Swiss Regulatory Update Banking 2016

Swiss and international regulatory developments, observations and impacts in the banking industry
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The financial industry has been in transition for many years, especially since the onset of the financial crisis. As a result, Swiss banks are facing numerous challenges. They operate in a difficult macroeconomic environment with record low (negative) interest rates and a demanding investment environment. Moreover, the implementation of national and increasingly international regulatory requirements are reflected in banks' margins and cost structures. Proven business models are to a certain degree being put into question, and some banks are primarily concerned with the past and not with forward-looking innovations and growth strategies.

The environment is characterized by VUCA - volatility, uncertainty, complexity and ambiguity. In the last few years banks were particularly concerned with the implementation of new regulatory requirements, which governing bodies have adopted in the wake of the financial crisis. This tendency has been strengthened by regulatory standards created by international organizations and governments focusing mainly on capital and liquidity, consumer protection and tax transparency. As a result, a variety of abbreviations have been created: IMD II, MiFID II, MiFIR, FIDLEG, EMIR, PRIIPs, CRD IV, CRR, AIFMD, UCITS V+VI, ELTIF, EuVECA, MAD II, RDR, FATCA, FINIG, BEPS, AEI, EUSD and Dodd-Frank Act - these are just a few examples of the mass of abbreviations and acronyms that financial institutions around the world have to grapple with. Regardless of their size and diversification, all businesses have to negotiate their way through this labyrinth of regulatory changes. Failure to comply means risking sanctions and fines. At the moment, aside from understanding the changes, the focus should be on the efficient, holistic and pragmatic implementation of these regulations.

The purpose of the EY Swiss Regulatory Banking Update is to serve as an overview of the landscape of current standards and norms which apply to the Swiss market. It delivers up-to-date facts and a comprehensible overview of legal changes.

We hope you enjoy reading our take on the subject and trust that our regulatory update inspires some interesting discussions.

Excerpt of Global, European and Swiss Regulations
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Tax Compliance & AML
Tax transparency – Measures for a tax-compliant and competitive financial center

The enforcement of tax legislation has become a top priority for governments of the large economies which struggle to keep the public budgets balanced. Increasing tax transparency is the method of choice to counteract tax avoidance by individuals and multinational companies. We are currently witnessing an unprecedented variety of measures and speed of implementation in international tax law to enhance tax transparency both at individual and corporate level:

**Corporate tax transparency** is an umbrella term for the current focus on how an institution manages its tax affairs. Increasing governmental, public and regulatory pressure has cast a spotlight on international organizations, incl. FIs, and their management of corporate tax. The regulatory tax landscape now includes substantial legislation and best practice guidance focused on corporates, e.g. CRD IV, Base Erosion and Profit Shifting (BEPS) and General Anti-Abuse Rules (GAAR) - these are all geared towards increasing stakeholder confidence that a ‘fair share’ of tax is being paid. There is also an expectation that corporates go ‘beyond compliance’, and integrate a strategic set of standards to manage their tax affairs in the most ‘fair and efficient’ way going forward.

**Customer tax transparency** relates specifically to a financial institution’s regulatory responsibility towards its customers, alongside the approach adopted to portfolio risk and optimization of its interaction with customers. The regulatory landscape has now become an extensive list of customer focused legislation, e.g. FATCA, OECD Exchange of Information, the European Union Savings Directive, etc. and has emphasized the need for a central tax transparency approach. As with corporate tax transparency solutions, clients are also considering the integration of tax into their overall governance framework and optimizing the benefits of an enhanced data flow.
Exchange of information - OECD and Global Forum aim at information exchange as from 2017 (based on 2016 data)

As of February 2016, Switzerland has so far signed agreements with the European Union, Australia, Jersey, Guernsey, The Isle of Man, Iceland and Norway to mutually exchange information from 2018 onwards. Unlike in other countries these agreements need to be approved by the Swiss parliament. The Swiss government has submitted such bill to the parliament in November 2015 and it is likely that they will be adopted and come into force by January 2017.

Operational Risk at banks
- Swiss Banks require a robust protocol to identify clients and will need to have electronic search capabilities in place for all of their clients starting from 2017
- These standards also require disclosure of account holders, beneficial owners as well as persons related to these accounts by way of a controlling capacity
- Compared to FATCA, the scale and coverage of reports is much more expansive; the same applies to the notion of financial accounts that need to be reported
- FATCA’s experience has shown that the remediation work ensuing the client due diligence must not be under-estimated as regards time and resources requirements

Timeline for early adopter countries (others to follow suit one year later)

1) Due Diligence on Accounts - establish client’s tax residence

- New Accounts
- Pre-existing High Value Individual Accounts
  - $1 million aggregate value
- Pre-existing Lower Value Individual Accounts
  - $1 million aggregate value
- Pre-existing Entity Accounts

2) Reporting and Exchange of Information

- Report to domestic tax office
  - may be prescribed nationally
- Exchange of information
  - for calendar year 2016
  - for calendar year 2017 and following

2015 2016 2017 2018
Observations & consequences

- The automatic exchange of information was largely inspired by the US FATCA rules. Financial institutions in countries that participate in AEI (referred to as “partner jurisdictions” or “participating countries”) must collect and deliver data – through their own tax authorities – to the client’s home country tax authorities. In general, the AEI requires the exchange of data pertaining to individual and specific entity clients who are resident in countries other than where their assets are booked by certain reporting financial institutions (specifically banks and asset managers).

- A particular challenge will be presented by the due diligence required for new and pre-existing individual and entity accounts. Ostensibly similar to FATCA due diligence processes, the AEI due diligence will be subtly different, thus requiring a new search logic.

- If in doubt on the tax residency of a client, information needs to be sent to multiple jurisdictions. In such cases, different data schemas might need to be adhered to. Double or multiple reports to various revenue authorities may also be required on a regular basis (in particular in the ambit of wealth management). The financial institution needs to be aware of these reporting lines and co-ordinate them.

Management agenda & prioritization

- Assess if Swiss FI is a headquarter company with subsidiaries and branches in EA countries or if the Swiss FI belongs to such a group headquartered in an EA country. If so, set up a project to be able to comply with new account regulations beginning 2016.

- Assess system readiness and data quality and establish minimum requirements for onboarding processes of new clients under the Common Reporting Standard (CRS).

- Assess data quality in respect of the necessary client due diligence (requirements go beyond those known under FATCA) to ensure smooth due diligence process – in particular for entity accounts.

Clients need to understand that the information submitted under the common reporting standard is not necessarily congruent with the information they receive in their tailored tax reportings (this may trigger questions and requests on their home country tax offices as both sets of information need to be reconciled); therefore, communication plans and training sessions for Client Relationship Managers (CRMs) need to be set up to inform clients well in advance that and how their personal and financial data will be communicated to their home country tax office.

Schematic representation of due diligence process under AEI
FATCA - Entity accounts and lower value individual accounts must have been scrutinized by 30 June 2016

Key Points
- Effective since 1 July 2014, FATCA system established in banks; the Swiss FATCA law obligates banks (and other Swiss FI) to register with the IRS
- For the reporting of non-consenting clients and non-participating Foreign Financial Institutions (FFIs) for the year 2015, an extension of time until 31 March 2016 is available
- Entity accounts and lower value individual accounts must have been scrutinized by 30 June 2016
- FATCA and AEI seem to have communality at first sight; but on the level of deployment, a “copy-paste” approach is not possible
- Switzerland currently re-negotiating its Model 2 Inter Governmental Agreements (IGA) aiming for a Model 1 IGA which contains - contrary to a Model 2 IGA - an automatic exchange of information
- The adherence to FATCA requirements will be subject to upcoming regulatory audits

Operational Risk at Banks
- The implemented processes, procedures and control systems are not sufficient to comply with FATCA

Perceived degree of Complexity

FINMA requests the auditors in Switzerland to conduct regulatory audit procedures for (presumably all) Swiss (banking) audit clients with regard to the implementation of FATCA the depth of the audit will be a so-called “critical assessment” and the regulatory audit procedures will be conducted in the form of an “additional audit” in the year 2016

FATCA has become operational with ca. 187,000 FIs having registered with the IRS worldwide, of which ca. 5,100 in Switzerland
FATCA - FIs should start to review their procedure, processes, and internal control systems

Observations & consequences

- With registration duties having been fulfilled by the vast majority of the Swiss FIs, the FIs are now scrutinizing their pre-existing lower value individual accounts and entity accounts
- For high value accounts, the treasury regulations and most of the IGAs provide a short-cut mechanism to prevent a paper-based search for indicia provided that a bank’s systems contain all FATCA-relevant data fields; in many cases, certain data fields are missing, so that client master files need to be searched with respect to the information that has not been stored electronically
- For the reporting of non-consenting clients and non-participating FFIs for the year 2015 which was due on 31 January 2015 an extension of time was available until 31 March 2016
- Banks are currently reviewing either through their internal audit department or through an independent third party provider their procedures, processes, and control systems ensuring FATCA compliance
- Adherence to FATCA requirements will be subject to upcoming additional regulatory audits

Management agenda & prioritization

- The current agenda shows the review of pre-existing entity accounts and pre-existing lower value accounts are priority items
- FIs should start to review their procedure, processes, and internal control systems in order that the Responsible Officer may certify FATCA compliance to the IRS
Qualified Intermediary (QI) – A review needs to be conducted for the period 2017

Background
In June 2014 the IRS released the new QI Agreement (Revenue Procedure 2014-39). This introduced a number of changes for QIs and in particular, introduced a number of requirements for Responsible Officers (RO) including a certification by the RO to the IRS covering a number of areas.

