Implementing the new Basel capital rules – Swiss-style

Supervisors in Berne are anxious to minimise implementation burdens, and any changes to the tried and tested system for ensuring Swiss banking soundness, explains Daniel Sigrist*

In some quite specific ways Switzerland's application of the new bank capital requirements – Basel II – will differ from their implementation in the European Union. That is hardly surprising for a country that has two very large, internationally-active banks, and several hundred much smaller banks, and where the banking industry accounts for some 10% of the economy – about double the share in the US and Britain. The role and structure of the industry in Switzerland are very particular.

Even so, the process of implementing the new capital standard is quite well advanced compared with progress in many other countries, and the Swiss Federal Banking Commission (SFBC), the country's bank supervisor, is closely following the timetable set by the Basel Committee, the body of regulators from 13 countries, including Switzerland, that effectively sets solvency standards for banks around the world.

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Under this timetable, the beginning of 2007 is the start date for banks adopting the simplest and intermediate approaches to measuring their credit and operational risks. Those electing to use the more sophisticated options – the advanced internal ratings based approach (A-IRB) for credit risks, and the advanced measurement approach (AMA) for operational risk – will start a year later. Switzerland, like the EU, has decided to apply the new capital regime to all its banks and investment firms, giving them the option to choose any of the three Basel II-designated approaches for measuring both credit and operational risk.

However, apart from the two large Swiss banks, UBS and Credit Suisse (CS), only a very few banks will apply the A-IRB and AMA. Just one cantonal bank and about a dozen foreign banks are expected to implement advanced approaches. Therefore, the focus in Switzer-land is on the simplest – standardised – credit measurement approach, which will be adopted by the vast majority of institutions. National consultation will continue until the end of 2005 among the public and the federal offices on the draft ordinances and circulars implementing the Basel Committee's new minimum requirement into Swiss law.

Impact study

In addition, a quantitative impact study (QIS-CH) is being undertaken during the last quarter of 2005 to test the proposed capital rules. This is being carried out among a representative sample of 77 financial institutions representing about 75% of the actual total capital requirement in Switzer-land's banking industry (excluding the two giants, UBS and CS). This QIS-CH will be the cornerstone for the final calibration of the risk weights and multipliers that will be used in the Basel II standard that is applied in Switzerland. Separately, UBS and CS will participate in an international test run of the new regime – the fifth quantitative im-pact study (QIS5) – together with major banks from around 30 countries.

The Swiss Banking Industry

There are around 350 banks and 70 securities firms in Switzerland. Roughly 125 of them are foreign-owned. These are mainly subsidiaries of banks headquartered in the EU or North America or Japan. These foreign banks focus their activities primarily on private banking. The rest of the Swiss banks are either local universal banks or specialise in wealth management (private banking and asset management).

By contrast, UBS and CS, the two dominating, globally active banks, account for over 50% of the domestic banking business. Abroad —mainly in the US and Britain — they have significant investment banking and wealth management businesses. They also have very sophisticated risk management. But, because of their dominance in the Swiss domestic banking sector and their huge operations abroad they are considered a substantial systemic risk for the Swiss economy. As a consequence, they are subject to close and tailor-made supervision by the SFBC. There is a close cooperation, too, between the SFBC and supervisors in the host countries where these two banks have operations.

On the whole, Swiss banks are profitable and well capitalised: the average ratio of capital-to-risk-weighted assets at the end of 2004 was 12.64%, compared with an official minimum requirement of 8%. In fact, because of the more conservative method used by the SFBC to calculate its minimum ratio, the 8% ratio in Switzerland is equivalent to 10% under a strict application of the existing Basel I rules. And, on top of this, the Swiss supervisor then applies a higher, "soft" minimum, which effectively brings this floor level up to 9.6%. Some two-thirds of Swiss banks have a capital ratio of 16% or above, ie. at least double the minimum requirement.

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The SFBC is eager to minimise the banks' implementing burden, and the changes that it makes to its tried and tested system for ensuring bank soundness. The result is that, although the Swiss standardised approach to credit risk measurement will fully conform to the requirements of Basel II, it will be customised to meet the country's own traditional way of doing things. While, the Swiss capital adequacy rules are actually

Financial profile of some leading Swiss banks

Financial year end December 31, 2004	Total assets Swiss fr. mil.	Pre-tax profits Swiss fr. mil.	Return on equity % (a)	Return on assets % (b)	Total capital ratio (c)	Tier 1 capital ratio (d)	Bad debts ratio (e)	Loan loss cover (f)
UBS	1,734,784	10,674.0	21.43	0.52	13.60	11.80	1.47	68.76
Credit Suisse Group	1,089,485	8,302.0	15.04	0.54	16.60	12.30	2.49	99.54
Zurcher Kantonalbank	80,345	695.0	13.38(g)	0.89(g)	na	na	na	na
Banque Cantonale Vaudoise	32, 295	439.5	15.23(g)	1.25(g)	17.40	16.50	na	na
Migrosbank	27,410	134.2	5.06(g)	0.31(g)	na	na	na	na
Basler Kantonalbank	23,785	296.4	14.21(g)	1.19(g)	na	na	na	na
Luzerner Kantonalbank	18,421	158.9	9.58(g)	0.70(g)	13.00	13.10	na	na
Julius Baer	16,038	274.0	14.53	1.46	17.70	17.70	na	na

Source: Fitch Ratings Exchange rate: $1 = 1.320 Swiss fr; €1 = 1.544 Swiss fr.
Footnotes: (a) = Net income to average equity; (b) = Net income to total average assets; (c) = Ratio of total capital to risk weighted assets; (d) = Ratio of Tier 1 capital to risk-weighted assets; (e) = ratio of gross impaired loans to gross loans; (f) = Ratio of loan-loss reserves to non-performing loans; (g) = Adjusted figures

more lenient relative to Basel II for certain mortgages, they are much stricter and differentiated in relation to interbank transactions and assets where no counterparty is involved. The concentration risk provisions for banks under the Swiss standardised approach will to be tied to the weights of the new capital requirements.

