

Basel III Finalisation

An overview of changes and
the expected impact on Swiss
banks

December 2021

Basel III Finalisation in Switzerland

Overview

In response to the last global financial crisis, the Basel standards were revamped and updated to support and guide post-crisis global reforms. The BCBS published the final documents on the Basel III Finalisation package in December 2017, which is generally referred to as “Basel III Finalisation” or “Basel IV”, with a primary goal of improving resilience within the global banking system. The revised set of standards covers multiple sets of regulatory changes, across all risk types, which seek to enhance the quantity and quality of regulatory capital and liquidity. Goals are to restore credibility in RWA calculations by enhancing the robustness and risk sensitivity of the standardised approaches, to constrain the use of internal model approaches to improve comparability and reduce complexity and to complement the RWA capital ratio with output floor and leverage ratio requirements.

The go-live date of the Basel III reforms has been formally deferred by the BCBS by one year due to the COVID-19 crisis, from the originally planned implementation date of January 2022, to January 2023.

Timeline for Switzerland

The implementation of these rules in Switzerland is currently under discussion by the National Working Group, with no formal announcements yet. We expect the implementation in Switzerland to be largely aligned to that in the European Union (EU), with limited deviations from the BCBS standards. The European Commission recently published its legislative package, with an application date of 1 January 2025. From a Swiss perspective, we expect that the consultation phase will start early 2022, with an official consultation of a revised Capital Adequacy Ordinance kicking-off in April 2022. As such, and as confirmed by a recent announcement by the Swiss Federal Council, we currently expect that the new Swiss regulation will be in force at the earliest in 2023, but as for prior regulations, we expect that a transition phase of at least one and a half years will be granted, so that from a regulatory point of view, all banks have to be ready to go-live under the new regulations probably from July 2024 onwards, or latest in January 2025 to be aligned to the EU.

Aspects not covered under Basel III Finalisation

Elements out of scope of the current Basel III Finalisation framework:

- ▶ Sovereign exposures - the BCBS noted that the Committee had not reached a consensus to make any changes to the treatment of sovereign exposures. Given the political nature of this particular topic, we don't expect any material changes to this in the immediate future
- ▶ Specialised lending - it was noted that banks would be permitted to continue using the advanced and foundation IRB approaches, and that the Committee will review the slotting approach for specialised lending in due course
- ▶ Climate risk and other elements of ESG
- ▶ Prudential treatment of banks' cryptoasset exposures (consultation paper by BCBS published for consultation by September 2021)
- ▶ Principles for Operational Resilience (issued by the BCBS in March 2021)
- ▶ Minimum haircut floors for securities financing transactions (consultation closed by the BCBS in March 2021)

Upcoming topics to be potentially addressed by the BIS Innovation Hub (Work programme FY 2021/22):

- ▶ SupTech and RegTech (AI / ML, market monitoring, data analytics)
- ▶ Next-generation financial market infrastructures (capital markets projects, foundational digital infrastructures, tokenisation of assets, cross border payments and payment infrastructures)
- ▶ Cyber security
- ▶ Central bank digital currencies (wholesale and general purpose CBDC, in-house DLT capacity)
- ▶ Green finance

60%

of respondents expect the quality and availability of data to be the most significant challenge in delivering the Basel III reforms

67%

of respondents have a governed, funded and resourced Basel III Reform program in place

Basel III Finalisation in Switzerland

Basel III Finalisation will impact all Swiss Banks, independent of size and business model, across all risk types.

The changes required to comply with the finalised Basel III rules emphasize the need for comprehensive management and capital underpinning of financial and non-financial risks. Banks can position themselves for the future by designing a risk management function that can adapt to these requirements whilst supporting the business. If no actions have been undertaken to date, then this work should begin without further delay.

The specific changes introduced by the Basel III Finalisation are described in detail on the following pages. We have clustered these changes along the following six areas, which we will address separately.





