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New risk diversification regulations for banks in Switzerland

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During its meeting on 22 November 2017, the Federal Council adopted a revision of the Capital Adequacy Ordinance (CAO), bringing risk diversification regulations into line with the Basel III international banking standards.

These new rules, also referred to as large exposure rules, impose a maximum limit on the size of loans in order to reduce the risk of a bank encountering financial difficulties as a result of a default on a large loan.

FINMA has updated the relevant provisions in the Circular 2019/1 "Risk diversification – banks", which will enter into force on 1 January 2019. Although facilities are granted to smaller institutions (banks in categories 4 and 5), these new provisions represent a definite tightening of rules from a Swiss perspective, and could have significant implications for the business activities of many banks.

The main changes

The new Basel III risk diversification rules bring changes which need to be taken into account in a number of key areas. We have summarised them for you on the next page.

The main changes concern the basis for measurement and replacement of the maximum limit.

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Element	*Previous regulation*	*New regulation*
Basis for measurement and maximum limit for cluster risks	Corrected eligible total capital (Tier 1 and Tier 2)	Corrected eligible core capital (Tier 1) • Small banks: additional hidden reserves in provisions
Possibility to exceed maximum limit of 25% with free equity	Permitted	• Principle: **not permitted** • Exception for interbank business
In addition: exemptions from the maximum limit of 25% and extended reporting obligations		

25% of total capital is no longer taken as a reference value when calculating the maximum limit. Instead, only core capital (Tier 1) is used as the basis for measurement. Smaller banks may also include hidden reserves recorded in "Other provisions", after deduction of deferred taxes.

- In principle, large credit exposures exceeding 25% of a bank's core capital are no longer permitted under the new rules. This also applies to interbank exposures, the only exception being intraday exposures. A number of facilities are also granted to smaller institutions for entering into interbank positions with non-systemically important banks.
- In the case of larger residential real estate loans, the limit applies to the entire loan amount, whereas up to half of the market value of the property was previously not covered by the limit. Banks in categories 4 and 5 can continue to enjoy privileged treatment under the previous regulations. However, this only applies to loans for residential real estate in Switzerland, for which the first 50% of market value can still be weighted at 0%.
- Swiss mortgage bonds may only be issued by two institutions, i.e. the respective central institutions of Swiss Cantonal Banks and of all other mortgage lenders. This small number of issuers makes it impossible for supervised institutions to diversify risks. FINMA favours a Look-Through-approach as an option. Instead of allocating Swiss mortgage bond exposures to the relevant issuing institution, this option entails allocating Swiss mortgage bond exposures to these institutions' member banks. Given that the implementation of the Look-Through-approach is seen as complex in relation to the risk underlying most funds, facilities are granted to banks in supervisory category 3 which hold fund units in negligible amounts (see margin no. 335 of FINMA Circular 17/7 "Credit risks – banks"). Banks in supervisory categories 4 and 5 may choose to apply a threshold of 2%. Despite this threshold, banks will still have to introduce the Look-Through-approach due to future equity capital developments.
- In future, cluster risk reports must not only be submitted to the auditors, but also to FINMA. The reporting scope will also be considerably expanded. As well as providing details of total exposure taking into account risk minimisation measures, the "gross value" of exposures will now also have to be reported, i.e. disregarding risk minimisation measures.

Total exposure and credit risk mitigation techniques

As mentioned above, the modified Basel minimum standards for risk diversification also bring changes in relation to large exposures, particularly if credit risk mitigation techniques have been utilised. The current approach for measuring total counterparty credit risk exposures and their weighting is known as the comprehensive approach. This is currently based only on net exposures, taking into account credit risk mitigation techniques in the form of financial guarantees.

Under the new risk diversification regulations however, the collateral taken into account is also explicitly allocated to its issuers (as was previously the case with the "simplified approach") to better reflect any concentration risks in terms of coverage. This is an important modification which requires aggregation and close monitoring of collateral by banks. It will lead to considerable changes and to potential cluster risks, particularly for major banks and for banks with large lombard loans and risk concentrations.

Collateral received by banks on the Swiss repo trading platform will however be permanently excluded from this new regulation. Furthermore, collateral only needs to be included in total exposure in relation to the relevant issuer if it exceeds certain thresholds. As banks do not always have full control over the receipt of collateral, they will be given a period of three months in which to implement risk mitigation measures to bring any risk concentrations below the applicable maximum limit.

