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Basel II Switzerland: a precision landing

Since 1998 the SFBC Annual Report has contained information on the revision of the Basel Committee on Banking Supervision's Capital Accord (Basel II). The focus has gradually shifted from the international level, where the minimum standard was drawn up over a period of many years, to the level of national implementation. The SFBC Annual Report 2005 is therefore primarily devoted to the implementation of Basel II in Switzerland, while still not losing sight of the ongoing work of the Basel Committee.¹ At both levels it represents a massive regulatory project that ties up enormous resources on the part of both banks and supervisors, but that should – at least as far as the texts of the regulations and calibration are concerned – be concluded in 2006. However, the focus at each level is different: in Switzerland, the vast majority of small and medium-sized institutions will primarily rely on the basic, standard approaches for Basel II. At the international level, however, in most cases work is still ongoing to fine-tune the advanced, institution-specific internal approaches (IRB and AMA) that the two globally active major Swiss banks will also apply from the start of 2008 onwards. The Swiss provisions for these sophisticated approaches are largely based on the rules drawn up by the Basel Committee, meaning that our involvement in this regard is focused on our active role within that Committee and its numerous technical working groups as well as the intensive and protracted acceptance process for the applicant banks.

In my speech I would like to update you on the current situation as regards the implementation of Basel II in Switzerland. However, I cannot provide you with any additional information on the results of the Quantitative Impact Study 5 (QIS5), the international study into the impact of Basel II conducted by the Basel Committee in the fourth quarter of 2005 – at the same time as the national study in Switzerland (QIS-CH). The data obtained from a large number of banks from all member countries of the Basel Committee but also those outside the G10 is currently being analysed in depth and will be evaluated by the Basel Committee at the end of May with a view to possible recalibration.

¹ SFBC Annual Report 2005: national implementation p. 15ff.; Basel Committee p. 97ff. (German) or p. 11 ss and p. 97 ss (French)



It has been agreed that national supervisory authorities will not publish even country-specific findings until the full results of QIS5 are published by the Basel Committee, but will simply communicate them informally to the institutions concerned. This decision has to be respected in the interests of ensuring a coherent opinion-forming process, even though it would be helpful from a domestic policy point of view to go ahead now and highlight the trends at the two major Swiss banks that took part in QIS5.

Results of the Swiss consultation process

In the fourth quarter of 2005 the Banking Commission consulted with official bodies on the draft text of the ordinances and circulars together with a detailed explanatory report on the implementation of Basel II. The drafts essentially met with approval, particularly in those circles which had originally feared that Basel II would threaten lending to SMEs. As the subject matter is highly technical, criticisms from the most directly affected group – the banking associations – focused primarily on specialised technical issues and practical proposals for simplifications designed to facilitate cost-effective implementation without any significant deviations from the universally accepted objectives. These criticisms have since been addressed through a constructive dialogue in the national working group that prepared the consultative drafts, and mutually resolved.

However, the banking associations' approval in principle of the concept for the Swiss implementation of Basel II was subject to a key general condition. Understandably, they requested that the calibration of capital adequacy requirements based on the quantitative impact study be carried out correctly, transparently and in full consultation with all parties involved, in the national working group and in accordance with the objectives formulated. Since the Swiss quantitative study was carried out at the same time as the consultation on the text of the regulations, the banks were unable to submit a definitive opinion on the risk weightings and multipliers proposed. At the end of the day, the key is how much capital is required under the new rules for the entire banking system and for individual institutions, how this compares to existing laws or – where relevant – to those applicable to foreign competitors, who the winners and losers are, whether the incentive structure is correct, and what changes can be expected in the future.

Results of the national study (QIS-CH) into the quantitative impact of Basel II in Switzerland

We published² the data obtained from 77 institutions on 11 April 2006 together with our comments. I can therefore restrict myself here to a summary of the most important findings:

- The purpose of the national study was to assess, on the basis of calculations from a representative sample of institutions, whether the quantitative goal of meeting overall capital adequacy requirements in the banking system (excluding the large banks)

² http://www.ebk.admin.ch/d/dossiers/pdf/Analysebericht_d.pdf (German) or
http://www.ebk.admin.ch/f/dossiers/pdf/Analysebericht_f.pdf (French)



can be achieved with the proposed risk weighting rates and rules for the Swiss implementation of Basel II. The study limited itself to the simple, standard approaches for credit and operational risks, which were compared with the currently applicable capital adequacy requirements under the Swiss version of Basel I.