Credit Risk

STANDARDISED APPROACH (SA)

Objectives

- ▶ Improving granularity and risk sensitivity across the exposure classes (e.g. LTV dependent real estate risk weights)
- ▶ Reducing reliance on credit ratings by requiring due diligence
- ▶ Providing the foundation for the revised output floor (refer to Capital section)

Key Changes

Due diligence is required whether using external ratings or not. Two assessment approaches are possible:

- ▶ External Credit Risk Assessment (ECRA), where external ratings are available and use is permitted by the national regulator, and
- ▶ Standardised Credit Risk Assessment (SCRA), for all other cases

Under the SCRA, additional differentiation of exposures (with some exceptions expected for banks in the categories 3-5):

- ▶ Banks are graded A, B, or C - depending on capacity to meet financial commitments and regulatory requirements
- ▶ Corporates are classified in investment grade vs. other, and require greater scrutiny (even when using external ratings)
- ▶ Real Estate risk weights follow classification between commercial and residential real estate, and are based on Loan-to-Value (LTV) ratio as main risk driver, with new categories and risk measures introduced
- ▶ Risk-sensitive haircut formula introduced, removal of option to use internal models and own estimates for haircuts
- ▶ Multiplier for currency mismatch for unhedged exposures

Expected Impact on Swiss Banks

All banks impacted, irrespective of current RWA calculation approach:

- ▶ RWA may increase due to partially higher risk weights in corporate segments, whilst mortgage portfolios with relatively low LTVs will benefit from lower risk weights
- ▶ For banks using the F/A-IRB approaches, the new SA will be used to determine the RWA floor and to calculate capital on all non-IRB portfolios
- ▶ New SA will be mandatory for all banks, with no Swiss "finish" envisaged
- ▶ New regulation requires due diligence processes also when using external ratings to assess credit risk, requiring enhanced internal risk assessment processes
- ▶ Changes to rules for real estate exposures require new data inputs
- ▶ Additional data inputs for haircuts of collateral and currency mismatches required

INTERNAL RATINGS-BASED APPROACH (IRB)

Objectives

- ▶ Reduce excessive complexity in terms of specific models, whilst increasing comparability between banks
- ▶ Improve robustness for certain asset classes that are difficult to model (often with limited input data)

Key Changes

- ▶ Move low-default portfolios to F-IRB or SA:
 - ▶ Large & mid-sized corporates (revenues \geq €500m)
 - ▶ Banks & financial institutions
 - ▶ Equities in the banking book (SA only)
- ▶ PD floors are recalibrated (for F-IRB and A-IRB)
- ▶ LGD and EAD floors are introduced
- ▶ Adjustments to LGDs for the F-IRB approach
- ▶ Greater specification of practices that banks may use for the model parameter estimation
- ▶ Removal of 1.06 scaling factor requirement
- ▶ Specialised lending to remain under A-IRB (for now)
- ▶ Various new disclosure requirements under the revised Pillar 3 framework

Expected Impact on Swiss Banks

Only impacts a small number of Swiss banks that currently apply the IRB approach:

- ▶ Where A-IRB is used for financial institutions and corporates portfolio, RWA will increase
- ▶ Accounting standards might require the use of modelling for some portfolios that will become unavailable for regulatory purposes
- ▶ Impact of parameter floors will be portfolio and jurisdiction driven
- ▶ More complex calculations to ensure all parameter floors are correctly applied



Operational Risk

Objectives

- ▶ Improve the comparability and simplicity of the operational risk RWA
- ▶ Complexity of larger organisations is taken into account by making the relationship between gross income and risk exposure non-linear