The three main responsibilities of an RO under the new Agreement are:
• Establish a Compliance Program and certify to the IRS that it is in place and effective. The Compliance Program includes the following:
  ▪ Written Policies and Procedures
  ▪ Training
  ▪ Systems
  ▪ Monitoring of Business Changes

• Designate an auditor to perform a periodic review of compliance with the QI requirements and FATCA requirements

• Certify to the IRS that the QI has effective internal controls by way of the Compliance Program, periodic review and disclose details of any material failures and that they have been remediated to the IRS

Timeline

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• A review needs to be conducted for the period 2017 and the review report will be issued to the RO. This will be one element of the basis for the decision of the RO certification. The first RO certification is required before 30 June 2018 and it will be in respect to the period from 1 July 2014 to 31 December 2017
Corporate tax transparency - OECD Action Plan on Base Erosion and Profit Shifting (BEPS)

Background
- 2012: the OECD launched the BEPS project in response to debate around perceived tax avoidance by multinational companies (Amazon, Google, Starbucks and others)
- 5 October 2015: the OECD issued its ‘final’ reports on the 15 Action points identified in its Action Plan on base erosion and profit shifting (BEPS). The Actions have been the subject of consultation and are supported by the G7 and G20 countries, the European Union (EU) has been working in parallel, and developing countries are involved as well
- For some Actions there is still more work to be done
- The recommendations need to be implemented in national law

Target areas of OECD Action Plan
- Challenges of the digital economy (Action 1)
- Establish international coherence of corporate taxation (Actions 2-5)
- Restore the full effects and benefits of international standards (Actions 6-7)
- Ensure that transfer pricing outcomes are in line with value creation (Actions 8-10)
- Ensure transparency (Actions 11-14)
- Enable swift implementation (Action 15)

Target areas of OECD Action Plan

Coherence
- Action 2
  Hybrid Mismatch Arrangements
- Action 3
  CFC Rules
- Action 4
  Excessive Interest Deductions
- Action 5
  Harmful Tax Practices (incl. Rulings)

Substance
- Action 6
  Tax Treaty Abuse
- Action 7
  Avoidance of PE Status
- Action 8
  TP Aspects of Intangibles
- Action 9
  TP Risk and Capital
- Action 10
  TP High Risk Transformation

Transparency
- Action 11
  Methodologies and Data Analysis
- Action 12
  Mandatory Disclosure Rules
- Action 13
  TP Documentation and CbCR
- Action 14
  Dispute Resolution
- Action 15
  Multilateral Instrument
**BEPS key potential impacts on Swiss banks**

- As part of the envisaged country-by-country reporting, multinational groups will have to report by country the revenues (split by third party and related party), profit, capital, headcount, taxes paid and other information; the data complexity and short reporting cycles will necessitate extensive automation of the reporting, hence may require overhaul or modifying financial reporting systems.
- Operating models, incl. digital strategies, may need to be reassessed or restructured in order to mitigate tax costs.
- Restrictions on tax deductibility of interest expense, both on internal and external debt, increased cost of funding; any group-internal hybrid financing arrangements need to be carefully reviewed.
- The OECD recommendations lead to significantly lower thresholds for deeming a taxable presence (permanent establishment) in cross-border business: cross-border activities and the location of servers/platforms/data may give rise to a multitude of additional taxable presences, thereby heavily increasing the compliance burden.
- Increased risk of reputational damage.

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**Impact on your enterprise**

The new global tax environment being driven by the global focus on BEPS touches every aspect of your organization. You must be prepared to respond effectively across all areas.

**Strategy**
- Corporate structure, capital and financing
- Substance
- Funds Structure
- Global booking models
- Mobile sales and digital channels
- Reputation and brand
- Audit/Defense and Advance Pricing Agreement (APA)/ Mutual Agreement Program (MAP) strategy

**Operations**
- Efficient investment structures
- Offshore Hubs
- Decision making functions - risk of shift in taxable income
- Scrutiny in cost allocations
- Operational risk and strategy around transparency and information sharing

**Infrastructure**
- Country by Country Reporting (CbCR) - infrastructure
- CbCR - strategy and reputational risk
- TP Documentation - master and local files
- Reconciliations and audit preparedness
- Cross-reference tax compliance, CbCR and Transfer Pricing (TP) documentation
- Automation and secure transmission of data exchange

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- Fully aligning transfer pricing with economic substance is a prerequisite to survive in the new age of corporate tax transparency.
Management agenda & prioritization

• Understanding the risk by assessing the bank’s international tax risk profile in terms of overseas affiliates, volume of intra-group transactions, mobility of workforce, expansion plans, etc.
• Prepare for country-by-country reporting by performing dry run, revealing data gaps in meeting reporting requirements and tax risks
• Conduct reviews of current Transfer Pricing (TP) policy and documentation
• Assess BEPS’ impact on financing structures, booking models and treaty availability
• Closely monitor the developments in the national implementations and assess impact on own organization
• Manage regulatory and tax risks of accidentally constituting corporate and/or personal taxable presences abroad by setting comprehensive guidelines for cross-border business (country manuals)

Risk assessment for global BCM business
Global business booking models are impacted by BEPS TP/substance workstreams.

Corporate structure, capital and financing are impacted by BEPS TP/substance and coherence workstreams.
In 2012, the revised Financial Action Task Force (FATF) Recommendations were released. Key changes are inter alia:

- Clear understanding of the money laundering and terrorist financing risks applying a risk-based approach in the respective countries
- Reinforcing transparency in ownership and control of legal entities
- Enhanced scope and application of international cooperation between authorities
- Significant expansion of law enforcement and Financial Intelligence Units
- Addressing new and aggravated threats such as the proliferation of weapons of mass destruction
- Consolidation of the requirements on financial institutions to identify politically exposed persons (PEPs)
- Expansion of predicate offences for money laundering list incl. serious tax crimes

Key changes of the 4th AMLD comprise:

- Qualification of tax evasion and other serious fiscal crimes as a predicate offence to money laundering
- Reduction of the threshold for a single value cash transaction from EUR 15,000 to EUR 10,000 for high value goods dealers or service providers
- Extension of the definition of politically exposed persons (PEPs) to cover domestic PEPs
- Central registration of beneficial owners of companies in the EU

FATF recommendations are not directly applicable to financial institutions

However, as they set an international standard for combating money laundering and the financing of terrorism, they significantly influenced regional (e.g. European) and national (e.g. Swiss) laws & regulations


Key changes of the AMLA 2016 comprise:
- Qualified tax offences deemed a predicate offence to money laundering. Prerequisite: evaded taxes amount to at least CHF 300,000 for each tax period
- Enhanced transparency regarding bearer shares: Acquisition of bearer shares of a company not listed on a stock exchange, the new bearer is obliged to report the acquisition to the company for proper identification
- Duty to establish the controlling person of operative companies
- Definition of politically exposed person (PEP) extended inter alia to cover both foreign and domestic persons
- Duty to report and the obligation to freeze a client’s assets are detached from each other
- Merchandisers (e.g., real estate brokers, art, gem dealers) subjected to a duty of due diligence when accepting cash payments > CHF 100,000

AMLO 2016
- Comprises the new due diligence obligations and reporting duties for traders and the former Federal Council Ordinance on the Professional Practice of Financial Intermediation (PFIO)

AMLO-FINMA 2016
- Material adjustments concern the concept of “controlling person”, special regulations for institutions subject to the Collective Investment Schemes Act, new payment methods and reporting requirements

CDB 16
- In addition to specifying the “controlling person” concept (incl. case studies) and introduction of new forms K, S, I the CDB 16 comprises editorial changes

Tax Compliance/Financial Integrity Strategy
Tax compliance/Financial Integrity Strategy

February 2013: The Federal Council launched a consultation regarding enhanced due diligence requirements obliging FIs to apply a risk-based assessment regarding the tax compliance of their customers.

November 2015: The provision in the Financial Institutions Act (FinIA) consultation draft requiring FIs to verify tax compliance of their customer’s assets following a risk-based approach was removed from the draft FinIA.

December 2015: Parliament rejected the Federal Council’s proposition to integrate the provision on the risk-based tax compliance assessment for customers with tax domicile in countries with which Switzerland has not signed an AEI agreement in the AMLA 2012; Introduction of a duty to verify tax compliance of customers is therefore off the regulatory agenda for now.

Automatic Exchange of Information (AEI)

November 2013: Decision to coordinate the new due diligence requirements introducing a global standard for AEI between Switzerland and its main partner countries.

February 2014: OECD presented new global standards on AEI.

December 2015: The corresponding Swiss implementing laws were passed by the Swiss parliament and should come into force on 1 January 2017 so that data can be collected from 2017 and exchanged from 2018.