However, it is recognised that this Swiss standard could create problems for the country's internationally oriented banks and large number of foreign subsidiaries that want to demonstrate comparability with their international peers. They would have to calculate their capital adequacy according to two standards – the Swiss standard and the Basel II standard. In order to dispense with this double calculation, the new regulations will allow some banks to adopt an international standardised approach that conforms both to the Basel II provisions and EU directives (concentration risk is not covered by the new Basel rules, but is defined differently under EU law than in domestic Swiss regulations, for example).

This international approach will be available for all institutions fulfilling at least one qualifying criteria indicating an international activity (being listed, applying an international accounting standard, being in possession of a rating from a big rating agency, being a foreign subsidiary, etc.). The international standardised version will be adjusted, using multipliers, to ensure that it does not diverge from the Swiss standardised approach.

Swiss supervisors have no intention of letting the level of capital in the country's banking system fall as a result of Basel II's introduction. A strong capital base is the cornerstone of the Swiss financial system's stability and is essential for customer confidence, which is especially crucial in the asset management and private banking businesses. And, Swiss capital adequacy requirements will continue to be well above the international minimum. An institution with a capital ratio falling below the SFBC's "soft" minimum requirement of 9.6% is subject to particularly close supervision until it is able to get the ratio back above this critical lower limit.

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While the SFBC will thus make some adaptations under pillar 1 of the new Basel capital regime, pillars 2 and 3 will be adopted in full (pillar 1 sets minimum capital requirements; pillar 2 deals with supervisory oversight; and pillar 3 with information disclosure and market discipline). To raise the quality of risk management generally, even banks on the standardised approach will be expected improve their internal risk models steadily towards the levels achieved by banks on the AIRB and AMA.

Swiss regulators will require banks to disclose only the minimum information required under pillar 3, although the SFBC does expect that the bigger and more complex a bank's activities, so the greater its disclosure will be.

As applied in Switzerland, the new capital rules will incorporate several other specifically local features. For example, the rules will allow for a multiplier that is set individually for each bank applying an A-IRB approach. This multiplier will allow the SFBC to control the level of regulatory capital for an A-IRB bank, which is especially important in the case of the two systemically relevant banks.

And, the Swiss supervisor has decided that it will not permit any allocation mechanism under the AMA approach for calculating operational risk. Under the Basel II rules, a cross-border banking group that calculates its AMA risk capital on a consolidated level is allowed to allocate a specific part of its capital to each of its individual subsidiaries. The SFBC regards such artificially attributed capital allocations as unacceptable because there is no certainty about the actual level of capital that will be made available by a parent bank to a subsidiary in the event of a crisis – especially a cross-border crisis. The SFBC will thus require that each subsidiary be fully capitalised on a stand-alone basis.

Basel II can be implemented in Swiss law without amending the country's Banking Act. Unlike in the EU, the new rules do not have to pass the Swiss parliament. The Federal Council (the Swiss federal government) will make the fundamental decisions and set the standardised risk weights and the minimum capital adequacy level via its ordinances. Basel II will be applied through

a new Capital Adequacy and Concentration Risk Ordinance. The technical explanations, with the detailed provisions will be issued in the form of four SFBC circulars on credit risks, market risks, operational risks and disclosure of capital. The Swiss supervisor is still working on an additional circular on concentration risk.

In the case of foreign banks whose parent company abroad applies an A-IRB, a simplified approval process will be offered — as long as this approach results in a capital requirement that is similar to the bank's requirement today.

Text for the new Swiss capital rules has been developed during twelve mostly full-day meetings of a national working group under the leadership of the SFBC. Every party that will be directly affected by the new regulation has been represented in this working group. In this way, the Swiss supervisor has been able to address the banks' concerns and needs without waiting for a public consultation. Banks have been particularly keen to get early publication of the new rules text and the new capital reporting forms so that they and third-party software providers have sufficient lead-time to implement the new regulation. The result has been a broad consensus on most of the questions and problems.

Dialogue meetings

That it proved possible to issue the new draft rules as soon as September 30, 2005 owes much to the fact that the working group focused on the standardised approaches for credit risk as well as on the basic indicator and standardised approaches for operational risk – in other words, on the approaches that the vast majority of the Swiss banks intend to adopt. Questions relating to the advanced credit and operational risk approaches are being dealt with individually in so-called "IRB dialogue meetings" and "AMA development meetings."

For the last three years these meetings have been held regularly. And, in 2004 the SFBC conducted a pre-examination with UBS and CS in order to check the readiness of their internal systems to meet the requirements of Basel II. Both banks met the SFBC's broad expectations.

The aim now is that the final new reporting forms will be ready by end of March 2006. Banks using the standardised approaches are expected to return the filled-in forms to the SFBC by end of May 2007 (reporting on their capital as of end of March 2007).

In spring 2006 the national working group will meet again, to consider the results of the consultation and make the corresponding adaptations to the rules text. Equally importantly, it will calibrate the final risk weights and the multipliers of the new Swiss rules, based on the results of the QIS-CH exercise. The new ordinances will be put forward to the Federal Council in the late summer, in order to become effective by January 1, 2007.

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