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Basel II – Swiss cuisine with something for all tastes

You may recall that I spoke about the Swiss implementation of the revised Basel Capital Accord – Basel II – at our media conference last year[1]. You can read in the new Annual Report[2] how the national working group is working hard to ensure that the new rules on capital adequacy and risk diversification, together with the explanatory circulars, can come into force on January 1, 2007.

A year ago, I dared to say that Basel II was in no way a case of overregulation if implemented with a healthy dose of Swiss pragmatism and perspicacity – not a set menu, but an *à la carte* regulatory framework for varying needs, with capital adequacy standards remaining well above the all too modest international minimum and a careful approach to loans to SMEs. We agreed with the Swiss Bankers Association (SBA) that, for such an important regulatory project, basic guidelines must be set out at the very top level before the experts start working on the finer points. This led to the addition of a new option to our menu, namely the international standardised approach. The Swiss Federal Council will shortly receive a discussion paper outlining the main points, rather than having to wait until next year and then being confronted with a fully spelt out draft ordinance packed with highly technical content.

So, what are the choices on our extensive menu[3], and whose tastes are they aimed at?

1. The Swiss standardised approach: healthy and traditional native fare with international ingredients

Tailored to universal banks with residential mortgage, retail and SME loans as well as institutions wanting to minimise their changeover workload. Likely to be adopted by the vast majority.

[1] see http://www.ebk.admin.ch/e/archiv/2004/referate2004.html
[2] see Annual Report 2004, page 17ff
[3] see Annual Report 2003, pages 23ff for the list of options defined in Basel II

The basic recipe can be traced back to the 1980 Banking Ordinance, for which an independent, differentiated system of risk weights was developed in the absence of any international standards. The first international minimum standard – Basel I – came from the Basel Committee in 1988 and was much more primitive. It was therefore a more logical progression simply to fine-tune the Swiss system, which was much more risk-oriented, and so new rules on capital adequacy for market risks were developed in Basel and incorporated in 1996/97. However, this "Swiss finish" – unfairly decried by opponents of overregulation – in no way meant that for all transactions a costly Swiss supplement to the international minimum was being forcibly imposed. Instead, the Swiss risk weights applicable to mortgage and corporate loans are precisely in line with the minimum prescribed in Basel I, while those for commercial mortgages with plenty of collateral and for collateral or "Lombard" loans (a Swiss speciality) are in fact lower. On the other hand, we have a much stricter and more differentiated stance on medium and longer-term interbank transactions, assets unrelated to counterparties (real estate and tangible fixed assets), investments and equities.

The changes to the standardised approach to credit risks triggered by Basel II are less than spectacular. We have set a target of integrating these changes completely into the Swiss standardised approach while making as few alterations as possible to the tried-and-tested Swiss system, which is in use throughout the country. What this means in concrete terms, notwithstanding the Swiss quantitative impact study (QIS Switzerland) planned for the fourth quarter of 2005, can be summarised as follows:

- Privileged risk weighting for private corporate debtors with a good external rating (25% or 50%, reduced from the current weighting of 100%)

- Reduction of the risk weighting for top-quality residential mortgages from 50% to 35%

- New, privileged category for retail loans (up to CHF 1.5 million) with a risk weight of 75% instead of the current 100%

- For Lombard loans, the simple Swiss flat rate as before, reduced from 75% to 50%, plus a choice of new and slightly more complex methods introduced by Basel II for risk-mitigating collateral.

The reductions are offset by the new rules on capital adequacy for operational risks, where we adopt the Basel II system unchanged. Basel II provides a choice of two relatively straightforward approaches in this respect: the basic indicator approach using a rate of 15% of the bank's total gross income, or the standardised approach whereby the bank is split into eight business lines whose gross income is subject to rates of 12%, 15% or 18% in order to determine the capital charge.

In a further effort to minimise the changeover workload, the current system for calculating and limiting risk concentrations will be kept as part of the Swiss standardised approach, albeit in a modified form that takes account of the changed risk weights for capital adequacy.

2. The international standardised approach: Basel II pure^{plus} – an EU-compliant *menu touristique*

Tailored to medium-sized Swiss banks with a stock market listing and an international focus as well as subsidiaries of foreign financial groups and all institutions that want to present their capital in accordance with the international standard (BIS ratio) without any double calculation. Considerable changeover workload.

You can read in the Annual Report (Key themes) what motivated us, following constructive dialogue with the SBA, to develop a second, international standardised approach alongside the Swiss standardised approach adapted in line with Basel II. This new approach obviously meets the needs of a certain group of banks, although it is not yet entirely clear who will ultimately make use of it. It is not intended for use by all financial institutions. The expensive set-up of this approach only really makes sense if the approach kept as close as possible to the Basel II requirements – which we refer to as "Basel II pure". The trouble is, Basel II pure cannot be thought of as a uniform concept because the Basel Committee's minimum standards in themselves leave plenty of scope for options and adaptation at national level. When looking for a concrete implementation the EU guidelines are a more useful reference, but even these allow for differences from country to country, so a choice between different variants still has to be made at some stage. There can at most be some scope for incorporating Swissness in cases where the EU does not prescribe specific regulations for a particular type of transaction, for example Lombard loans.