AML - EY Point of View (PoV) & observations

Important points

- The implemented and upcoming changes require an adaption/calibration of (i) your client documentation and (ii) your IT-systems.
- The implementation of other regulations including FATCA, FWT etc. partly deal with similar challenges.
- Although the implementation date is not confirmed yet, an analysis of the interdependencies should be conducted as soon as possible.

EY PoV & market observations

- The implemented and upcoming change in regulations will increase the trend towards concentration.
- Some financial institutions implement the provisions of the different upcoming regulatory changes separately. Taking into consideration the different timelines of the implementation, this is understandable. However, synergies are not always identified and utilized.
- With an exception for very small institutions, the new internal AML frameworks need to be highly industrialized to (i) be able to comply with the new regulations and (ii) to keep costs within a certain limit.
- Not all financial institutions have the appropriate systems in place/ have their systems customized appropriately.

- A cornerstone of Switzerland’s “Financial Integrity Strategy” is to prevent the abuse of the Swiss financial sector for purposes of tax evasion.
- One contemplated measure is the introduction of a global standard for the AEI between Switzerland and its main partner countries.
- Introduction of a duty for Swiss financial intermediaries (FIs) to verify tax compliance of their clients’ assets is no longer on the agenda.
- Newly implemented regulations will continue to have an impact on your business.
- Be conscious of the different projects currently running in the area of “Know your Customer” and their interdependencies (e.g. FATF implementation, FATCA, FWT, etc.).
- Systems need to be fit for purpose to deal with the upcoming changes.
Challenges of cross-border financial business

Key points
- Since 2010, FINMA has emphasized the risks arising from cross-border financial activities
- As a part of the ongoing supervision, FINMA assesses the cross-border concept of supervised entities
- Lately, international standard-setters have addressed the growing need for a coherent and coordinated approach to the regulation of cross-border business
- 2010: FINMA published a position paper addressing the increased legal and reputational risks in cross-border financial business; 2012: FINMA issued FAQs on the same topic
- Supervised FIs approaching their client on a cross-border level are expected to have a sound cross-border framework as a basis for assessing and monitoring the regulatory risks and conducting sustainably compliant cross-border business
- The elements of the cross-border framework (see the box “Elements”) are assessed as a part of the ongoing supervision and the regulatory audit
- June 2013: The International Organisation of Securities Commissions (IOSCO) formed a task force to address the growing need for a coherent and coordinated approach to the regulation of cross-border business
- 25 November 2014: This task force published a consultation report, identifying and describing cross-border regulatory tools and challenges

Restrictions to be considered in cross-border financial business

```
<table>
<thead>
<tr>
<th>Product universe</th>
<th>Restricted activities &amp; services</th>
<th>Regulatory product restrictions</th>
<th>Tax suitability</th>
<th>Investment suitability</th>
</tr>
</thead>
<tbody>
<tr>
<td>Restricted</td>
<td>Restricted</td>
<td>Restricted</td>
<td>Unsuitable</td>
<td>Unsuitable</td>
</tr>
</tbody>
</table>
```

Elements

- Cross-border approach and concept
- Internal (incl. country specific) guidelines
- Training and certification
- Monitoring and controls

Simplified
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Thought Leadership

OECD releases draft country-by-country reporting template
The tiny tax with global ramifications. Are you ready?
Program for non-prosecution agreement or non-target letters for Swiss banks
FATCA Newsletter Published in January 2014

Managing Complexity
Cross Border Private Banking

20 | Swiss Regulatory Update Banking 2016
Capital & Liquidity Agenda
Basel III - Capital requirements

Key points
Basel III represents wide-ranging changes to the minimum standards for bank capitalization, incl. changes to the definition of eligible capital and required capital, along with the introduction of global leverage and liquidity standards.

Implementation in Switzerland
• Pure Basel III international standard is embedded into Swiss regulation for minimum requirements (abolishment of “Swiss finish” within Pillar 1 as previously known, i.e. deviation of very specific risk weights); for non Globally and Domestically Systemically Important Financial Institutions (G-SIFI/D-SIFI) the transition phase to abolish “Swiss finish” ends on 31 December 2018 at the latest
• New ordinance effective as of 1 January 2013, acknowledging international transition periods (with a few exceptions mainly concerning buffers, see below)
• Countercyclical buffer invoked since September 2013 (1%) and increased to 2% in June 2014
• Additional domestic loss-absorption buffer concept super-equivalent with international conservation buffer/G-SIFI
• Definition of capital and loss absorption criteria: adjustment to equivalency with regards to other legal entity forms and respective nature of capital (private banks, cantonal banks)

Components of Basel III Capital Requirements

<table>
<thead>
<tr>
<th>2016</th>
<th>2017</th>
<th>2018</th>
<th>2019</th>
</tr>
</thead>
<tbody>
<tr>
<td>Countercyclical capital buffer</td>
<td>0 - 2.5%</td>
<td>0 - 2.5%</td>
<td>0 - 2.5%</td>
</tr>
<tr>
<td>Capital conservation buffer</td>
<td>0.625%</td>
<td>1.25%</td>
<td>1.875%</td>
</tr>
<tr>
<td>Total capital</td>
<td>8%</td>
<td>8%</td>
<td>8%</td>
</tr>
<tr>
<td>Tier 1 capital</td>
<td>6%</td>
<td>6%</td>
<td>6%</td>
</tr>
<tr>
<td>Common Equity Tier 1</td>
<td>4.5%</td>
<td>4.5%</td>
<td>4.5%</td>
</tr>
</tbody>
</table>

• Additional capital conservation buffer of 2.5%, consisting of Common Equity Tier 1.
• Overall Common Equity Tier 1 ratio of 7%
Basel III - Capital buffer and Too Big To Fail (TBTF) requirements/Total Loss Absorbing Capacity (TLAC)

In Switzerland, the domestic concept of capital buffers and capital planning requirements are aligned to the bank categories; banks are categorized into descending order by means of:
- total assets
- Asset under Management (AuM)
- privileged deposits
- required capital

TBTF regime (applies on top of/in parallel to Basel III), acknowledging proportionate transitional arrangements on the basis of Basel III introduction path.

TBTF requirements for G-SIFI according to TLAC to be implemented by end of 2019
- Risk weighted assets of 28.6%
- Minimum CET1 requirement 10.0%
- Minimum T1-Capital (HT-Cocos) 4.3%
- Bail-in instruments (for “gone concern”) 14.3%

TBTF Unweighted requirements (Leverage ratio) of 10%
- Minimum CET1 requirement 3.5%
- Minimum T1-Capital (HT-Cocos) 1.5%
- Bail-in instruments (for “gone concern”) 5.0%

Swiss domestic concept of capital buffers and capital planning requirements:

<table>
<thead>
<tr>
<th>Category</th>
<th>Capital ratio determining capital adequacy target</th>
<th>Capital ratio below which immediate and extensive action is taken under supervisory law (intervention threshold)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Category 2</td>
<td>13.6% - 14.4%</td>
<td>11.5%</td>
</tr>
<tr>
<td>Category 3</td>
<td>12%</td>
<td>11%</td>
</tr>
<tr>
<td>Category 4</td>
<td>11.2%</td>
<td>10.5%</td>
</tr>
<tr>
<td>Category 5</td>
<td>10.5%</td>
<td>10.5%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Category</th>
<th>CET1 (Art. 21 ff. CAO)</th>
<th>AT1 (Art. 27 ff. CAO) or better</th>
<th>T2 (Art. 30 ff. CAO) or better</th>
</tr>
</thead>
<tbody>
<tr>
<td>Category 2</td>
<td>8.7% - 9.2%</td>
<td>2.1 - 2.2%</td>
<td>2.8% - 3.0%</td>
</tr>
<tr>
<td>Category 3</td>
<td>7.8%</td>
<td>1.8%</td>
<td>2.4%</td>
</tr>
<tr>
<td>Category 4</td>
<td>7.4%</td>
<td>1.6%</td>
<td>2.2%</td>
</tr>
<tr>
<td>Category 5</td>
<td>7%</td>
<td>1.5%</td>
<td>2%</td>
</tr>
</tbody>
</table>
Basel III – Large exposure rules

Global SIFIs (G-SIFIs) and Domestic SIFIs (D-SIFIs)
- Global SIFIs are announced on a yearly basis by the Financial Stability Board (FSB) and published on their homepage
- So far SNB declared 3 banks as domestic systemically important financial institutions (D-SIFIs): ZKB, Raiffeisen and PostFinance
- No privileged risk weighting of exposures at sight or overnight to G-SIFIs and D-SIFIs is applicable under Basel III

Counterparty corporates and public-sector entities (incl. governments)
- For all counterparties which are not banks or securities dealers, the upper limit is always 25% of total of eligible capital
- All positions are in general risk-weighted with 100% except for public sector entities with a risk class of 1 and 2 (0% respective 20% risk-weight)
- TBTF: SIFIs and D-SIFIs have to measure and limit concentration risks not against the total of eligible capital but in relation to the Common Equity Tier 1 (CET1)

