

# Pillar 2 Capital Adequacy Requirements for Banks

A strong equity base for banks is crucial to the stability of the Swiss financial sector. In its approach to capital adequacy, FINMA has taken its lead from the international standard, which is based on three pillars. Under Pillar 2, FINMA can set an additional capital requirement in order to adequately cover the risks of particular financial institutions.

Banks must have adequate capital to underpin their risk-bearing capacity. However, the minimum capital adequacy requirements under Pillar 1 do not include all the risks that banks enter into. In order to ensure that the minimum requirements can be met even in difficult circumstances, FINMA requests institutions to hold additional capital under Pillar 2.

## The Basel Three-Pillar Approach

Switzerland's capital adequacy regulations implement the requirements of the Basel Committee on Banking Supervision, which defines international standards in relation to banking regulation and supervision, including the three pillar approach to capital adequacy. Switzerland has enacted this approach in national legislation.

Pillar 1 specifies the minimum requirements that apply to all banks, irrespective of their size or specific risks.

Pillar 2 enables the supervisory authorities to define additional capital requirements for particular banks depending on their risk profile. The international Basel regulations demand that supervisors have the authority to specify capital adequacy requirements above the minimum level. This allows FINMA to set higher requirements, depending on the

type and level of company-specific risks. There is considerable variation in the size and business models of banks, and it therefore makes good sense to allow fine-tuning of the regulations.

This discretion is explicitly demanded by the Basel Committee so that supervisory authorities can react rapidly and flexibly to changes, either in the general environment or within an institution. If, for example, a bank takes on substantial interest rate risks or pursues a high-risk business strategy, the supervisory authority can demand that additional capital be set aside to cover these risks. The institution will then be better prepared to cope with any shocks.

Pillar 3 contains rules on transparency and disclosure. This improves comparability among institutions and increases the discipline of market participants.

## More flexible, risk-based, additional capital requirements

For some years now, FINMA has required all supervised institutions to hold additional capital under the Pillar 2 regulations, with the aim of covering risks that are not fully covered under Pillar 1. Steps have also been taken to ensure that the banks have a buffer that can be used to cushion

Pillar 1 Minimum capital adequacy requirements	Pillar 2 Prudential oversight	Pillar 3 Disclosure requirements
Standardised calculation of credit risks, market risks and operational risks	Coverage of institution-specific risks (size, complexity, business strategy)	Market discipline through increased transparency

losses. In the past, FINMA imposed an across-the-board Pillar 2 supplement of 20% of the minimum capital requirement on all banks.

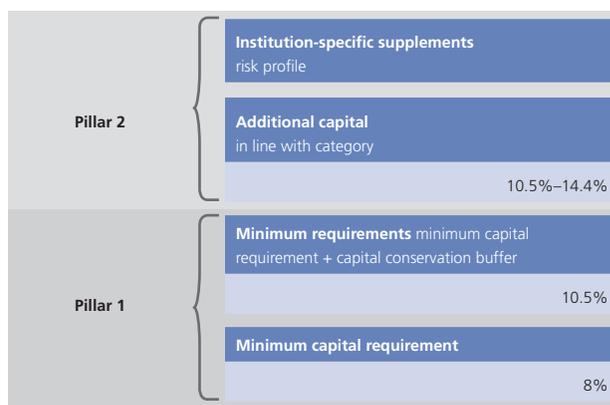
Under its risk-based supervisory approach, FINMA has now introduced a flexible system to replace its previous practice of applying a standard buffer for all institutions. The Pillar 2 requirements take account of the size, complexity and business activities – and hence the overall risk – of each financial institution. As a result, smaller, less complex banks must have a lower capital buffer than larger, more complex institutions.

## Classification by risk profile and systemic importance

In order to make the capital adequacy requirements as transparent as possible, the level of additional capital to be held under the new Pillar 2 regime is defined on the basis of four criteria: balance sheet total, assets under management, privileged deposits and minimum capital requirements. These simple criteria provide an adequate basis for assessment, especially as regards modelling the risk of default for creditors, depositors and the Swiss financial centre.

Based on these criteria, supervised institutions are assigned to one of five categories. The capital requirements for systemically important institutions are defined directly in the Banking Act and the Capital Adequacy Ordinance and are higher than the requirements for the rest of the banking sector. However, the 'too big to fail' (TBTF) regime does not exclude the possibility of individual Pillar 2 supplements, since the systemically important banks are subject not only to the TBTF regime but also to the general regulations for banks.

All other banks are assigned to categories 2 to 5, in line with falling risk. The parameters for the categories are defined in a FINMA circular. In order to ensure a degree of flexibility, FINMA has defined a target capital requirement and an intervention threshold for each category, expressed as total capital ratios. The capital requirement for banks in category 5 is set at 10.5%, exactly matching the minimum requirements set out in the Basel III regulations.



Larger banks, those in category 2 for example, must have a total capital ratio of between 13.6% and 14.4%. These requirements reflect the heightened risk and the increased danger of potential losses.

Today, most supervised institutions in Switzerland already have capital levels that exceed the targets set out in the circular.

The flexible capital adequacy requirements under Pillar 2 form an integral part of Switzerland's capital adequacy regulations and make a key contribution to the stability of the country's financial system.



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