Key Changes

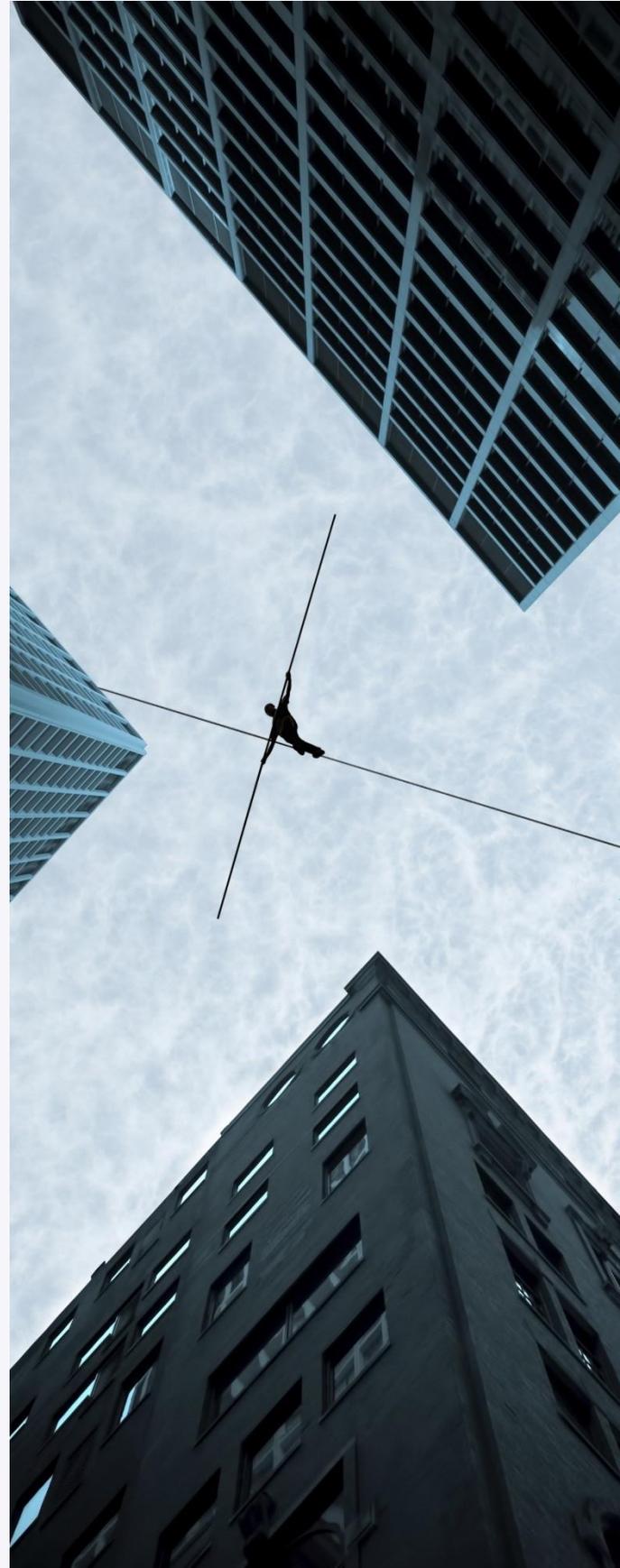
- ▶ New standardised measurement approach (SMA) replaces all existing methods (incl. AMA) and is applicable for all banks (not model-based anymore)
- ▶ New SMA formula (non-model based):

$$\text{Operational Risk Capital} = \text{Business Indicator Component (BIC)} \times \text{Internal Loss Multiplier (ILM)}$$

- ▶ BIC as a proxy of operational risk exposure assumes that operational risk increases at an increasing rate with a bank's income. Calculated by multiplying several components by marginal coefficients to correspond to a progressive measure of income that increases with a bank's size
- ▶ ILM is based on bank-specific loss data assuming that banks which have experienced greater operational risk losses historically are more likely to experience operational risk losses in the future. Calculated as a function of the BIC and the loss component (15 times a bank's average historical losses over the preceding 10 years)
- ▶ National discretion is permitted in the design and application of the ILM
- ▶ The new standardised approach applies to all internationally active banks on a consolidated basis, and national supervisors may also apply the framework to non-internationally active banks
- ▶ Additional disclosure requirements regarding the components of the SMA (disclosure of BI sub-items for each of the three years of the BI calculation window / 10 years for banks with BI exceeding EUR 1 billion, or that use internal loss data in the calculation of operational risk capital)

Expected Impact on Swiss Banks

- ▶ Expected impact on most banks in Switzerland is an increase in RWA. For category 3-5 Swiss Banks the principles of proportionality may apply
- ▶ Increased requirements on quality of the loss database to ensure accurate 5-10 year loss data is expected





Leverage Ratio

Objectives

- ▶ Buffer and safeguards against unsustainable levels of leverage of banks
- ▶ Increase leverage ratio requirements for G-SIBs by establishing a buffer requirement
- ▶ Refine exposure measure (i.e. LRD) to mitigate against beneficial usage of internal vs. standardised approaches