Swiss large exposure rule according to Art. 95 - 123 CAO
- All positions to banks and securities dealers are weighted at 100% (regardless of maturity and rating)
- For institutions with eligible capital of up to CHF 1 billion, the upper limit for positions to non-SIFI banks and securities dealers will be 100% of the eligible capital, but at the maximum CHF 250 million
- For institutions with eligible capital above CHF 1 billion, the upper limit is always 25% of the eligible capital
- For all institutions the upper limit for positions to system-relevant banks (G-SIFIs and D-SIFIs) is 25% independent of the institutions level of eligible capital
- All large exposure risks surpassing these limits need to be covered by free available capital surplus according to Art. 41 of the CAO. The basis for the capital requirement is no longer minimum capital of 8% but the institution specific requirement:
  - minimum capital requirement
  - capital buffer
  - anti-cyclical buffer
  - additional buffer (if required by FINMA)

FINMA Circular 2013/7
“Intragroup Exposure Banks”: Limitation of intragroup exposure for relevant financial institutions being part of a foreign banking group, which are not under the consolidated supervision of FINMA:
- A potential mismatch in regard of an intragroup risk exposure when the intragroup exposure exceeds CET1 capital of the financial institution
- If FINMA comes to the conclusion that the consolidated supervision of a foreign banking group - of which a Swiss subsidiary is part of - is not adequate, FINMA has the power to order a reduction of the intra-group exposure or to increase the capital requirement by an additional institution-specific capital buffer
FINMA Circular 2016/1
“Disclosure Banks”: The Circular applies to all banks and securities dealers which are incorporated in Switzerland, with the exception of private banks that do not publicly solicit client deposits:
• When calculating capital adequacy and liquidity requirements on the level of a finance group or conglomerate, the disclosure duties are in general only to be applied on a consolidated basis (“consolidation discount”)
• Foreign-controlled banks are in general exempt from disclosure if comparable information is published abroad at group level
• However, banks which benefit from the consolidation discount as well as foreign-controlled banks which are in general exempt from capital disclosure nevertheless have to publish as a minimum: CET1, T1, total capital ratio and the applicable capital adequacy targets (incl. anti-cyclical capital buffer) according to FINMA Circular 2011/2 (from 31 December 2015 onwards)

Key points of revised Pillar 3 disclosure requirements
Implementation of the new disclosure requirements according to FINMA Circular 2016/1:
• Category 1 banks have to publish the revised capital disclosure requirements for the first time for year end 2016
• Category 2 and 3 banks have to publish the revised capital disclosure requirements for the first time for year end 2017
• Category 4 and 5 banks have to publish the revised capital disclosure requirements for the first time for year end 2018

Partial disclosure
• Partial disclosure is only applicable for category 4 and 5 banks

Large banks/SIFIs
• Specific disclosure requirements for large banks (banks with minimal capital requirement for counterparty credit risks of more than CHF 4 billion)
• Specific capital disclosure requirements for systemically important financial institutions or groups (G-SIFI, D-SIFI)

Disclosure according to FINMA Circular 2008/22
Partial disclosure for banks which meet all the following requirements:
• The minimum capital required for credit risk is less than CHF 200 million
• The Basel Standardized Approach (SA-BIS) is used to calculate the minimum capital requirements for credit risk or the Swiss Standardized Approach (SA-CH) during the transition period up to and including 31 December 2018
• The basic indicator approach (BIA) or the standardized approach is used to calculate capital adequacy requirements for operational risk
• Only applies if securitization transactions as per FINMA Circular 2008/19 “Credit Risk – Banks” are not used

Qualitative capital disclosure requirements
• Equity interests and scope of consolidation/eligible and required capital/credit risk/market risk/operational risk

Quantitative capital disclosure requirements
• Eligible capital and capital requirement
• Specific information (tables) for counterparty credit risks
Main topics (compared to current Standardized Approach (SA-BIS))

Haircuts:
- Prohibition of using internal models and own estimates for the calculation of haircuts
- SA haircut formula revised to obtain more risk sensitive results given the above prohibition
- Change in formula: distinction between the effect of netting longs and shorts
- Haircuts (irrespective of external ratings allowed) range from 0.5% to 30%

Credit Risk Mitigation (CRM):
- If compliant with domestic regulation, external ratings still permitted with certain restrictions
- Alternative approach: Certain securities will be eligible provided that the supervisor is sufficiently confident that the market liquidity of the security is adequate

Currency mismatch:
- 50% risk weight add-on for unhedged exposures with different currencies between the loan and the counterparty’s main source of income
- Applies to retail, real estate and corporate exposures

Implications

Capital:
- Potential increase of risk weighted assets, depending on the bank’s business activities and specifics of its credit portfolio

Operational:
- Revised calculation of risk weights and additionally required data fields might trigger operational changes within the IT infrastructure

BCBS – current status
- Second draft published, incorporating feedback received on 1st paper
- Feedback on 2nd paper requested until 11 March 2016

BCBS – next steps
- Analysis and evaluation of QIS (completed)
- Adjustments expected based on feedback and QIS
- No binding implementation plan scheduled so far, but significant progress expected in 2016

FINMA
- No formal activities so far

* Revisions to the Standardized Approach for Credit Risk - BIS 2nd Consultative Document December 2015
BCBS aims to strike an appropriate balance among simplicity, risk sensitivity and comparability

Through the 2nd Consultative Document, a combination of external credit ratings and obligation for due diligence (DD) is sought

Key points

Banks:

- External Credit Risk Assessment Approach (ECRA) - jurisdiction allows external rating (if available)
- External credit ratings together with DD form the basis of the risk weight calculation
- Standardized Credit Risk Assessment Approach (SCRA) - all other cases
- Banks classify exposures in three buckets (lowest to highest risk weight: Grade A, B and C)
- Risk weight before DD between 20% and 150%, including short-term exposures

Corporates:

- Same as for banks for non-SME
- 85% risk weight for SME exposures (exception: 75% risk weight for corporates that qualify for retail classification)
- Issue-specific external ratings for project finance, object finance and commodity finance (if available, otherwise separately defined risk weights between 100% and 150%)

Retail - Real Estate:

- Loan-to-Value ratio as main risk driver
- Distinction between Residential and Commercial Real Estate
- Risk weight higher where repayment is dependent on the transaction revenues

Retail:

- 75% risk weight for retail exposures meeting regulatory definition
- 100% risk weight for all other retail exposures

<table>
<thead>
<tr>
<th></th>
<th>Dependent on rent/sale of the property</th>
<th>Independent on rent/sale of the property</th>
</tr>
</thead>
<tbody>
<tr>
<td>Residential</td>
<td>70%-120%</td>
<td>25%-85%</td>
</tr>
<tr>
<td>Commercial</td>
<td>80%-130%</td>
<td>Min (60%, RW of counterparty)</td>
</tr>
</tbody>
</table>
Capital floors - For banks with model approaches*

**Alternatives discussed in the BIS Consultative Document**

**Risk category-based floor**
- Minimum average risk weight for each risk category (credit-, market-, operational risk)
- No offsetting across risk types
- Floor for each risk category is the higher of the Standadized Approach (SA) and the internally modelled Risk Weighted Assets (RWA)

**Aggregate RWA-based floor**
- Floor based on total RWAs
- More flexible than category-based approach
- Easier to apply than category-based approach

**Adjustment to the numerator of the capital ratio**
- Reverse all Internal Ratings Based (IRB) additions/deductions made to capital resources and apply the SA treatment to provisions
- “IRB measure of capital” is, therefore, effectively transformed into a “standardized approach measure of capital”

**Adjustment of the RWAs**
- Relevant provisions get converted to a “RWA equivalent”
- RWA-equivalent then added to/removed from the RWAs to calculate the capital floor

**Objectives:**
- Ensuring minimum capital level
- Mitigation of model risk (due to too little model specification, unsuitable data, etc.)
- Combating incentive-compatibility issues of over optimistic models
- Enhance comparability

**Status:**
- Industry feedback completed; calibration (outside scope of consultative document) and finalization originally planned by the end of 2015, now expected to be postponed; no binding implementation plan scheduled so far
- Current: national floor for credit risks and operational risks; minimal capital requirement for banks which apply the model approaches of 80% - calculated compared to the standard approach

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* BIS Consultation Document from December 2014
Leverage Ratio

Key points
- 1 January 2015: begin public disclosure; the Committee will continue monitoring the impact of these disclosure requirements
- The final calibration, and any further adjustments to the definition, will be completed by 2017, with a view to migrating to a Pillar 1 (minimum capital requirement) treatment on 1 January 2018
- The Basel Committee continues to test a minimum requirement of 3% for the leverage ratio during the parallel run period (i.e. 1 January 2013 - 1 January 2017)
- Analysis of effects of minimum capital ratios, Liquidity Coverage Ratio (LCR) and leverage ratio is key (find right balance between trade-offs)
- Netting is generally forbidden (assets need to be included on a gross basis in the denominator) with specific netting rules for derivatives and Securities Financing Transactions (SFTs) (i.e. repo-style transactions, which are based on the Basel II framework)

