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Swiss Federal Banking Commission media conference, April 29, 2004

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Implementation of Basel II in Switzerland

The new Capital Accord is due to enter into force at the end of 2006. Basel II is coming then, even though it is a very laborious process. Since the Swiss Federal Banking Commission (SFBC) regards a strong capital base as the mainstay of our banking system it has opted for the so-called "Swiss finish". In doing so it is relying on solid Swiss pragmatism applied with the requisite measured judgement. Basel II will therefore not sound the death knell for SMEs.

So much has been said and written about Basel II that there is nobody left in this country who thinks we are talking about the reserve team of our national football champion FC Basel. For a more detailed account of the accord I would therefore refer you to the latest Annual Report of the SFBC. Under "Key Themes" (I/2) we set out our ideas on the implementation of Basel II in Switzerland and under "International Matters" (VI/1.1.2) we give details of the ongoing discussions in the Basel Committee on Banking Supervision. If you prefer your information in chart form, we recommend visiting our website and taking a look at the PowerPoint presentations from our Road Show on Basel II[1]. In the short time available I will therefore focus on a few central issues surrounding Basel II.

1. Will Basel II ever see the light of day?

The answer is: yes, but it is a very laborious process.

In summer 1998 the Basel Committee decided that its original Capital Accord (Basel I), which was then ten years old, could not be patched up with just a few modifications here and there, but would need a complete overhaul. We would never have dreamt, however, that nearly six years later we would still not have finished work on the new international minimum capital adequacy standard for banks. With each round of consultations and the statistical data collections that accompanied them (the so-called Quantitative Impact Studies) new problems or objections arose and the time schedule had to be pushed back several times. Last year the whole project threatened to derail when the USA suddenly woke up to certain aspects to which it was fundamentally opposed. It

[1] http://www.ebk.admin.ch/d/aktuell/20030701/m030701_01d.pdf

was salvaged only by the compromise reached in Madrid involving a conceptual change of the internal ratings based approach for credit risks (IRB). We are still chewing this problem over, especially given the fact that the data previously gathered by the banks are of limited use for assessing the impact of the latest changes and are not very reliable in general. The Basel Committee will in all likelihood approve the new accord this summer but will have to make all sorts of changes to it before it goes into force at the end of 2006. By the middle of 2004 then, we will have more than just another consultative document and something more like a solid basis for national implementation processes; it will not be the definitive accord, however.
Too much work and prestige has already been invested in Basel II and too high are the expectations that have been aroused in the financial services industry, which is basically positively inclined towards the accord, for the Basel Committee to risk the project being abandoned. A retreat to Basel I, which is currently still in use all over the world, would not be credible, given that for sophisticated internationally active banks this standard is generally regarded as too outdated and crude a tool. If, contrary to expectations, no agreement is reached with the United States in Basel by 2006, we in Europe, including Switzerland, would have to ask ourselves whether we are prepared to go through with the project alone. For the global operators among the banks this would not be a satisfactory solution, however. It is clear, on the other hand, that we in Switzerland cannot implement Basel II in isolation; this can only be done through an internationally coordinated approach and certainly not before the EU. There can thus be no question of us jumping the gun – an accusation we have heard on occasion.

2. Why do we need a “Swiss finish”?

The answer is: because a strong capital base is one of the mainstays of our banking system.

Basel II is only a minimum standard: the lowest common denominator that regulators and central banks in the G10 countries – of which there are actually 13 – with their individual interests, regulatory systems and above all their differing political weights, can agree on. It is thus open to each individual country to set its capital adequacy requirements higher than the international minimum standard and to make simplifications or incorporate more flexibility into the system, provided that they are at least equivalent. In practice, the upper limits to stricter domestic regulations are dictated by the need to remain competitive internationally and to maintain the attractiveness of one’s own financial centre and banking industry. In this delicate balancing act we can set our Swiss capital adequacy ratios significantly above those of the international minimum standard but not way beyond them. We did that when implementing Basel I in Switzerland and we plan to do the same again with Basel II. Overall we want to keep capital adequacy ratios at the current high level, without either raising or lowering them with the implementation of Basel II. We are not doing this because we seek to be paragons of virtue in everything – as some people with tunnel vision have asserted. There are enough examples of situations where we have not opted to exceed international standards or are even below them and need to catch up – as for instance with international administrative assistance in the field of securities trading or with on-

site inspections by foreign banking supervisors. Where capital adequacy is concerned we are going beyond the international minimum standard because we are convinced of the need for our banking system to have a strong capital base. This is particularly important for the confidence of banking clients in the solvency of our banks, which in turn is a central prerequisite for our wealth management industry. This cautious policy proved its worth during the domestic credit crisis in the nineties, when the banks had losses of some 60 billion Swiss francs to digest, and equally so during the three-year bear stock market which came to an end in March 2003. The fact that capital adequacy ratios in Switzerland are 20 to 50 percent higher than the minimum prescribed by Basel I, depending on the risk structure of the individual institution, is apparently not a competitive disadvantage for our banks. Otherwise it would be hard to explain why at the end of 2003 their capital averaged 156 (2002: 159) percent of the Swiss minimum and almost two-thirds of the banks had as much as double and more of the level required.

