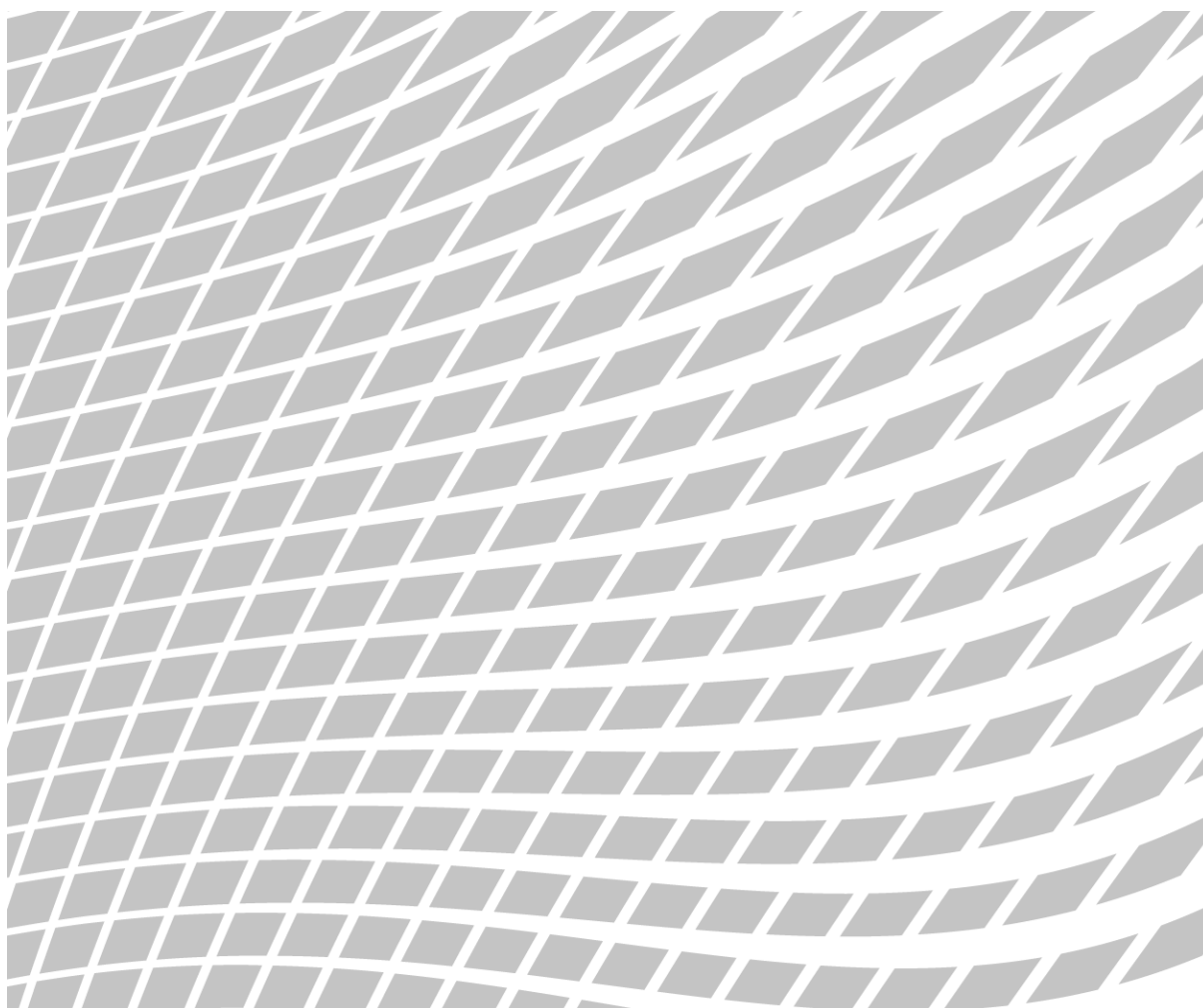


14 July 2010

Key points

Revisions of FINMA Circulars on market and credit risks, capital adequacy disclosure, and risk diversification



The financial market crisis clearly demonstrated the shortcomings in the trading business and securitisations of banks and the fragility of the interbank market. Based on new standards of the Basel Committee and the European Union, FINMA intends addressing these defects and is opening a consultation to adapt four circulars that regulate this area. The consultation is being conducted in agreement with the State Secretariat for International Financial Matters (SIF), which, at the same time, is also holding a consultation on amending the Capital Adequacy Ordinance. Both consultations end on 20 August 2010.

Banks and securities dealers (herein referred to as “institutes”) have for decades been required to adhere to statutory provisions on capital adequacy and risk diversification. Capital adequacy requirements define the minimum amount of equity capital institutes must hold to sufficiently cover loss exposure from their business operations. The aim is to ensure that institutes sustaining substantial losses do not become insolvent, which could in its wake lead to greater financial damage. On the other hand, risk diversification requirements regulate the maximum counterparty risk an institute may take. In particular, it is intended to avoid that an institute runs into financial difficulties and causes widespread financial damage should there be a default in credit payments relevant to the institute’s equity capital.