Leverage ratio elements
Capital
  ▪ CET 1 (Common Equity Tier 1) after deductions

Exposure
  ▪ On-Balance Sheet items
  ▪ Off-Balance Sheet items

The Basel III leverage ratio is defined as the Capital Measure (the numerator) divided by the Exposure Measure (the Leverage Ratio Denominator (LRD)), with this ratio expressed as a percentage.
Disclosure requirements (FINMA Circular 2016/1)

Content
- Category 1-3 banks: full disclosures required, i.e.
  - Summary comparison between total assets (financial statements) and LRD - Table 46, Annex 2 to FINMA Circular 2016/1
  - Detailed disclosure for leverage ratio - Table 47, Annex 2 FINMA Circular 2016/1
- Category 4-5 banks: partial disclosure (if applicable), i.e.
  - As partial disclosure the Capital Measure (CM), the LRD and the leverage ratio need to be disclosed (Corresponding to lines 20-22 in Table 46, Annex 2 FINMA Circular 2016/1)
- Bank subsidiaries (including those controlled by foreign banking groups):
  - Banks’ subsidiaries need to disclose at the minimum the leverage ratio in their annual report in all cases (including those where consolidated disclosures are prepared in the banking group)

FINMA Circular 2015/3
Challenges for category 2 to 4 banks
- Balancing of minimum capital ratios, LCR and leverage ratio; e.g. banks are tending to hold more cash positions to fulfill LCR requirements; cash has usually a risk weight of 0% for the minimum capital ratios, and has no impact on them; however, as the leverage ratio does not take into account market of default risks these cash positions are included in the LRD
- Netting: for calculating the LRD it is generally forbidden to offset assets and liabilities (assets need to be included on a gross basis in the LRD) with the exception for netting derivatives and SFTs (repo-style transactions) according to specific netting rules deriving from the Basel II framework
- Master Netting Agreements (MNA): in order to be allowed to net derivative and SFTs according to the specific rules, a MNA must be established with each counterparty that contains specific features; the enforceability of the MNA in all relevant jurisdictions must be confirmed by a legal opinion
- Cross Product Netting: an exception to the Basel II netting rules, cross product netting is not allowed for the purpose of calculating the LRD (e.g. derivative with SFTs)
- Items deducted from Basel III eligible capital: deductions that derive from the asset side of the balance sheet can be deducted from the LRD accordingly; not all deductions from eligible capital are items from the asset side in the balance sheet (e.g. dividend accruals, accruals for own shares)
- LRD Optimization strategies: primarily by means of netting and balance sheet reductions

FINMA published the new Circular 2016/01 on disclosure requirements for banks
- For leverage ratio no material changes compared to the previous Circular 2008/22, except for bank subsidiaries
- Timing: Leverage Ratio disclosures need to be made with the same frequency as the disclosures for minimum capital requirements from the risk based framework, depending on the banks individual disclosure frequency requirements:
  - annually,
  - semi-annually or
  - quarterly
Liquidity Rules

- Liquidity continues to be a focus topic for regulators
- While LCR has reached a fine-tuning stage, the reporting requirements are again notably increasing as FINMA is requesting the quarterly submission of additional monitoring tools
- NSFR will kick into force in 2018 but pro forma reporting will become mandatory for all banks in mid 2016
- New Circular expected to be published in 2016

Liquidity requirements in Switzerland

<table>
<thead>
<tr>
<th></th>
<th>2016</th>
<th>2017</th>
<th>2018</th>
<th>2019</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Liquidity Coverage Ratio (LCR)</strong></td>
<td>In force since 1 January 2015</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td><strong>Net Stable Funding Ratio (NSFR)</strong></td>
<td>Test phase with selected banks</td>
<td>Official reporting for all banks</td>
<td></td>
<td>Effective date for minimum standard</td>
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<td><strong>Disclosure</strong></td>
<td>New Circular 2016/1</td>
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<tr>
<td><strong>Monitoring Tools</strong></td>
<td>Test phase with selected banks</td>
<td>Official reporting for all banks</td>
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<tr>
<td><strong>Minimum Reserve</strong></td>
<td>Requirements still in force</td>
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<tr>
<td><strong>Qualitative Liquidity Requirements</strong></td>
<td>In force since 1 January 2014</td>
<td></td>
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</tr>
</tbody>
</table>

Liquidity Coverage Ratio (LCR)

\[
LCR = \frac{\text{Stock of high quality liquid assets (HQLA)}}{\text{Net cash outflow over a period of 30 days}} \geq 100\%
\]

<table>
<thead>
<tr>
<th></th>
<th>2016</th>
<th>2017</th>
<th>2018</th>
<th>2019</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Min Ratio</strong></td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
</tr>
<tr>
<td><strong>Min Ratio SIFIs</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Min Ratio other banks</strong></td>
<td>70%</td>
<td>80%</td>
<td>90%</td>
<td>100%</td>
</tr>
</tbody>
</table>

Net Cash Outflow

- Outflows of retail deposits
- Outflows of unsecured wholesale funding
- Outflows of secured funding
- Additional outflows, i.e. other contingent funding liabilities (such as guarantees, letter for credits, revocable credits and liquidity facilities)

Contractual cash inflows due within the next 30 days:
- Maturity of secured lending transactions
- Margin lending backed by all other collateral
- All other assets due within the next 30 days

Limitation of cash inflow to maximum 75% of the cash outflow
Net Stable Funding Ratio (NSFR)

Objective of NSFR:
Ensure that long-term and illiquid assets are funded with stable liabilities.

Latest NSFR form and related instruction document were released by FINMA on 2 February 2016. Frequency of reporting is tied to the bank category. Category 1&2 banks are required to submit the NSFR report on a monthly basis while banks within the categories 3-5 can submit it quarterly

\[
\text{NSFR} = \frac{\text{Available amount of stable funding}}{\text{Required amount of stable funding}} \geq 100\%
\]

Available Stable Funding (ASF)
Defined as reliable sources of funds over a 1 year time horizon under conditions of extended stress, which includes:
- Capital (defined as BCBS Tier 1 + Tier 2 + other preferred equity with maturity > 1 yr) and Secured and unsecured funding with maturity > 1 year (100% Factor)
- “Stable” and “Less Stable” non-maturing (demand) deposits and/or term deposits (as defined in LCR) with residual maturities of less than 1 year provided by retail customers and SME (90% Factor/Stable, 80% Factor/Less Stable)
- Unsecured wholesale funding, non-maturing deposits and/or term deposits with a residual maturity of < 1 year, provided by non-financial corporates, sovereigns, central banks, multilateral development banks and PSEs (50% Factor)
- All other liabilities and equity categories not included above will have an ASF factor equal to 0%

Required Stable Funding (RSF)
- Required funding is a function of the liquidity characteristics of the assets, Off Balance Sheet (OBS) contingent exposures and/or activities performed by the institutions
- Calculated as the sum of the value of the assets held and funded by the institution, multiplied by a specific RSF factor assigned to each particular asset type, added to the amount of OBS activity
- Liquid assets are more readily available and receive lower RSF factor
- Assets considered less liquid require more stable funding, so the RSF factor is higher
Qualitative Liquidity Requirements

- Qualitative Requirements are based on Liquidity Ordinance and FINMA Circular 2015/2 “Liquidity Risks - Banks”
- Banks must have a liquidity risk management framework in place, which is effectively integrated into the bank’s overall risk management process. General Principle: “Ensuring a bank’s continuous solvency, even in situations of liquidity stress”

Key elements of the liquidity framework:

- Setting of liquidity tolerance by the Board of Directors and periodic review thereof
- Definition of strategies for the management of liquidity risk
- Identification, assessment, measurement, management and monitoring of liquidity risks
- Liquidity buffer: A bank should hold assets, which can easily be monetized in times of need
- Risk reduction: implementation of a limit system
- Definition of stress scenarios and implementation of stress testing (incl. for intraday liquidity)
- Steering function (transfer price system): Consideration of liquidity costs and risks in business activities (fixing prices, profitability measurement)
- Creation of an emergency plan

The principle of proportionality stipulated in the FINMA Circular 2015/2 applies to banks of smaller size and can be adopted for business activities of lower complexity/riskiness

Disclosure Requirements

FINMA Circular 2016/1 applies with transition phases for category 2 and 3 as well as for category 4 and 5 banks

Who needs to disclose what?