- The starting point and first benchmark of the comparison with current law was the Swiss standard approach for credit risks, augmented with the new elements of Basel II, and the newly introduced requirements for operational risks, which were adopted unchanged from Basel II (Basel II SA-CH). The result, as you can see from the graphical representation of the relative change between Basel I and Basel II SA-CH, is an accurate precision landing. According to the system, the overall capital adequacy requirements of the 77 institutions amalgamated to form a single, overall bank – known as the weighted average – fell by just 2.34%. This slightly negative value would increase only negligibly if the institutions made full use of all the reduction options offered by the new rules. We have therefore been spared the trials of a recalibration exercise, which would have become especially politically sensitive if certain risk weighting rates (e.g. for residential construction mortgages) had had to be increased.
- The redistribution effect of the new Basel II rules is also very balanced: almost half of the institutions need to hold less capital, while the other half have higher requirements. The relative change is unevenly distributed, however. As is to be expected, the cantonal, regional and Raiffeisen banks active in traditional lending business, primarily with residential construction mortgages and retail loans (including small-scale corporate loans), tend to have a lower capital requirement than before. Conversely, the new requirements for operational risks lead to a relatively sharp increase in capital requirements particularly among those institutions that focus primarily on asset management, investment advisory or trading services. However, these are generally the same banks that currently have very large capital surpluses, as they are exposed to relatively few credit and market risks and were therefore only marginally affected by the rules, which until now have only targeted these risk categories. This means that, for them, the relief granted in respect of credit risks cannot compensate for the increase necessitated by requirements for operational risks, leading to a reduction in their high capital surplus. In no cases, however, does the new regime result in a capital deficit.
- The second aim of QIS-CH was to determine the size of the multipliers required to bring the international standard approach for credit risks (SA-BIZ) offered as an alternative (and now, following the consultation process, available without restrictive conditions to all institutions) up to the same level as the Swiss standard approach (SA-CH). This approach, which we also refer to as Basel II pure, is the truest and most flawless possible implementation of the standard approach from the Basel II rules or the EU Directive, with no additions, omissions or simplifications on the part of Switzerland. The comparative study of the two approaches showed that while the Swiss standard approach on average leads to higher capital adequacy requirements, these are not as high as had been assumed in the multipliers proposed in the consultation package. The multipliers were therefore reduced accordingly and are being accepted by the banks.



No cost analysis, but no adverse effect as a result

In the explanatory notes to the consultation package and in the Annual Report 2005 the Banking Commission announced that it planned to carry out an analysis of the costs of implementing Basel II in the first quarter of 2006 in cooperation with the Swiss Bankers Association. Unlike QIS-CH, which looked at the impact of Basel II on capital adequacy requirements, the aim of this analysis was to estimate the costs of preparing for and changing over to Basel II in the banks as well as its subsequent day-to-day application. After we had prepared the corresponding survey and discussed it in the national working group, the heads of the Bankers Association and the Banking Commission agreed at the beginning of April not to carry out the Basel II cost analysis after all. Meaningful cost estimates are difficult to draw up and involve a great deal of time and effort on the part of all those involved. The timing was felt to be unfavourable, as firstly the banks are already heavily weighed down with their changeover projects, and secondly work on the rules is already so far advanced that major changes appear almost impossible in any case given the tight schedule. At the same time, a reliable cost analysis could not be carried out if the rules to be applied had still not been sufficiently defined. We therefore frequently run the risk of being too early or too late with the cost estimate.

Both parties are also in agreement, however, that the decision not to proceed with the analysis in the Basel II case should not prejudice quantitative cost/benefit analyses for subsequent regulatory projects. Principle 2 of the Guidelines for Financial Market Regulation³ published by the Federal Department of Finance in September 2005, which the Banking Commission played a major role in formulating and which we feel obliged to comply with, expressly requires the regulatory authorities to estimate as accurately as possible the impact and costs of regulation for those affected and weigh these against the expected benefit. We will therefore develop the methodology for such analyses in conjunction with the Bankers Association and select a suitable regulatory project. Basel II was perhaps too great a challenge as an initial test subject. However, the basic concept of weighing up costs and benefits and above all differentiating according to varying needs was applied in full at every stage of the regulation process for the Swiss implementation of Basel II.⁴

Conclusion

We have reached the home straight for the Swiss implementation of Basel II. Agreement has been reached with the banking associations affected on all key issues. The national working group is taking care of the final, detailed adjustments and is also examining the deferred consultative proposal for a Banking Commission circular on concentration risk and the capital requirements for guarantees and credit derivatives.⁵ At the end of June 2006 the Banking Commission will deliver the proposal for publication of the ordinances to the Federal Department of Finance for submission to the Federal

³ <http://www.efd.admin.ch/dokumentation/grundlagenpapiere/00818/index.html?lang=en>

⁴ cf. Daniel Zuberbühler, Basel II – Swiss cuisine with something for all tastes, SFBC media conference on 19 April 2005, http://www.ebk.admin.ch/e/publik/refer/pdf/050419_Referat_Z_e.pdf

⁵ http://www.ebk.admin.ch/d/regulier/konsultationen/060306_01_d.pdf (German) or http://www.ebk.ch/f/regulier/konsultationen/060306_01_f.pdf (French)



Council and complete its own five circulars. Provided the Federal Council approves the ordinances in the autumn, Basel II can enter into force in Switzerland for the simpler approaches on 1 January 2007. In accordance with EU law a generous deadline of the end of March 2008 will be set for application. Under the guidelines issued by the Basel Committee and the EU, the advanced approaches for Basel II (Advanced Internal Ratings Based Approach for credit risks and Advanced Measurement Approaches for operational risks) will be available from 1 January 2008.

While it would be unwise to count our chickens before they're hatched, we are nevertheless confident that the highly complex Basel II regulatory project will be successfully completed by the end of this year. The national working group headed by Daniel Sigrist, Head of the Banking Commission's Risk Management Group, already merits particular praise; it has conducted its discussions in an open and constructive spirit, and both sides have put in an immense amount of work. One final example of the close cooperation between regulators and those subject to regulation in the Swiss financial sector is that the national working group is to remain in existence even after Basel II comes into force in order to jointly address the questions of interpretation that will inevitably arise in the months and years following implementation.