However, this new regulation also contains exemption clauses, depending on the category of the bank. Under the comprehensive approach, banks in categories 4 and 5 do not need to account for the collateral they receive. If a bank exercises this right, it must take appropriate measures to limit and monitor the resulting concentration risks. Regular stress tests must be carried out in relation to these credit risk concentrations. The tests must take into account the recoverable value of all relevant collateral.

A category 3 bank can benefit from the same exemption provided that the gross value of its entire lombard loan portfolio does not exceed 25% of its eligible core capital. However, it can be said that this exemption for banks operating in the area of wealth management has been set at a very low level, and is therefore only likely to be of relevance to locally based banks in the retail segment.

Special rules for systemically important banks

For systemically important banks, core capital is now also used as the basis for measurement when it comes to limiting cluster risks. This is a simplification in comparison with the previous regulations, which used hard core capital as the basis for measurement with regard to the maximum limit of 25%.

In accordance with international standards, a maximum limit of 15% now applies when dealing with a counterparty that is a systemically important Swiss bank or a global systemically important foreign bank.

Major banks and banks operating internationally face a number of key challenges due to the new rules: meeting requirements for determining connected counterparties, consistently measuring total exposure taking into account credit risk mitigation techniques in the trading book, and recording collateral for aggregation with other cluster risks. The action to be taken should not be underestimated.

Transitional provisions

By modifying the transitional provisions in Art. 148g of the CAO, the Federal Council has also provided an opportunity to apply the market value method for derivatives and the previous rules for fund investments held in the banking book for an additional two years beyond 31 December 2017, i.e. until 31 December 2019.

Furthermore, since the end of 2017 amounts due from the Central Depository SIX SIS AG are to be reported as amounts due from customers due to its loss of banking status. The reason for this accounting change is the introduction of the new licensing category "financial market infrastructures" in accordance with FMIA. This new accounting treatment results in an unintentional tightening of rules for small banks. Until further notice, FINMA has decided that – irrespective of the accounting treatment – institutions may continue to consider amounts due from SIX SIS AG and SIX x-clear AG as amounts due from banks for risk diversification and capital adequacy purposes.

With the exception of these transitional rules, the changes described above must be consistently implemented from 1 January 2019, unless the CAO is modified again before this date.

We can offer you the following support during implementation

The challenges for your institution (bank, securities dealer or financial group) are multifaceted. Besides the introduction of the new measurement processes, you will no doubt have to review your limit setting and reporting systems to ensure that no limits are exceeded.

Particular attention should be paid to verifying major loans, given that exceptions for residential real estate loans have ceased to apply, in order to prevent the corresponding limits from being exceeded from 1 January 2019.

In accordance with the transitional regulations of the CAO, all positions expected to exceed the maximum limit on 1 January 2019 should originally have been reported to FINMA by the end of March 2018 (see example). FINMA has since extended this deadline to the end of May 2018.

An initial assessment of the effects has shown that under the new rules, it is possible that the relevant maximum limit may be exceeded, depending on the size of the bank. It should also be noted that the impact study carried out was still based on the market value method according to the previous version, and not on the standardised approach (SA-CCR) introduced on 1 January 2017 which, according to our analysis, will have further noticeable impact. PwC has addressed the new requirements and the additional changes in detail. We can help you to assess the effects of the new risk diversification regulations on your institution, and assist you with the implementation and revision of your internal processes, rules and controls.

Example of measurement

Bank's equity: 100 million (including 80 million Tier 1 capital)
Large loan: 22 million (with 50% collateral)

Previous rules	**New rules**
Maximum limit: 25 million (25% of total capital)	Maximum limit: 20 million (25% of core capital)
Cluster risk: 0 million (exception: collateral ≤ 50%)	***Cluster risk:*** 22 million (exceptions no longer applicable)
No limits exceeded	***Limit exceeded****

*Securitisation with free equity is no longer possible. Facilities are granted to smaller institutions (collateral of up to 20%)

Your advantages – our approach

- Early evaluation of the effects of risk diversification regulations – Have you already calculated the impact on the credit portfolio of your institution and/or your financial group?
- Evaluation of the internal controls with respect to loan restrictions and the monitoring of cluster risks – Have the necessary processes, monitoring systems and controls been implemented?
- New rules for credit mitigation techniques – Have your IT systems been adapted yet?
- Implementation of changes in relation to the aggregation of connected counterparties, the determination of concentrations in collateral received and the consistent implementation of total exposure and credit risk mitigation techniques, particularly in the trading book
- Clarification of the applicability of capital adequacy requirements for investments in assets under management – Has the Look-Through-approach been implemented yet?

Have we sparked your interest? We would be very happy to answer any questions you may have about risk diversification regulations!