Eidgenössische Bankenkommission
Commission fédérale des banques
Commissione federale delle banche
Swiss Federal Banking Commission

Basel II
Implementation in Switzerland
Summary of the explanatory report of the Swiss Federal Banking Commission

Summary of the explanatory report of the Swiss Federal Banking Commission for the consultation among the public and federal offices on the implementation of the revised Basel capital adequacy framework (Basel II) in Switzerland

September 2005

1 Basel II

Basel II goals

The Basel Committee on Banking Supervision published the new Capital Accord (Basel II) at the end of June 2004. The aim of this international regulatory framework is to strengthen the **stability of the international financial system** and – by harmonising capital adequacy requirements at the international level – to improve **the international level playing field among banks**. In general, **the Swiss banking system's overall capital level** should be maintained.

Main points and significant changes in Basel II

The Basel II goals shall be achieved via a **three-pillar principle**. Pillar one regulates the minimum **capital requirements** for various types of risk. Under pillar two, the **supervisory review process,** the supervisory authorities have to ensure that every bank has set up the required internal risk management procedures and has covered the risks not included under the pillar one. Finally, pillar three should provide for **improved disclosure and transparency** to give market participants a better picture of a bank's risk profile and whether its capital underpinning is appropriate to this profile. Stricter, standardised transparency requirements should enforce market discipline.

Operational risks are accounted for separately under the new system. Under Basel I, they were implicitly subsumed by the capital requirements for credit risks. To calculate the capital requirements for credit, market and operational risks, Basel II offers a **menu** of various approaches that are differentiated by bank types. The simple, standardised approaches are less burdensome as regards application and calculation, but their lower degree of specificity leads, as a general rule, to higher capital requirements relative to the complex approaches that are specific to each institution. The latter are more closely related to the internal risk management developed by banks themselves and result in relatively low capital requirements insofar as banks' risk profiles allow. The institution-specific approaches are applied subject to strict conditions and must be approved by the relevant supervisory authority.

Basel II brings significant changes, in particular in the calculation of capital requirements for **credit risks**. Institutions may choose between a **standardised approach** similar to the one already used under Basel I and a new, more demanding **Internal Ratings Based** (IRB) Approach, which comes in two versions: the **Foundation IRB (F-IRB)** and the **Advanced IRB (A-IRB)**. The standardised approach uses predefined risk weights for certain types of credit exposures. Here, creditworthiness is assessed using ratings from external rating agencies where available or alternatively via all-encompassing risk weights as before, albeit ones that are somewhat more differentiated than under Basel I. Basel II allows a wide range of credit risk mitigation techniques under the standardised approach. The institution-

specific IRB approach relies on a bank's own internal ratings of its debtors' creditworthiness.

As regards **operational risks**, the **Basic Indicator Approach (BIA)** and the **standardised approach** are the simple ones. The capital requirement under the BIA is 15% of a bank's "gross income". The calculation is similar under the standardised approach, except that gross income is broken down into eight business lines and each "gross income" is weighted with at its own percentage rate (12%, 15% or 18%). With the **institution-specific Advanced Measurement Approach (AMA)**, the banks have the option of determining their own capital adequacy requirements using an internal model for assessing operational risks.

The **market risk regulation**, under which banks can already choose from a variety of approaches tailored to their needs, remains essentially unchanged under Basel II. Additions and amendments have merely been made in respect of trading activities and the treatment of double default with a view to ensuring smooth interaction between the regulations on market risk and Basel II. The Basel Committee developed the relevant rules jointly with the International Organisation of Securities Commissions (IOSCO).

Basel II timetable

Basel II has the simpler approaches (including F-IRB) coming into force on January 1, 2007 and the most advanced institution-specific approaches (A-IRB and AMA) a year later in order to give the concerned banks sufficient time to prepare for this major changeover.

2 Aims of implementation in Switzerland

The following **five aims** should serve as pointers for calculating the capital adequacy requirements for credit risks.

1. Simple implementation for banks with mainly domestic business

The implementation workload shall be kept as small as possible for the many small and medium-sized universal banks engaged in domestic retail business.