One could understand if our two big banks complained, given the keenly competitive international banking environment, that they were not only required to comply at all times with the stricter Swiss minimum standards but also had to accommodate the SFBC's additional target buffer of 20 percent, like all the other banks. The banks are only permitted to fall short of this buffer target temporarily, on specific grounds and under close supervision. Viewed from the standpoint of systemic risk, however, and ultimately the protection of the taxpayer, it would be irresponsible to subject the two banking organizations that account for roughly half of our domestic market and its infrastructure, and are exposed to the manifold risks of the global financial markets through their worldwide operations, to laxer standards than the small and medium-sized banks. With shareholders' equity that does not constitute more than 3-4 percent of their total assets, our global giants and their foreign competitors are far from being overcapitalized. Frankly, the old argument that too much equity encourages companies to spend foolishly appears somewhat incongruous coming from the mouths of highly-paid senior executives. Surely they of all people could be expected to handle their equity capital responsibly and professionally without allowing themselves to be blinded by problematic ratios such as their return on equity.

3. Is Basel II an example of overregulation?

The answer is: no, at least not if it is applied with Swiss pragmatism and measured judgement.

Basel II is not a rigid one-size-fits-all corset but a prime example of flexible, differentiated regulation. By offering a choice of menus between the simple, standardised approach and complex, internal approaches it accommodates the individual needs of banks that are very diverse in terms of size, business and organizational structure, complexity and risks. Basel II is wrongly perceived as standing for regulatory capital adequacy requirements based on complex internal ratings based approaches for credit risk (IRB) and somewhat arcane and yet rather experimental internal approaches for operational risk (so-called Advanced Measurement Approaches, AMA). Granted, IRB and AMA are the biggest conceptional innovations of Basel II; but

here in Switzerland they will be used for regulatory purposes only by the two big banks, a number of subsidiaries of foreign big banks and possibly one or two other institutions. The overwhelming majority of our banks and securities firms will use the Basel II standardised approach, however, which is only marginally more complex than that prescribed by current Swiss law and can still be simplified selectively in the process of national implementation.

We continue to repeat emphatically: we do not expect small and medium-sized banks to go to the tremendous lengths of having complex, internal systems approved by the authorities just to determine what their regulatory minimum capital adequacy requirements are. Nor do we consider such an effort appropriate. Thanks to their ample surpluses they are not in need of a finely calibrated capital adequacy calculation. What we consider reasonable and consequently expect of all banks, is that they make an effort to improve their risk management in line with the focus of their activities. This is best achieved by using the excellent basic principles underlying the internal approaches incorporated in Basel II as a guide and an upper benchmark. Banks that are not involved in complex securitizations or derivative transactions can save themselves the trouble of wading through dozens of pages of extremely intractable prose on this subject in the Basel Accord. Those banks that choose – like the vast majority – the standardised approach for credit risks or even the simple, basic approach for operational risks will get by with reading a tenth of the 600-page compendium at the most.

Occasionally we are asked why we do not apply Basel II (like the United States) just to the biggest internationally active banks but then in its most complex form and leave the rest on Basel I. We agree with our US colleagues that the complex options under Basel II are primarily designed for the top league of internationally active banks and are not suited for general application throughout the system. Basel II in its simplest form is still a clear step forward, however, and merits being adopted in a way that fits our banking system and market.

4. Does Basel II sound the death knell for SMEs?

The answer is: no. Loans to small and medium-sized enterprises (SMEs) will experience some relief under Basel II and will certainly not be discriminated against.

For many, Basel II is synonymous with internal credit rating systems. The banks employ these to assess the individual creditworthiness of their borrowers on the basis of financial and non-financial factors and to assign them to different risk classes with corresponding risk premiums or loan interest rates based on statistical empirical evidence. To start with, this does not apply to the standardised approach under Basel II, which does not use bank-internal ratings but, as under Basel I, relies on a few general risk weighting categories prescribed by the regulatory bodies. It is, however, correct that the more complex options under Basel II now also permit a more flexible calculation of the capital underpinning required for credit risks based on internal ratings. In this, Basel II is merely emulating a system that well-managed banks introduced long ago of their own accord to improve their management of credit risks, thereby disregarding the rather

crude approach to borrowers enshrined in the current capital adequacy regulations. The debate over possible disadvantages suffered by small and medium-sized business borrowers in our country thus goes back years before the launch of the Basel II project and has merely been revived as the spectre of Basel II approached. There are, however, no grounds for concern in this respect because the IRB procedure under Basel II gives preferential treatment to loans to SMEs within the corporate lending portfolio, with additional privileges being accorded to smaller loans in retail banking both under IRB and the standardised approach. On top of this, capital underpinning for credit risks will be generally reduced with the first-time introduction of operational risks as a new category for which capital must be provided.

The lively debate over Basel II and SMEs is nevertheless useful. For one, it has forced banks and regulators to explain in detail the reasoning behind and the criteria used in bank-internal rating systems and to show SMEs how they can improve their ratings. For another, it has helped to promote understanding – even among critics – for risk-adjusted lending policies and pricing that protects the interests of creditors and fosters ongoing economic progress.