- Category 1-3 banks have full disclosure requirements, these banks need to publish LCR data as per Appendix II Table 48 of the Circular and provide comments to the data
- Category 4 and 5 banks have partial disclosure requirements, these banks need to publish the LCR ratio, the HQLAs and the net cash outflows
- Banks benefiting from a consolidation discount (as per FINMA Circular 2016/1 mn 9): if a bank has capital credit risk requirements > CHF 4bn it is considered a large bank and needs to provide a partial disclosure; small banks just publish the LCR ratio
- Disclosure of liquidity requirements apply to all banks with headquarters in Switzerland, except private bankers who do not advertise and securities dealers
Method of LCR calculation

- Banks publishing only annual financial statements: average LCR data of each of last four quarters
- Banks submitting semiannual financial statements: average LCR data of last two quarters
- Banks submitting quarterly financial statements: average LCR data of last quarter
- For all banks the average calculation is based on the monthly LCR reports. Starting in January 2017, systemically important banks must calculate the average figures based on daily closing values

Form of disclosure

- Banks of category 1-3 must publish the information on their websites; information should be published for the four preceding years (if available)
- Banks of category 4 and 5 without a website can disclose the information in their financial statements

Monitoring Tools according to FINMA information published in August 2015

- Part of the new liquidity regulations set out in Basel III, complementing the short-term liquidity (LCR) and structural liquidity (NSFR) ratios
- FINMA published the monitoring tools template (Excel spreadsheet) along with an instruction manual on 28 September 2015 (https://www.finma.ch/de/news/2015/08/aktuell-liquiditaetsregulierung-20150818/)
- No minimum requirements need to be met (data is for informational purposes only)

Template contains 3 Monitoring Tools/spreadsheets requiring following information

- Monitoring Tool I: breakdown of the bank's cash flows (similar fields as in LCR but data needs to be provided by maturity buckets)
- Monitoring Tool II: exposure to largest funding counterparties (broken down by maturity)
- Monitoring Tool III: unencumbered collateral/Potential liquidity generation capacity over the next 90 days

All Monitoring Tools need to provide sum of all currencies, CHF, and largest currencies.

Banks participating in the test phase

- All banks of supervision category 1-3, selected institutions from category 4 have to submit 6 test reports (first test report as of 30 September 2015)
- Submission times: First report within 3 months, i.e. by 31 December 2015; all other reports within 2 months

General Monitoring reporting for all banks

- Starting as of 31 March 2017
Standardized Approach - Counterparty Credit Risk (SA-CCR) - Overview

Key points
- The SA-CCR can be seen as the simplified «model approach» to counterparty exposure
- The close-out risk will be calculated based on stressed volatilities and correlations
- Improved recognition of close-out netting and collateralization
- Net independent collateral amount (NICA): Bankruptcy remote NICA does not count as additional exposure
- Data requirements are increasing (e.g. product details like put/call, strike, underlying data and margining/netting data like margining frequency, threshold, minimum transfer amount, margin period of risk, independent collateral)
- Higher standards for processes (e.g. proof of bankruptcy remoteness, determination of margin period of risk)

The counterparty credit risk capital charge applies to derivatives in the trading book and in the banking book.
Fundamental Review of the Trading Book (FRTB) – Overview and timeline

BCBS rules published on 14 January 2016

Highlights of the final rule include:
- Prescriptive standards designed to limit implementation interpretations and promote consistency across firms and jurisdictions
- A revised trading book/banking book boundary with more explicit requirements for inclusions and exclusions of positions and limitations on reclassifications to reduce the scope for arbitrage
- An overhaul of the Internal Models Approach (IMA) to focus on tail risk, varying liquidity horizons, constrained diversification and risk factor observability standards
- Stringent trading desk level IMA approval standards including model performance Profit and Loss (P&L) attribution tests to assess the risk factor alignment between risk management and pricing models
- An overhaul of the Standardized Approach (SA) to make it more risk sensitive, explicitly capture default and other ‘residual’ risks, and serve as a floor to IMA charges

The FRTB overhauls the market risk capital framework to meet the Basel Committee’s objectives of addressing shortcomings of the current Basel 2.5 framework and reducing the variability of market RWA across firms and jurisdictions.
Key areas of change in the final standards include:

- Extended implementation timeline as compared to prior Committee communications, with National supervisory rulemaking expected by January 2019 and banks required to report under the new standards by 31 December 2019
- Confirmation that a SA floor will be employed as a limit on IMA charges, though calibration to be finalized through future analysis and impact studies
- Notable recalibrations including the addition of a fair value cap on the SA capital charge for individual securitizations decreases, decreased liquidity horizons and decreases to risk weights of certain products, contrasted by increases to the risk weights for other products and an increase to the internal capital charge multiplication factor, that in aggregate are described as having lowered, on average, market RWA relative to the results in 4th QIS
- Despite the accommodations, the committee estimated the FRTB will result in an approximate 40% weighted average increase in total market risk capital requirements as compared to Basel 2.5
- Modifications to the Profit and Loss (P&L) attribution tests for ongoing use of internal models at desk level, which may somewhat ease prior concerns over operational challenges to align risk and finance market data inputs and pricing models under the P&L attribution requirements

Areas not final or subject to change

The Committee acknowledges that certain areas require further finalization or may be subject to further change, including:

- the calibration of the SA floor
- the finalization of P&L attribution test thresholds
- the standards for Pillar 3 disclosure requirements, which will be proposed in a separate public consultation
- the finalization of the revised credit valuation adjustment (CVA) framework using the FRTB framework
FRTB – The capital charge components at a glance

Population
- Inclusions
- Exclusions

Trading Book
- Internal risk transfers – credit and equity
- Internal risk transfers – interest rates

Trading Desk
- Definition
- Criteria

Capital Components
- Internal Model Approach (IMA)
  - Expected Shortfall (ES)
  - Non-modellable risk factors (NMRF)
  - Default risk charge (DRC)
  - Partially addressed through RNiVs in certain jurisdictions

- Standardized Approach (SA)
  - Sensitivity based risk charge
  - Default risk charge (DRC)
  - Residual risk add-on

Basel 2.5
- VaR$^1$ + Stressed VaR$^1$
- Incremental Risk Charge (IRC)$^2$
- Standardized Charge$^3$
- Standardized Charge$^3$

Additional requirements
- Intraday limit monitoring
- Stress-testing
- Market liquidity
- Disclosures
- P&L reports
- Inventory aging reports

---

$^1$ Securitization positions are included in the Value-at-Risk and stressed Value-at-Risk measures under Basel 2.5. FRTB requires that securitization positions are excluded from the IMA and only included in the SA

$^2$ Modeled default risk charges for correlation trading positions (CPT) are measured through the Comprehensive Risk Measure under Basel 2.5. FRTB requires CTPs to be capitalized under the standardized approach

$^3$ Certain jurisdictions apply Basel 2.5 standardized charges only for products with specific risk. Additionally, certain jurisdictions provide De Minimis charges for positions not included in VaR
FRTB – Standardized approach

The standardized approach requires the calculation of five different charges
The sensitivity data needed for the standardized approach calculations needs to be obtained from the same sources that are used for market risk management reporting.

Key consideration
- Prescriptive standards are designed to limit implementation interpretations and promote consistency across firms and jurisdictions
- Each of the above components requires granular bucketing of positions and sensitivities therefore banks will need to dedicate significant resources to accommodate the complex database structures, which support sourcing and storage of additional data (e.g., bucketed sensitivities, new reference data, parameter configurations)

The Default Risk Charge and Residual Risk add-ons explicitly capture default and other risks, whereas Basel 2.5 standard calculations did not

Standardized approach capital requirement

- Sensitivities-based risk capital charge
  - GIRR / CSR / FX / Equity / Commodity
- Default risk capital charge
  - Non-sec (non-CTP) / Sec (CTP)
- Residual risk add-on
- The linear risk capital charge (delta and vega)
- The non-linear risk capital charge (curvature)
FRTB - What banks should consider now

**Final rule analysis**
- Developing rule interpretations and assumptions that will impact the bank's view of implementation requirements prior to launching projects

**RWA impact analyses**
- Updating RWA impact analyses to reflect the updated liquidity horizons, risk weights and other changes to enhance the estimate of projected RWA impact from FRTB at various levels (e.g. top of the house, specific lines of business, trading desks)

**Business impact and program strategy discussions**
- Forming business strategy and capital optimization working groups or projects to understand the drivers of FRTB pro-forma RWA to allow for early identification of priority work streams, and assessment of future potential impacts of the FRTB (e.g., market liquidity, bid-ask spreads, pricing, profitability) to support taking actions in advance of the effective date, as necessary, to rebalance portfolios and business strategies

**Gap analyses**
Executing high level and targeted gap analysis efforts, to assess the banks current state infrastructure and in-flight programs, against the FRTB key requirements to identify critical gaps. Identify areas with the longest implementation lead times such as modelling, data and overall risk infrastructure enhancements that will not only be needed for minimum compliance but also for RWA optimization strategies e.g. through pursuing model approval

**FRTB Communication program**
- Increasing FRTB communication with senior management and the front office as to the implementation timing of the FRTB, the national supervisory rulemaking status, the anticipated RWA impacts, business strategy considerations and the anticipated size and scale of the bank’s FRTB program and related resource needs

**Launching strategic FRTB programs**
- Launching strategic FRTB programs, migrating from tactical working groups and QIS execution teams, formalizing the governance, oversight and accountability of stakeholders, and developing resource and budget needs across the bank
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Thought Leadership

BCBS 239 - Risk data aggregation and reporting

Regulating from Within. Bank Strategy

Global regulatory network. Executive Briefing
3

Consumer Protection
Markets in Financial Instruments Directive II (MiFID II) - Creating a single rulebook

Objectives
- Ensuring market equality through a level playing field between market participants
- Increase market transparency for market participants
- Strengthen regulatory powers and regulatory coordination at European level
- Raise investor protection
- Reduce organizational deficiencies and improve internal control functions of market participants