2. Comparability for internationally active banks

Internationally oriented banks have until now calculated their capital adequacy requirements both under Swiss law and voluntarily in accordance with the Basel I provisions. They will in future be relieved from this double calculation.

3. Advanced approaches tailored to large banks

The sophisticated institution-specific approaches for calculating capital requirements for credit and operational risks (IRB and AMA) are mainly intended for internationally active large banks that have the required resources.

4. SME financing not under threat

Implementing Basel II is not intended to endanger the financing of SMEs. Instead, it will involve fully incorporating the leniency Basel II expressly provides for in respect of the capital underpinning of SME loans into the Swiss provisions.

5. Maintaining the Swiss capital level

A strong capital base is a cornerstone of the Swiss financial system's stability and is thus essential for customer confidence, which is especially crucial in the asset management and private banking business. The Swiss capital adequacy requirements shall therefore remain well above the international minimum.

3 Main points of implementation in Switzerland

As is the case with all the members of the Basel Committee (except the US) and of the EU/EEA, Switzerland will incorporate all the approaches in the Basel II menu and the three pillars into its regulation. The IRB, the approaches for operational risks and the changes for market risks will be adopted from Basel II in unmodified form. Switzerland additionally plans to have a bank-specific multiplier for the IRB, allowing the SFBC to give banks more flexibility in applying their IRB and at the same time preventing distortions of competition at national level. Along with up to 20 interested foreign banks, only the two large banks and one cantonal bank are at present intending to use IRBs. Aside from the big two, very few institutions are opting for the AMA. The vast majority will be applying the simple approaches, which is why the implementation of Basel II has largely focused on these. Two versions of the standardised approach for credit risks will be on offer in Switzerland.

Swiss standardised approach

The **Swiss standardised approach** will incorporate in full the changes of Basel II. Otherwise (i.e. in the areas unaffected by Basel II), however, as little as possible should be changed in the tried-and-tested Swiss system in use throughout the country. The risk weights for mortgage and corporate loans are in principle in line with the international minimum. The Swiss capital adequacy requirements are actually more lenient relative to Basel II for certain commercial mortgages with conservative loan-to-value ratios and for Lombard loans. They are much more strict and differentiated, however, when it comes to interbank transactions and assets where no counterparty is involved. The rules in these two areas have not changed at all under Basel II.

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Switzerland will incorporate in full the leniency in respect of capital adequacy for retail and homeowner mortgages, loans to companies with good external ratings and SMEs. The concentration risk provisions for banks with the Swiss standardised approach will continue to be tied to the weights of the capital requirements. The workload for the implementation should therefore be minimal with the Swiss standardised approach.

International standardised approach

Many internationally oriented Swiss banks and a large number of subsidiaries of foreign banks calculate their capital adequacy requirements not only in accordance with Swiss law, but also in accordance with the Basel provisions (BIS ratio) for the sake of better international comparability. In order to dispense with this double calculation in future, the new regulations provide for an **international standardised approach** which, without any divergence from the Basel provisions and in line with EU directives, lays down the capital requirements for credit risks. To prevent capital arbitrage and distortions of competition vis-à-vis the Swiss standardised approach, the capital adequacy requirements under the international standardised approach will be calibrated appropriately with the aid of multipliers. The European Union's approach, which takes gross exposure as the benchmark for concentration risk, will be adopted for the concentration risk provisions. All banks that meet certain criteria concerning international orientation are entitled to use the international approach, but it does involve a substantial workload for the implementation.

Pillar two

The SFBC will maintain its established practice of risk-oriented regulatory supervision. It will continue to monitor the two large banks more closely and individually. It is already in a position today to impose capital increments on top of the requirements under pillar one on a case-by-case basis in line with the risk situation of the institution in question. In confirmation of the practice to date, then, the capital surplus of minimum regulatory capital expected by the SFBC is at least 20%. While undershooting this level is permitted, it would involve closer monitoring of the bank in question and, if necessary, intervention by the SFBC.

