulnerabilities of the bank.

Authorities might begin by defining prudential objectives governing corporate governance and risk management requirements/expectations that they will apply across banks. Authorities could translate these prudential objectives to differentiated requirements that are suited to banks in each segment (see Annex Section 1). The differentiated requirements could include setting out expectations for the board of directors related to their responsibility to establish the bank's objectives and strategies and promote a culture of good governance. This could serve as the foundation for implementing differentiated corporate governance and risk management requirements across segments.

One example where proportionality is frequently used is the assessment of board members' suitability. There may be benefits in tailoring guidance on fitness and propriety and on board composition requirements to banks with varying ownership structures. However, this tailored guidance would still need to be consistent with the Committee guidelines for a clear and rigorous process in identifying, assessing and selecting board candidates, with criteria on integrity and reputation, in particular, being preserved. Expertise and time needed to serve on bank boards may vary according to the bank's risk profile, size, complexity and systemic importance. The suitability criteria used to determine a candidate's fitness generally relate to time commitment, practical experience and expertise.

Authorities might apply proportionality to their expectations of banks' board and committees in various areas of regulatory requirements, eg in relation to board composition, disclosure of information and remuneration. In applying proportionality, authorities would normally place responsibility on the financial institution's board to ensure that there are governance policies and mechanisms appropriate to the structure, business and risk of the group and its affiliates. For instance, in jurisdictions where banks are part of a conglomerate, authorities might consider requiring the creation of a related party transactions committee. Simple and small banks may be required to constitute only the audit committee, highlighting the importance of checks and balances system and controls.

Sometimes these simple banks are family-owned or are family corporations, and possibly with only a small personnel count. In these cases, the governing boards and management team comprise closely related individuals, which may weaken corporate governance due to conflicts of interest. Thus, even here supervisors may wish to require creation of other board-level committees with independent members, based on the assessment of risk areas requiring deeper focus from the board.

### 9.3 Risk management

While board responsibility to establish comprehensive risk management strategies, policies and procedures, identify the material risks facing the bank and set appropriate risk tolerance and risk appetite exists regardless of the size of the bank, there are potential ways they can be adjusted to smaller and simpler banks.

The risk management function is a key element of the second line of defence of banks. While larger and more complex banks are required to appoint a Chief Risk Officer (CRO) with sufficient stature, independence, resources and access to the board, in the case of some simple and small banks, authorities might allow the bank to either not appoint a CRO or assign the same responsibilities to another officer. In any case, the CRO or the person responsible for the CRO's tasks would be expected to have adequate stature and authority, as well as direct access to the board.

While all banks need an internal audit function as well as other key internal control functions, for smaller banks the committees relating to areas of audit and risk (among others) could be tailored to the circumstances of the firm. For example, the number of committees and members could be smaller.



Appointing a Chief Audit Executive (CAE), CRO and Chief Compliance Officer (CCO) may increase the cost of compliance to a level that may not be commensurate with the bank’s scale and complexity of activities and level of risk exposures, though authorities might consider retaining the CRO appointment requirement for all banks. In addition, in some small banks the governance structure may not have enough executives to populate these roles individually. In such cases, the bank may assign more than one function to the same individual. For example, a bank may designate the CCO and the CRO in a concurrent capacity. It would then be the delegator’s responsibility to ensure that the delegatee possess all the qualifications necessary to handle the roles. Similarly, some authorities may allow small banks to implement a system of independent reviews, eg conducted by external experts, of key internal controls as an alternative to establishing a dedicated internal audit organisation unit.

Expectations about bank-run internal stress tests, which form an integral part of their risk management process, might also be adjusted by authorities. Since stress tests are expected to capture material sources of risk to the bank, in the case of small and simple banks authorities might clarify that their expectation is for stress tests to cover only one or two main risks. That count could increase progressively for banks in segments higher up in the size or complexity scales. In terms of methodology, supervisors might also clarify that for the small and simple banks stress tests could comprise techniques as simple as sensitivity analyses with a sufficiently conservative adverse scenario, which also enables the results to be used in decision-making, risk management processes and the assessment of capital and liquidity levels.

**9.4 Self-guided itinerary**

Table A.9 below contains a set of questions that may be useful as a starting point for internal discussion in individual authorities when considering approaches to proportionality in relation to corporate governance and risk management matters.

| Corporate governance and risk management  |           |
|---|-----------|
| Questions guiding a proportional approach   | Table A.9 |
| Governance (CGDB principles 1–5)  |           |
| <ul style="list-style-type: none"> <li>• What risks have historically been associated with governance structures in your jurisdiction? Have boards of directors (BODs) taken sufficient responsibility to address these risks? Have BODs been adequately qualified and organised to address these risks? How and which information about BOD governance do banks disclose in your jurisdiction? Does the BOD and senior management understand the risks posed by the bank group’s organisational structure?</li> <li>• What are the responsibilities of the BOD in your jurisdiction? How do they set corporate culture and values? How do they implement risk management and oversight of senior management? How is the quality of the BOD ensured?</li> <li>• What are the responsibilities of senior management? How is the quality of senior management ensured?</li> <li>• How are group structures managed?</li> <li>• What level of simplification of governance structures is reasonable in smaller organisations? How would you address the risks that simplification entail?</li> </ul> |           |

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Risk management (CGDB principles 6–12)

- Historically, what have been the deficiencies in risk management practices of banks in your jurisdiction? Do banks in your jurisdiction have effective independent risk management functions? Have banks' risks been identified, monitored and controlled adequately? Have risks been adequately communicated to the relevant stakeholders? Have compliance risks been adequately addressed? Has the internal audit function performed as required? Have banks' compensation policies resulted in unsound governance and risk management?
  - What are the key activities of sound risk management functions? How is the independence of the chief risk officer (CRO) ensured? How are risks identified, monitored and controlled by the CRO? How are risks communicated by the CRO to the BOD and other relevant stakeholders?
  - Is there an independent compliance function requirement in your jurisdiction? What are the roles of this compliance function? How are compliance issues identified, monitored and controlled by this function? How are compliance issues communicated, including to the BOD by this function?
  - Is there an independent audit function requirement? What is the mandate of the audit function? How is its independence ensured?
  - How do banks ensure that remuneration structures are consistent with sound governance and risk management practices? How is the appropriate level of transparency of bank governance matters ensured for stakeholders to effectively monitor the bank?
  - What level of risk management simplification is reasonable for smaller organisations, eg integrating lines of defence? How would you address the risks that simplification entail?
-