Regulatory timeline (indicative)

<table>
<thead>
<tr>
<th>Published in Official Journal &amp; in force (2 July '14)</th>
<th>Consultation on national implementation</th>
<th>ESMA draft ITS to Commission (11 Dec '15)</th>
<th>Application of new rules (3 January '18)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Q1 Q2 Q3 Q4</td>
<td></td>
<td>ESMA advice to Commission (3 January '15)</td>
<td>Delegated Acts</td>
</tr>
<tr>
<td>2014</td>
<td>2015</td>
<td>ESMA draft RTS to Commission (3 July '15)</td>
<td>National transposition (3 July 2017)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>ESMA and Commission consultations on Level 2 measures</td>
<td></td>
</tr>
</tbody>
</table>

- MiFID II is the evolution of the already existing MiFID I regime
- The implementation date will postponed from 3 January 2017 to 3 January 2018
- With the release of the Delegated Directive and Delegated Regulations in Q2 2016 the much needed clarity is available to finalize the analysis and to commence with the implementation
Markets in Financial Instruments Directive II (MiFID II) - Strategic challenges and trends in private banking

Key topics

• Advised services: advisory model + value proposition + pricing strategy need to be re-assessed locally and globally
• Inducements: along with the potential strategic decision of being an independent advisor, financial advisors will have to adapt their business model due to the resulting impact on inducements and profitability
• Market access: financial advisors with operations in third countries need to analyse potential changes in their operations and business model initiated by revised MiFID II requirements and assess the interplay with corresponding local 3rd country regulation
• Capital markets: re-evaluation and adaption of product offering and partnering due to cost considerations; trading processes and trading data management will require adaptions
• Commercialization: with the much anticipated clarity of the Delegated Acts, firms should start thinking about the wider market ramifications of MiFID II/ MiFIR and assess how to leverage resulting market opportunities

Challenges and trends

What are the key strategic challenges and related questions in private banking?

Advised services
- What are the benefits and the downsides of independent advice?
- What is the impact on the product shelf and open architecture?

Inducements
- What fees are potentially at risk and what is the impact?
- Is the current distribution model fit for MiFID II?

Market access
- How is the cross-border business affected (direct vs. delegated model)?
- What happens with Inter Company (IC) outsourcing?
- Active vs. passive client servicing

Trading & execution
- How significant is the derivative business as part of own offering?
- What services will clients request in future when trading derivatives?

What trends are we observing in private banking?

Distinct value proposition
- Brand for best advice
- Introduction of advisory pricing combined with modular and enhanced advisory offering and experience
- Distinct value proposition by segment

Inducement free offering
- Inducement free offering in waves
- Development of alternative provider fee models
- Review of remuneration schemes
- Full transparency

Reducing complexity
- Review of the operating model and service delivery model
- Harmonization with no/low country-specific solutions
- Clear and distinct market offering

Extended services
- Large players with full capability vs. small players assessing alternatives
- Increased use of trading platforms by professional participants in the future
FIDLEG - The strive for equivalent Swiss law generally aligned to Europe’s MiFID objectives

Key points

1. Scope of supervised entities: financial service providers including banks, insurance companies and asset managers
2. Corporate governance: adequate organizational measures also regarding collaboration with intermediaries, conflicts of interest and employee transactions
3. Cross-border regulation: market access rules for foreign financial institutions providing services within or into Switzerland
4. Client classification: classification of clients into retail clients, professional clients and institutional clients
5. Key rules of conduct: including duties in the advisory process regarding the suitability assessment and the best execution principle
6. Documentation: documentation of products (prospectus and basic information sheet) and services (advisory minutes) ensuring transparency and comparability

The upcoming Swiss Financial Service Act (FIDLEG) will be aligned with MiFID I and MiFID II to a large extent; however, differences regarding the Suitability and Appropriateness (S&A) concept, treatment on inducements and product governance requirements exist.

Many Swiss banks will need to integrate the FIDLEG set of requirements into ongoing projects, while locally oriented market players will have to start from scratch.
Regulatory timeline (indicative)

- **Federal Council addressed to establish draft (Mar ‘12)**
- **Legislative process by consultation (Jun ‘14)**
- **Expected parliamentary approval (Q4 ‘16)**
- **FINMA position paper on distribution rules (Feb ‘12)**
- **End evaluation/start hearing (Feb ‘13)**
- **Federal Council’s dispatch published (4 Nov ‘15)**
- **Expected application of new rules (Q1 ‘18)**

**Key points**
- Dispatch and draft legislation published by Federal Council on 4 November 2015
- First chamber of Parliament (Ständerat) is expected to consider the draft legislation early this year (next debate in the WAK-S in April)
- Entry into force planned for 2018 (given the delays of MiFID II, we believe that FIDLEG will enter into force in Q1 2018 earliest)

- The legislation process of FIDLEG is highly aligned with the EEA agenda (timeline of MiFID II)
- A political debate about the regulation of advisory services remains open
Key differences are that FIDLEG
• introduces a new S&A concept
• does not require a mandatory ban on inducements
• does not contain product governance requirements

Key points
In general, FIDLEG is aligned with MiFID I/II especially regarding consumer protection rules such as:
• Client classification
• Best execution
• Disclosure and information requirements

Main differences:
• FIDLEG proposes a new S&A concept distinguishing between transaction and portfolio related advice, whilst the S&A concept under MiFID II distinguishes between advised and non-advised services
• The current FIDLEG draft drops the differentiation between dependent and independent advice (and the corresponding ban on inducements) and replaces it with higher transparency requirements
• FIDLEG does not set out any product governance requirements (including the target market definition)

Other FIDLEG specifics:
• Key investor document similar to PRIIPS
• Facilitated access to courts for clients due to new procedural rules
• RMs to be adequately trained and registered (in certain cases)
The Protocol Requirements pursuant to CISA - A foretaste of the profiling standards under the upcoming FIDLEG

**Key points**
- Duty to establish written protocol - protocol requirements pursuant to the Swiss Collective Investment Schemes Act (CISA)
- The Swiss Bankers Association drafted guidelines on how to interpret and implement the protocol requirements (see diagram “Elements”); these guidelines set a minimum standard recognized by FINMA
- The duty to establish a written protocol is triggered in case of a distribution activity, a personal recommendation regarding the acquisition of units of a specific collective investment scheme

**Scope**

<table>
<thead>
<tr>
<th>Distribution activity</th>
<th>Personal recommendation</th>
<th>Acquisition</th>
<th>Specific collective investment scheme</th>
</tr>
</thead>
<tbody>
<tr>
<td>= any offering or advertisement, except • advice with a mandate • discretionary asset management • execution only upon the customer’s own demand</td>
<td>• addressed to a specific investor (≠ public) • takes the specific needs of that investor into consideration • ≠ financial research, sales lists, recommendation lists etc.</td>
<td>• ≠ keep or sell ≠ re-investment (unless the target investment is a collective investment scheme)</td>
<td>≠ shares, bonds, derivatives, structured products etc. ≠ the mere indication of an investment category ≠ comparison of two collective investment schemes</td>
</tr>
</tbody>
</table>

**Elements**

Client needs= investment profile
- Contains the investment objectives and the risk profile
- To be established prior to the first recommendation and amended if needed

Protocol
- Personal recommendation
  - Reason for the personal recommendation reg. the acquisition of a certain collective investment scheme
  - To be established with regard to every recommendation

Match
- Match
Implications

- The revised FINMA Circular 2009/1 on “Guidelines on asset management“ which entered into force on 1 July 2013, sets out the guidelines applied by FINMA as a yardstick when an asset management organization seeks to have its code of conduct recognized as a minimum standard
- The Swiss Bankers Association’s (SBA) Portfolio Management Guidelines were revised accordingly and had to be implemented by all portfolio managers in 2015

The main changes concerned the:

- duty of investigation (client’s risk profile)
- information duties (risk disclosure)
- due diligence obligations (updating the client’s risk profile)
- disclosure duty for retrocessions

Key points of FINMA Circular 2009/1 and the SBA Guidelines

- Investment strategy to be defined with clients based on their risk profile (must be documented), financial situation and investment restrictions
- Portfolio managers’ contracts must specify who is entitled to any third-party payments received by portfolio managers; at the request of clients, asset managers must also disclose the amount of any third-party inducements already received

Portfolio managers must:

- take clients’ experience and knowledge into consideration and a risk profile must be drawn up, outlining clients’ risk tolerance and risk capacity, while reflecting the client’s financial situation, investment objectives, knowledge and experience (pre-contractual duty/duty of investigation)
- ensure that investments are always in line with the risk profile and designated investment objectives and restrictions (duty of due diligence)
- review the investment strategies employed on a periodical basis and assess whether clients’ risk profiles are in line with their current financial circumstances (duty of due diligence)
- inform their clients, in an appropriate manner of the risks associated with investment objectives, restrictions and agreed strategies (duty of information/disclosure obligations)
Thought Leadership

MIFID II
Wesentliche Auswirkungen der MIFID II auf den Finanzplatz Liechtenstein

Relaunch Investment Suitability
FINMA Distribution Regulations: International Comparison and Need for Actions