We believe it is important to ensure that banks choosing the international standardised approach, which is less accurate in terms of risk differentiation, are not able to derive a competitive advantage from it or engage in regulatory arbitrage. The target of a solid capital adequacy platform well in excess of the international minimum standard must take precedence. The insufficient capital adequacy with regard to interbank business and assets unrelated to counterparties, as well as the lower risk weight of 20% (compared with 25% in the Swiss approach) for certain privileged transactions, must therefore be balanced out using one or two multipliers. Put simply, the risk-weighted assets calculated as per Basel II pure must be multiplied using not the 8% rate as in the Swiss approach or Basel II pure, but, say, 9% or 10%. We could call this Basel II pure^{plus}. The Swiss capital adequacy requirements, which are higher overall, are thus immediately made transparent without the bank having to make two sets of calculations or post a lower BIS ratio.

An alternative route is also needed for the risk concentration rules, since the EU guidelines use the same limits but a different calculation method. However, for capital adequacy for market and operational risk the same rules apply as when using the Swiss standardised approach.

3. Institution-specific internal procedures for credit and operational risks: the gourmet feast you prepare yourself under the watchful eye of the kitchen inspector

Tailored to large, internationally active banks with a highly sophisticated risk management apparatus. UBS and Credit Suisse Group with Advance Internal Ratings Based Approach (A-IRB) to credit risks and Advanced Measurement Approaches (AMAs) to operational risks. Simpler variant for credit risks, Foundation Internal Ratings Based Approach (F-IRB), conceivable for a few larger domestic universal banks. Highly demanding, large workload.

IRB and AMA are the big innovations in Basel II. The Basel Committee is still busy improving and refining the more complex, institution-specific approaches to credit risks in Basel II and intends to set the definitive risk weights (calibration) in about May 2006.[4] The crux of the IRB approach is that the regulators would like to base their regulatory capital adequacy requirements on the banks' internal credit risk assessments, but would prefer not to accept such estimates unquestioned. The internal assessment procedure should be as risk-sensitive as possible, but should nevertheless result in a sufficiently solid, cautious capital base and avoid the distortion of competition via differing approval standards. The banks, for their part, insist that their meticulous risk management methods be acknowledged by the regulators and that a good risk profile be rewarded with a further reduction in capital adequacy requirements. Balancing out the two sides' interests inevitably leads to ever more complicated regulation with masses of qualitative and quantitative standards. The dogma of risk sensitivity is being pushed too hard for my liking: while it may make sense for internal risk management needs, it is not practicable for regulatory purposes.

There is good news, though, as regards national implementation. The Basel Committee has ironed out all the details for the IRB approach, so there is no need to define everything from scratch at national level. Essentially, all that is needed is a reference to the Basel regulations; everything else can be solved pragmatically in the practical application as long as there is no likelihood of a huge rush of requests. Approving and validating each bank's internal procedures, on the other hand, is a major challenge that calls for proven, experienced specialists. It is no easy task for a government authority to recruit such specialists, let alone keep them.

Our attention here is focused on Switzerland's biggest two banking groups. They intend to adopt the most advanced approaches of all, which according to the Basel timetable will not be approved until early in 2008. The quantitative impact study (QIS 5) planned by the Basel Committee for the fourth quarter of 2005 and the definitive calibration of the international minimum standards will tell us just how large their capital bases will need to be under Basel II. A massive reduction in capital is certainly not on the cards, however. For subsidiaries of foreign banks we have a pragmatic offering.[5]

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[4] see Annual Report 2004, page 96f
[5] see Annual Report 2004, page 20f

4. Swiss branches of foreign banks: the "Cassis de Dijon" principle

If a bank based outside Switzerland operates a branch in Switzerland that is not an independent legal entity, that branch is not subject to the Swiss rules on capital adequacy and risk concentrations.[6] It is instead subject to the rules in force in the parent bank's country of domicile, i.e. that country's version of Basel I and later Basel II. This applies in particular to the provision of cross-border banking services without a physical presence in Switzerland, for which there is no licensing requirement under Swiss law. This is known as the "Cassis de Dijon" principle after an EU ruling stating that a product made legally in one EU country (in the case in point French blackcurrant liqueur) may be sold in any other EU country despite diverging national regulations. I only mention this because, as part of the debate over domestic policy, some think tank might hit on the idea that we have to introduce this principle in our banking sector in order to make allegedly cheaper banking services available and thus boost growth in the industry. The truth is that the principle has been valid in Swiss banking for over 20 years.[7]

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The title of my speech is no exaggeration: the Swiss implementation of Basel II really does cater to all tastes. Differentiated regulation comes at a price, however. The sheer volume of regulations is growing to such an extent that there is no more room in the Banking Ordinance as it stands, and a separate ordinance on capital adequacy and risk diversification is needed. However, efficient regulation that takes account of market conditions cannot be measured by the number of articles in an ordinance or the number of margin notes in a circular. Only a small fraction of the overall framework will ever be relevant to an individual institution, and only this fraction needs to meet that institution's specific needs, regardless of what other exotic treats are on the menu. For the regulator and the specially licenced auditing companies, on the other hand, the amount of choice on offer is something of a challenge. They have to know all the recipes, ensure that they are kept up to date and give advice on how to serve each and every one. It should therefore be clear that differentiated regulation is definitely not a means of reducing the number of regulatory personnel. Even this factor, though, is insignificant in terms of a comprehensive cost/benefit analysis. Realistically, economists will only be able to supply such an analysis in a few years' time when the regulatory machine is already well and truly in motion for quite a while.

[6] Art. 3 para. 1 of the Swiss Federal Ordinance on Foreign Banks in Switzerland of 21 October 1996 (Foreign Banks Ordinance, RS 952.111)
[7] Art. 2 of the Foreign Banks Ordinance of 22 March 1984 (RO 1984 604)