Key Changes

- ▶ Introduction of a leverage ratio buffer for G-SIBs depending on the HLA requirement bucket
- ▶ The leverage ratio buffer for G-SIBs amounts to 50% of risk weighted higher loss-absorbency requirement, which needs to be met with Tier 1 capital
- ▶ Establishing refinements to the leverage ratio exposure measure (i.e. LRD) focusing on products like derivatives and off-balance sheet items aiming to increase consistency of these product exposure calculations to the standardised RWA credit risk approach
- ▶ Where G-SIB leverage buffer requirements are not met, capital distribution constraints will result

Expected Impact on Swiss Banks

- ▶ The G-SIB buffer only impacts the Swiss G-SIBs, but LRD refinements to the exposure measure will target other Swiss banks too (mainly those with internal approaches)
- ▶ LRD requirement for G-SIB banks expected to increase based on buffer and LRD refinement
- ▶ The buffer will increase the minimum leverage ratio requirement to be met with Tier 1 capital from 3% to 3.5% at a minimum. Depending on the bucket allocation for HLA requirements, the leverage ratio requirement can increase up to 4.5%
- ▶ Most Swiss banks only impacted by minor changes, especially when using standardised approaches





Counterparty Credit Risk

CREDIT VALUATION ADJUSTMENTS (CVA)

Objectives

- ▶ Ability removed to fully rely on internal models driven by complexity of the A-CVA calculation
- ▶ Implementation of a standardised approach (SA-CVA) or a basic approach (BA-CVA) to reduce calculation complexity

Key Changes

- ▶ Revised framework for CVA Risk and alignment with market risk
- ▶ Removal of the use of the internal modelled approach (i.e. A-CVA)
- ▶ New CVA capital regime does not exempt transactions from the calculation but incorporates a wider range of eligible hedges. Existing approaches recognise only the hedges to credit spread risk while the new approach includes the variability of changes in risk factors as well
- ▶ SA-CVA calculates the risk sensitivity based on credit spreads and the market risk factors driving the values of derivatives. The capital requirements for SA-CVA is calculated based on the sum of delta and vega risks of the CVA portfolio reduced by eligible hedges
 - ▶ Delta and vega calculation for six risk types: interest rate, foreign exchange, counterparty credit spread, reference credit spread, equity and commodity risk types
- ▶ BA-CVA consisting of two alternatives also introduced:
 - ▶ Reduced BA-CVA including only the capital requirements for covered transactions
 - ▶ Full BA-CVA capturing the CVA capital requirements for covered transactions and for eligible hedges

Expected Impact on Swiss Banks

- ▶ Increased RWA expected based on the removal of the internal approach, with new approaches leading to higher RWAs
- ▶ Extension of CVA scope to include securities financing transactions at fair value increases CVA capital requirements
- ▶ Limited impact on smaller banks as a simpler approach can be applied, where banks have small derivative portfolios (100% of CCR capital requirement for firms below materiality threshold)

COUNTERPARTY CREDIT RISK (CCR)

Objectives

- ▶ No changes to the Internal Model Method (IMM)
- ▶ Replacing Current Exposure Method (CEM) and standardised method with new standardised approach (SA-CCR) for some Swiss banks (recalibrated CEM will remain for category 4 and 5 banks, as well as some category 3 banks with low derivative volumes)
- ▶ Increased risk sensitivity through the incorporation of netting agreements and risk mitigation via collateral

Key Changes

- ▶ Under SA-CCR the EAD is determined for each netting set based on the Replacement Cost (RC) and Potential Future Exposure (PFE), which are multiplied with a factor of 1.4. RC and PFE are calculated differently for margined and unmargined netting sets
- ▶ Unmargined transactions: RC is determined as the difference between the value of the transactions in the netting set, and the available collateral (if positive, otherwise RC is zero)
- ▶ Margined transactions: the possibility of margin calls is also considered, therefore capping the RC at the largest amount that would not trigger a margin call
- ▶ The PFE is determined through the aggregate add-on component, which depends on the asset class of the underlying transactions, and a multiplier, which depends on the over- or under-collateralisation of the netting set

Expected Impact on Swiss Banks

- ▶ Leads to a more risk-sensitive assessment of derivative exposures
- ▶ SA-CCR required more detailed assessment of margin requirements
- ▶ Impact can be significant even if number and volume of derivative transactions is small
- ▶ Already implemented and live in Switzerland



Market Risk - Fundamental Review of the Trading Book (FRTB)