Pillar three

In implementing pillar three of Basel II, the Swiss regulations are restricted to the absolute minimum required. For banks with the Swiss standardised approach, the requirements in question are even significantly less strict.

4 Legal framework of implementation in Switzerland

Separate Capital Adequacy and Concentration Risk Ordinance

Basel II can be implemented in Swiss law without amending the Banking Act. As is already the case, the Federal Council will make the fundamental decisions and set the standardised risk weights and the 8% capital adequacy rate via its ordinances. The current Banking Ordinance is already bursting at the seams with comprehensive guidelines on capital adequacy and concentration risk. There was therefore no more room to include the full Basel II menu as well. The Federal Council will accordingly regulate all of the Basel II material in a separate Capital Adequacy and Concentration Risk Ordinance. The provisions of the current Banking Ordinance on capital and concentration risk that are not changed by Basel II will be removed and incorporated into this new ordinance. The provisions of the Banking Act regarding the supervision of groups and conglomerates, which come into force on 1 January 2006, will be explained in more detail in the Banking Ordinance.

Circulars with technical explanations

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 SFBC is still working on an additional circular on concentration risk. The circular on credit risks refers directly for the IRB to the original English-language minimum standards issued by the Basel Committee and is restricted simply to making them more precise wherever necessary.

Quantitative Impact Study

In order to maintain the Swiss system's current endowment with capital, the risk weights for the Swiss standard approach will be definitively laid down in the first quarter of 2006. As the risk weights for the international standardised approach are taken directly from Basel II, they cannot be changed. In order to achieve the aforementioned capital adequacy goal here, too, the level of the capital requirements will be adjusted with the aid of multipliers. For defining the definitive risk weights and multipliers, the SFBC will rely on a **Quantitative Impact Study** (QIS-CH) to be carried out at Swiss banks in the fourth quarter of 2005. The SFBC also intends to undertake an **assessment of the implementation costs** of Basel II in Switzerland in close cooperation with the Swiss Bankers Association in the first quarter of 2006. This assessment will hinge on the support of the banks, especially as participation in the survey will be on a voluntary basis.

Timetable

Switzerland will adhere to the timetable foreseen under Basel II, which has also been agreed by the EU. The drafts of the new Capital Adequacy and Concentration Risk Ordinance and the revised Banking Ordinance are due to be submitted to the

Federal Council in good time for them to **come into force on January 1, 2007**. The SFBC, for its part, will approve the planned circulars in the fourth quarter of 2006 after the aforementioned ordinances have been issued by the Federal Council.

5 Economic impact

Impact on banks

Depending on their risk profile, individual banks may be faced with higher or lower capital requirements than at present. The average capital requirements for small and medium-sized universal banks are unlikely to change to any significant degree with the switch to Basel II. Slightly lower capital requirements under the Swiss standardised approach to credit risks (analogous to the international standardised approach) will make up for the additional requirements for operational risks. Banks will therefore not face any new special charges in terms of capital adequacy.

No negative impact on customers, especially SMEs

Long before Basel II and regardless of any kind of regulation, the banks started to use internal rating systems in their lending business. The new IRB capital adequacy provisions are thus nothing more than narrowing the gap between current bank practice and regulation. To that extent, Basel II has no decisive influence on banks' lending policies. The same applies all the more to banks that use a standardised approach for calculating the capital requirements for their credit risks. This is because there is no direct relationship between the capital requirement in question and changes in a borrower's creditworthiness, except where external ratings are used, which is generally only the case with larger companies. A company’s operating variables, i.e. its economic efficiency, are instead what determines the interest rate charged on a loan via the related risk costs of capital. The switch from Basel I to Basel II will not change anything here either. All the same, by incorporating the leniency proposed in Basel II in full, the Swiss implementation accommodates the concerns of SMEs.

Consequences of differentiation

Differentiation via a large number of approaches obviously means a substantial increase in the volume of regulations, but individual institutions will only have to apply a fraction of these. The differentiating menu approach thus allows the regulations to be applied in a way that is not only cost-effective, but also adapted to each institution's individual needs.