The international minimum standards applicable to capital adequacy are set down by the Basel Committee on Banking Supervision of which Switzerland is also a member. At the beginning of 2007, the new minimum standards of the Basel Committee (“Basel II”) were implemented in Swiss law, on the one hand, by the enactment of the Federal Ordinance on Capital Adequacy and Risk Diversification for Banks and Securities Dealers (Capital Adequacy Ordinance, CAO), and on the other hand, by the entering into force of the FINMA circulars (FINMA-Circ.), which contain the implementing provisions for the CAO. Neither in “Basel II” nor in “Basel I”, which was valid until the end of 2006, did the Basel Committee issue any detailed provisions on risk diversification requirements. Subsequently, since the 1990s, Swiss risk diversification requirements have essentially been based on EU regulations for large exposures. By integrating Basel II into Swiss law, the current provisions have been supplemented by an approach that comes very close to EU regulations: “the international approach to risk diversification.” Alongside the implementation of Basel II in Switzerland, it was combined with the international approach to covering loss exposure from credit transactions in order to save internationally active institutes from having to make costly and time-consuming double-entry calculations, a concern which the institutes themselves had voiced. In the meantime, more than 40 Swiss institutes, amongst which are also Switzerland’s two big banks and numerous foreign bank subsidiaries, apply the international approach to risk diversification.

Prior to the financial crisis, the Basel Committee and the EU were actively making improvements to “Basel II” and the EU regulations on loss exposure (and risk diversification). The financial crisis considerably influenced these reforms, particularly in the case of Basel II, in terms of time and content. In July 2009, the Basel Committee published its first response to the financial crisis by tightening the provisions on covering loss exposure from trading operations and securitizations, which stood at the core of the financial crisis. Likewise in July 2009, the EU published its revised requirements for large exposures and risk diversification. In December 2009, the Basel Committee went on to issue its proposals for a further comprehensive revision of its minimum standards. This is unofficially referred to as “Basel III” and should be concluded in the course of 2010.

The proposed amendments concern the CAO and four FINMA circulars containing the relevant implementing provisions. These changes aim to safeguard the continuing compatibility of Swiss regulation with the international reference standards applicable; even more importantly from a prudential viewpoint, it is intended that the new rules, which are to enter into force as planned at the beginning of 2011, will eliminate the deficits in the current regulations which emerged during the financial crisis.

The financial crisis has demonstrated abundantly clear that capital adequacy to cover loss exposure from trading operations and securitizations was too low. This was clearly the case for institutes with investment banking units whose equity capital for market risks was determined on the basis of a model approach (key word "value at risk"). The revised Basel prescriptions, which will cause these institutes to significantly increase their capital adequacy requirements for market risks (at least three times higher than is specified in the current requirements), will be adopted unchanged in the Swiss regulatory framework. Apart from the two big banks, there are four other institutes using the model approach that will be affected. Other institutes which do not apply the model approach will only have a marginal capital adequacy increase of just under 5%.

The financial crisis additionally brought to light the fragility of the financial system. In many countries state intervention was necessary to avoid a chain-reaction collapse of institutes as a result of their credit relationships (interbank claims). The revised EU large exposures regime directly addresses this issue, in particular, by considerably limiting the volume of authorised interbank claims between institutes. (The maximum credit authorised for other counterparties such as companies, regional administrative bodies, etc. has, however, not been changed). Although other items of the EU large exposures regime have also been amended, only substantial changes considered prudential from a national viewpoint have currently been integrated into Swiss regulations. The present amendment to the CAO focuses on the adjustments to the international approach to risk diversification which is being applied by a good 40 out of the over 300 institutes in Switzerland. The "Swiss approach to risk diversification" used by the majority of Swiss institutes will not be altered. Rather, within the framework of "Basel III", this approach will be adapted in the coming years to keep in line with international developments. The extent to which regulations on the international approach will be tightened depends on the size of the institute. Here tightened restrictions refer to a reduction of the maximum amount or limit of an interbank claim: in terms of the current regulations, this implies a reduction of 20% for small institutes, 80% for big banks (including both big banks), and 20% – 80% for medium-sized institutes. Whether these restrictions, or rather reductions, are relevant in practice depends on the extent to which institutes have already come close to exceeding their limits under the current regulations. This issue has been examined in an empirical study conducted over a period of 5 quarters, in which 8 institutes participated. Only in the case of one (big) institute was the limit notably exceeded under the tightening of restrictions applicable (80%, i.e. a maximum limit that is 5 times lower than the limit currently prescribed).

The planned regulations outlined above will substantially affect the Swiss big banks, and concerns them and their international competitors equally. These tightened restrictions do not emanate from the too-big-to-fail debate, which is also being conducted at international level, but rather the whole issue involves regulations specific to system-relevant big institutes that go beyond the current regulations applicable to all institutes. In this regard, the particular size of a big bank in relation to the economy has to be taken into account in Switzerland.