Objectives

- ▶ Clearer and stricter differentiation and delineation between the regulatory banking and trading book (simplified rules for category 3-5 banks)
- ▶ Focus on risk sensitivities in the revised standardised approach
- ▶ Internal model approach (IMA) revised, moving away from Value-at-Risk (VaR) to Expected Shortfall (ES) measurement
- ▶ Increased focus on trading desks, by replacing a bank-wide model approach with trading desk level approvals for model usage

Key Changes

- ▶ Transferring instruments between the banking and trading book in order to profit from regulatory capital arbitrage is restricted by establishing strict limits and capital disincentives. Transfers are still allowed, but not followed by beneficial capital treatments
- ▶ Revision of the standardised approach by increasing the reliance on risk sensitivities and introducing a default risk charge (DRC) and residual risk add-ons (RRAO): Sensitivities-based method + DRC + RRAO
 - ▶ Sensitivities based method: calculates capital charges for delta, vega and curvature risk factor sensitivities within the risk classes general interest rate risk and credit spread risk
 - ▶ DRC: treatment of default risk similar to banking book accounting for hedging effects
 - ▶ RRAO: risk-weight applied to notional amount
- ▶ The IMA for market risks captures tail risks and market illiquidity driven by revised calculation metrics. The change from VaR to ES and by taking into consideration different liquidity horizons introduces tail risks and an illiquidity focus
- ▶ The approval of using an IMA moves from a bank-wide to a desk level approval approach

Expected Impact on Swiss Banks

Largest impact on banks with IMA and material trading books:

- ▶ Higher RWAs for market risk in the trading book is expected
- ▶ Depending on trading book related trading instrument (i.e. asset) definitions, the trading book will increase leading to higher RWA and capital requirements
- ▶ Based on trading desk level approval of internal models, more exposure will be measured using SA instead of IMA
- ▶ Increased model governance and data management requirements in order to run sensitivities-based method
- ▶ For the smaller banks (i.e. category 3-5 and immaterial/no trading book), limited impact as the current simplified approach for small trading books is still planned to be permitted





Capital

Objectives

- ▶ Limit regulatory capital benefits for banks using internal model-based approaches compared to standardised approaches
- ▶ Increase trust in RWA calculation metrics
- ▶ Improvement of comparability through disclosures

