Circular 2008/23
Risk diversification – banks

Concretizations on risk diversification for banks

June 2015
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2 Other Languages
FR: Circ. FINMA 2008/23 Répartitions des risques - banques 18.9.2013
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Circular 2008/23
Risk diversification – Banks

Risk diversification at banks

Reference: FINMA circ. 08/23 Risk diversification – banks
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Last amendment: 18 September 2013 [amendments are denoted with an * and are listed at the end of document]
Concordance: previously FINMA circ. 06/5 “Risk diversification” of 29 September 2006

2006 Legal bases:
FINMASA Article 7(1)(b)
BA Articles 3(2)(b), 3g, 4(2) and (4), 4bis(2)
SESTO Article 29
CAO Articles 2, 95-123

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I. Object
This Circular concretizes Articles 95-123 of the Capital Adequacy Ordinance (CAO; SR. 952.03). It regulates how to consider credit derivatives in the trading book and banking book as well as short-term inter-bank positions with regard to risk diversification. It is not to be applied for the purpose of determining capital requirements.

II. Credit derivatives

A. CONSIDERATIONS OF THE PROTECTION BUYER
Credit Default Swaps and Total Return Swaps: positions secured by credit default swaps or total return swaps¹ may be deducted from the respective reference account receivable of the debtor’s total position. In any event, the credit equivalent (as defined in art. 56 CAO) for the relevant credit default swap or total return swap must also be considered as a component of the total position of the protection seller in question.

Credit linked notes: receivables secured by credit-linked notes² may be deducted from the respective reference account receivable of the borrower’s total position. The protection seller’s total position is not affected by credit-linked notes.

First-to-default swaps: given their non-specific hedge effect, the total positions of borrowers may not be reduced by positions hedged by first-to-default swaps. However, a credit equivalent for the first-to-default swap is to be considered as a component of the total position of the protection seller in question.

Second-to-default swaps and n-th-to-default swaps: the total position may also not be reduced by second-to-default swaps and n-th-to-default swaps by positions hedged by such contracts. A credit equivalent for the second-to-default swap and the n-th-to-default swap respectively is to be considered as a component of the total position for the protection seller in question.

B. CONSIDERATIONS OF THE PROTECTION SELLER
Credit Default Swaps and Total Return Swaps: hedge commitments through credit default swaps or total return swaps must be added to the debtor’s total position in respect of the reference instrument. In any event, a credit equivalent for the relevant credit default swap or total return swap must also be taken into account as a component of the total position of the protection buyer in question. In the case of a credit default swap, this is not to exceed the sum of the outstanding, undiscounted premium payments.

Credit linked notes: hedge commitments through credit linked notes must be added to the debtor’s total position in respect of the reference instrument. In addition to this, the receivable related to the debt instrument issued by the protection buyer is to be added to the protection buyer’s total position.

¹ Hedges are recognized provided they fulfill the conditions of margin nos. 204-216 and 220-231 of FINMA circ. 08/19 “Credit Risks–Banks”.
² cf. margin no.1.
First-to-default swaps: all hedging commitments entered into in the form of first-to-default swaps must be added to the debtor’s total position for the receivables in question. In addition, a credit equivalent must be included as a component of the total position of the protection buyer in question. However, this is not to exceed the sum of the outstanding, undiscounted premium payments.

Second-to-default swaps: as a rule, second-to-default swaps are to be considered in the same way as first-to-default swaps (cf. margin no. 8). However, until the default of the first position in the basket, the smallest of all risk weighted positions in the basket must not be added to the debtor’s total position. When taking the credit equivalent into account, the provisions set out in margin no. 8 are to be applied.

nth-to-default swaps: these are taken into account as per the process set out in margin nos. 8 and 9. The n-1 smallest positions in the basket in risk-weighted terms must not be added to the issuer’s total position. Whenever one of the positions in the basket defaults, the variable n decreases by one. For example, following the default of one of the positions in the basket, a fifth-to-default swap becomes a fourth-to-default swap. When taking the credit equivalent into account, the provisions set out in margin no. 8 are to be applied.

III. Short-term interbank positions

A. PURPOSE
For risk diversification purposes, the FINMA imposes a lower risk weight for short-term positions to certain banks in order to facilitate the handling of transactions in the interbank business. The conditions under which banks are entitled to apply such a facilitation are set out below.

B. RISK-WEIGHTING OF SHORT-TERM INTERBANK POSITIONS
Repealed

Contrary to Article 115(1) CAO and in application of Article 112(2)(g) CAO, the risk-weights for positions on demand and overnight positions to banks rated 1 or 2 as defined in Article 63(2)(4) CAO in conjunction with Article 68(1) CAO, provided this bank has not been designated as systemically important in Switzerland or abroad, and to non-systemically relevant cantonal banks whose complete non-subordinated liabilities are guaranteed by the canton, are set as follows:

- 32% if eligible capital amounts to less than CHF 250 million;
- 16% if eligible capital amounts to between CHF 250 million and 1000 million;
- 8% if eligible capital amounts to more than CHF 1000 million.