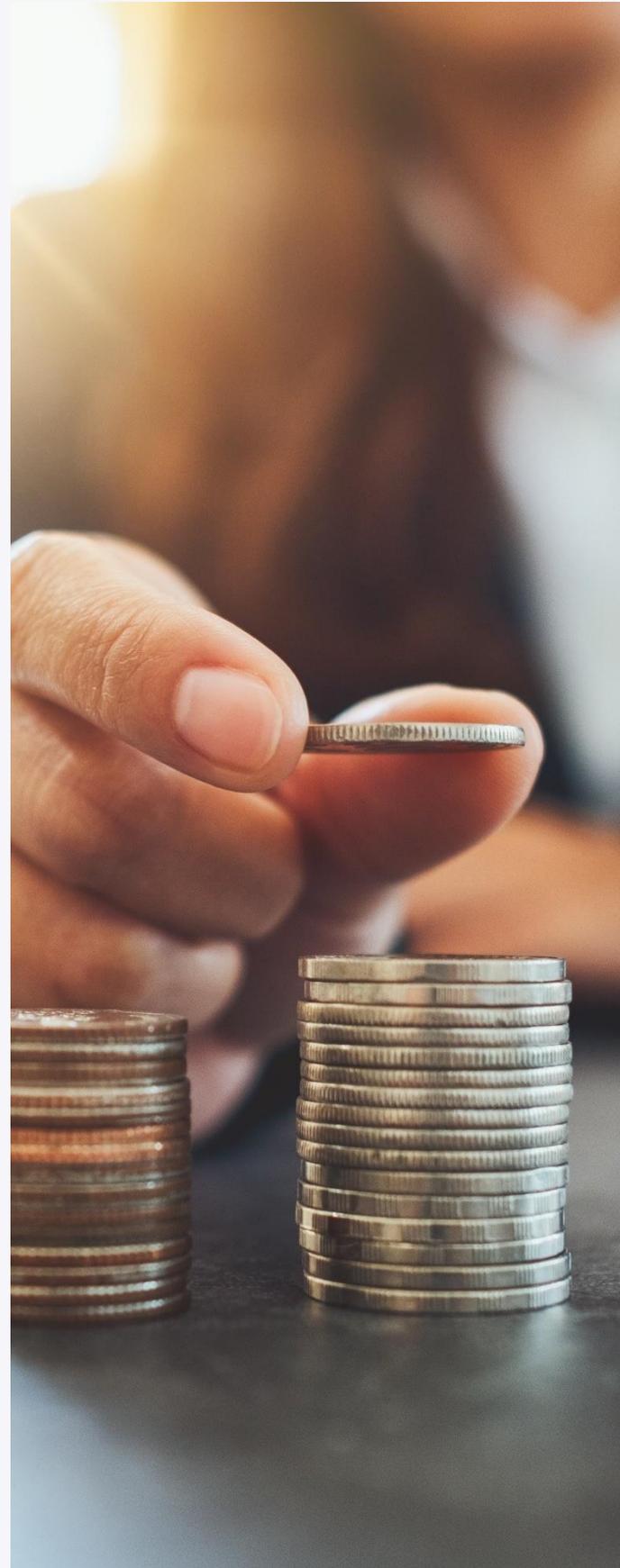
Key Changes

- ▶ RWA is defined as the higher amount of internal model approaches and 72.5% of RWAs calculated by using standardised approaches only
 - ▶ Approaches used for bank-internal models must be approved by the regulator
 - ▶ Approaches used for standardised calculations include fully applied credit risk, counterparty credit risk, CVA, securitisation, market risk and operational risk
- ▶ For output floor calculation the following standardised approaches are used: Credit risk SA, counterparty credit risk (SA-CCR), CVA (SA-CVA or BA-CVA or 100% of counterparty credit risk capital requirement), securitisations (SEC-ERBA or SEC-SA or 1250% risk weight), market risk (SA or simplified SA), and operational risk SMA
- ▶ Under BCBS timelines, phased-in from 2023 (50%) to 2028 (72.5%) (year-on-year increases of 5 percentage points - 2026 to 2027 the remaining 2.5 percentage points)
- ▶ Disclosure of RWA and capital ratios required for both calculation approaches, including and excluding the impact of the capital floor

Expected Impact on Swiss Banks

Impacts Swiss banks that apply internal modelling approaches:

- ▶ RWA is expected to increase for banks using internal approaches, as it is likely that the floor will eventually have an impact on most of the affected banks, especially towards the end of the phase-in period
- ▶ Data and calculation efforts increase in complexity and computing power, as full parallel calculations between internal models and standardised approaches will be required on an ongoing basis, also requiring revamped RWA control frameworks
- ▶ More detailed disclosure requirement in Pillar 3 reporting



Basel III Finalisation in Switzerland

Expected impact on Swiss Banks

- ▶ We currently expect divergence in the impact on RWA across the Swiss banking sector, depending on a number of factors such as the composition of the credit risk portfolios, as well as the magnitude of market and operational risks. Currently, on average, we expect credit risk RWA to stay largely flat, whilst market and operational risk to increase slightly. A principle of “capital neutrality” was agreed in Switzerland, although in practice this remains a challenge to achieve at an individual bank level, and hence is still a discussion point for the industry.
- ▶ Planned changes for the standardised approaches will impact all Swiss banks, adding new calculation approaches (e.g. Operational Risk SMA), as well as process requirements and additional data to be collected in order to comply with new calculation requirements.
- ▶ Due to changes in model requirements and increased complexity in calculations, an increased model governance as well as more stringent data management framework will be necessary. Further, more detailed disclosures in Pillar 3 reporting is to be expected for most Swiss banks.
- ▶ In general, principles of proportionality may apply to all category 4 and 5 banks, and to a certain extent also to category 3 banks.

How EY can help

EY can support with a variety of offerings including (but not limited to):

- ▶ Gap-analysis and / or impact assessments (incl. dedicated RWA / capital assessment tools built specifically by EY to assess the impact of the Basel III reforms)
- ▶ Model methodology support (revision and update of models)
- ▶ Comprehensive project approach and project management
- ▶ Data quality and enhancement
- ▶ Operational transformation (incl. IT) and governance / control framework related aspects
- ▶ Benchmarking
- ▶ Capital and leverage ratio optimisation
- ▶ Support with enhanced disclosure requirements

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