For banks that calculate their eligible capital on a stand-alone basis as well as on a consolidated basis, the eligible capital on a consolidated basis is decisive for calculating the risk weighting percentage in accordance with margin nos. 12.1 to 12.4.
The ratings considered in margin no. 12.1 must come from a FINMA-recognized rating agency. In addition, these ratings must be long-term ratings. If several rating agencies issue ratings for a specific counterparty, the rating class mentioned in margin no. 12.1 is determined in accordance with margin no. 6 of FINMA circ. 2008/19 “Credit Risks – Banks”. The preferential weightings mentioned in margin nos. 12.1-12.4 may also be used by banks that do not use external ratings as per Article 64 CAO for the calculation of their capital adequacy requirements.

The preferential weighting rates according to margin nos. 12.1 - 12.4 are to be applied only to positions against the parent company or to the foreign parent bank or the cantonal bank whose non-subordinated liabilities are all guaranteed by the canton. It is not applicable to other companies (banks or non-banks) belonging to the same group. The weightings applicable to these must be the regular ones set out in Article 115(1) CAO.

UBS AG and Credit Suisse Group and any of their affiliated group banks are not permitted to take advantage of the preferential ratings specified in margin nos. 12.1 to 12.6.

Group banks are not permitted to apply the preferential weightings specified in margin nos. 12.1 to 12.6 to positions to their parent company in Switzerland or abroad. Likewise, group banks that are controlled by cantonal banks whose non-subordinated liabilities are all guaranteed by the canton are not entitled to apply the preferential weightings specified in margin nos. 12.1 to 12.6 to positions to the parent cantonal bank. However, where the conditions for group-internal counterparties stipulated in Article 99(1) CAO are fulfilled, the positions to the banks in question must be excluded from the upper limit.

Repealed

By way of exception to Article 115(1) CAO and in application of Article 112(2)(g) CAO, the risk-weighting for positions held by banks belonging to the Swiss Organization of Regional Banks (German: RBA) to Entris Banking AG with a residual term to maturity of up to one year is to be set in accordance with margin nos. 12.1 through 12.4.

Repealed

Two or more members of a group form a group of related counterparties and hence constitute a single risk position (Article 109(1) and (2) CAO). Entris Banking AG and the other companies belonging to RBA Holding likewise form a single risk position.

All positions will continue to be included in the risk position of the group in question as per art. 113 CAO and reported in accordance with Article 100(1) and (2) CAO and Article 102 CAO. The total risk position may not exceed the upper limits specified in Article 97 CAO and Article 116 CAO.

C. PROCEDURE IF A GRANTED FACILITY NO LONGER APPLIES

If a counterparty no longer complies with the criteria set out in margin nos. 12.1 to 12.6, positions to this bank are to be assigned the normal weightings specified in Article 115(1) CAO.
During the period specified in margin no. 21, an institution may only enter into new positions with the counterparty concerned if the total risk position, once the positions have been weighted according to Article 115(1) CAO, does not exceed the upper limit defined in Article 116 CAO.

IV. Transitional provisions

A. AMENDMENTS OF 1 JUNE 2012 (ART. 138 CAO)

The margin nos. 16, 18, 22, 23 and 25 that were repealed as at 1 June 2012, as well as the references made to them in the margin nos. 12.6, 13, 14, 15, 17, 20, 21 and 24 remain applicable until 31 December 2018 in the version dated 17 November 2010.

The same applies to margin no. 12 that was repealed on 1 June 2012.

B. AMENDMENTS OF 18 SEPTEMBER 2013

The amendment of margin no. 12.1 of 18 September 2013 enters into force on 1 January 2014 and must be complied with on 31 March 2014 at the latest.
List of amendments

The circular is amended as follows:

These amendments were passed on 17 November 2010 and enter into force on 1 January 2011.

- Newly inserted margin nos. 12.1 -12.6, 25, 26
- Amended margin nos. 12, 13 – 15, 17, 19 - 21, 24

These amendments were passed on 1 June 2012 and enter into force on 1 January 2013.

- Newly inserted margin nos. 27, 28
- Amended margin nos. 12.1, 12.6, 13 - 15, 17, 20, 21, 24
- Repealed margin nos. 12, 16, 18, 22, 23, 25

  In addition, the references to the Capital Adequacy Ordinance (CAO; SR 952.03) have been adapted to the version entering into force on 1 January 2013.

These amendments were passed on 18 September 2013 and enter into force on 1 January 2014.

- Newly inserted margin no. 29
- Amended margin no. 12.1
- Other amendments amended title IV before margin nos. 27 et seqq., new title before margin no. 27, new title before margin no. 29
The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavor to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received, or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.

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