MIFID II
Need for action for Swiss investment firms

FIDLEG – new standards for the Swiss financial market Impacts and opportunities

The world of financial instruments just got more complex. Time to take note. Capital markets reform: MIFID II 2013

The world of financial instruments is more complex. Time to take action. Capital markets reform: MIFID II 2014

Adapting to the challenges of multiple regulations: don’t let change leave you behind European capital markets reform
AIFMD - Harmonized rule set for managers of alternative investment funds in the EU

Background and timeline
- The Alternative Investment Fund Managers Directive (AIFMD) establishes a regulatory regime for entities (AIFMs) managing alternative investment funds (AIFs) in the EU
- AIFMD covers the management and marketing of AIFs in the EU. Third country market actors (non-EU AIFMs) are also in scope if the AIF is set up in the EU or distributed to investors in the EU
- In addition to management and marketing, the harmonized rule set deals with the topics of custody, disclosure and reporting, risk and liquidity management, professional liability, delegation as well as remuneration
- AIFMD entered into force on 22 July 2011. The national implementation was due on 22 July 2013. By 21 July 2014, existing EU AIFMs had to apply for authorization
- On 30 July 2015, ESMA published its opinion and advice on applying the AIFMD marketing passport to non-EU AIFMs and AIFs, and on 19 January 2016, the European Commission responded
- Non-EU AIFMs may use the national private placement regimes (NPPRs) to market AIFs in the EU, which may exist until 2018

First experiences with AIFMD from a third country perspective
- As third country AIFMs are not eligible for the pan-European marketing passport, non-EU AIFMs approach EU investors under the national private placement regimes or on a reverse solicitation basis (and thus are not in scope of AIFMD). However, the marketing passport might be extended to third countries; the respective assessment of ESMA is currently on-going
- The NPPRs vary widely. Some EU Member States have decided to implement the minimum AIFMD NPPR requirements only, while others have imposed additional requirements such as the “depositary-lite” regime
- The notification or registration process of non-EU AIFs with the local regulators under the NPPRs is equally diverse. Whereas marketing in some jurisdictions is allowed upon filing a notification, in other jurisdictions the non-EU AIFM needs to await a (written) confirmation from the relevant supervisory authority prior to undertaking any marketing activities

Implications for the asset management industry
- Significant compliance cost: due to the increased regulatory requirements, the initial and ongoing compliance costs for AIFMs are significant
- Increase in operational burden: onerous disclosure obligations for AIFMs will have time and cost implications
- Lack of clarity: despite numerous publication of ESMA (technical advice, guidelines and Q&As) addressing different AIFMD relevant topics, risks arising from the lack of clarity and guidance are abundant
- Reduction in the number of funds: firms may close or merge funds which are no longer economically viable under AIFMD
- Potential for greater demand: alternatively, the regulatory framework put forth by AIFMD may encourage investments from investors who have thus far remained on the sidelines due to apprehensions about the lack of adequate disclosures and investor protection
MiFID II - Strategic challenges and trends in the asset management industry

**Important points**
- MiFID II - mainly aiming at enhancing consumer protection and market structures’ regulations - will heavily impact the AM industry and change operational models
- One of the greatest challenges is the ban on inducements for independent financial advice or discretionary portfolio management, indirectly impacting asset managers and forcing them to rethink their distribution and remuneration models

**Challenges and trends**

**What are the key strategic challenges and related questions in asset management?**

<table>
<thead>
<tr>
<th>Distribution</th>
<th>Inducements</th>
<th>Market access</th>
<th>Enhanced disclosure</th>
</tr>
</thead>
<tbody>
<tr>
<td>• How to retain distribution power?</td>
<td>• How will independent advice and ban on inducements impact the product landscape?</td>
<td>• What is the impact on intercompany cross-border SLAs (incl. non-EU)?</td>
<td>• Enhanced disclosure requirements on product level (more granularity)</td>
</tr>
<tr>
<td>• Sustainability of alternative distribution models?</td>
<td>• Sustainability of tactical measures, e.g. restructuring of fee flows</td>
<td>• Impact on tax agreements (transfer pricing/ income tax)</td>
<td>• If inducements are paid, detailed disclosure requirements</td>
</tr>
</tbody>
</table>

**What trends are we observing in asset management?**

<table>
<thead>
<tr>
<th>Changing distribution models</th>
<th>Changing remuneration structures</th>
<th>Revenue flow review</th>
<th>Transparency leverages margin reduction</th>
</tr>
</thead>
<tbody>
<tr>
<td>• New distribution channels</td>
<td>• Production of inducement-free share classes to respond to rising demand for inducement-free products</td>
<td>• Future of cross border operations (e.g. Lux ManCo/ Swiss Manager or Swiss Distributor)</td>
<td>• Future of cross border operations (e.g. Lux ManCo/ Swiss Manager or Swiss Distributor)</td>
</tr>
<tr>
<td>• Consolidation of product demand/offering</td>
<td>• Ring fencing challenges</td>
<td>• Remediation of potential tax implications</td>
<td>• Rising demand for inducement-free products</td>
</tr>
</tbody>
</table>
PRIIPS - Harmonization of product documentation for packaged investment products in the EU

Key points
The European Regulation on key information documents for packaged retail and insurance-based investment products (PRIIPS) was published in the EU's official Journal on 9 December 2014 and entered into force 20 days later. The PRIIPS regulation requires a Key Information Document (KID) to be provided to retail investors ahead of their investment in a product.

KID objectives are:
• To help retail investors to make a more informed decision as to whether an investment is right for them or not
• To increase comparability between PRIIPs

KID is mandatory for all products, excluding:
• life insurance contracts where benefits are payable only on death and incapacity
• deposits other than structured products/securities
• occupational pension schemes
• pension products
• UCITS will be allowed a 5-year transition period following implementation, during which time they can continue using UCITS-KIID (as per the UCITS Directive)

Content
KID is a three page document which addresses:
• What is this investment?
• What is it for?
• Could I lose money?
• What are the risks and what might I get back?
• What are the costs?
• How has it performed in the past?
• What might I get when I retire?

PRIIPS regulatory timeline

- 29 December 2014: new PRIIPS regulation entered into force
- 31 December 2016: the regulation will be directly applicable in the EU Member States and by then a Key Information Document (KID) will need to be provided for packaged retail and insurance-based investment product
Asset Management UCITS V - Undertakings for the collective investment in transferable securities

**Key points**
The EU adopted Directive 2014/91/EU on 23 July 2014; the UCITS V Directive addresses certain issues that have arisen during the financial crisis, and focuses on three areas:
- Clarification of the UCITS depositary function and amendments to liability provisions (as well as oversight functions and conditions that govern delegation)
- Introduction of rules on remuneration policies which must be applied to key members of UCITS managerial staff (management company, group structures and individual compensation)
- Harmonization of the minimum sanctions available to supervisors in case of violation of UCITS rules

Other areas of the UCITS framework, such as money market funds, the use of collateral, liquidity management and the use of derivative financial instruments will be addressed at a later stage, as more work and consultation is required to assess the robustness of the existing framework.

**Key considerations**

<table>
<thead>
<tr>
<th>Depositary Liability</th>
<th>Introduction of enhanced liability will require pricing to be revisited</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>• Expanded responsibility of depositaries to effectively monitor the fund administrators’ activities (e.g. valuation, NAV calculation, etc.)</td>
</tr>
<tr>
<td></td>
<td>• How will depositories respond to new liability requirements/manage their sub-custody networks?</td>
</tr>
<tr>
<td></td>
<td>• Who will be the key players in the value chain?</td>
</tr>
<tr>
<td></td>
<td>• Depositaries to revisit overall service offering and pricing</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Remuneration</th>
<th>Three areas of concern</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>• Remuneration based on performance exposes investors to higher potential losses as managers chase returns</td>
</tr>
<tr>
<td></td>
<td>• Remuneration structures might be skewed so managers participate in materialized returns but not in materialized losses</td>
</tr>
<tr>
<td></td>
<td>• Remuneration structures seldom disclosed in fund offering documents</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>National Sanction Regimes</th>
<th>Consultation differences across EU member states</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>• Differences in size of fines for same breach</td>
</tr>
<tr>
<td></td>
<td>• Different criteria to determine amount of administrative sanctions</td>
</tr>
<tr>
<td></td>
<td>• Differences in the application of sanctions</td>
</tr>
<tr>
<td></td>
<td>• Harmonization of regimes with minimum levels to be specified</td>
</tr>
</tbody>
</table>
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Thought Leadership

Global ETF Survey 2015 and beyond
Nine key drivers of change for the global wealth and asset management industry
Shifting strategies
Winning investor assets in a competitive landscape
Positioning to win - 2015 global private equity survey
The Swiss Collective Investment Schemes Regulations
Change in motion
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Markets & Infrastructure
**EMIR - Global regulatory reforms are fundamentally reshaping the OTC derivatives industry**

**Key points**
The European Market Infrastructure Regulation (EMIR) entered into force on 16 August 2012. It has been gradually implemented since Q1 2013.

Clearing obligation (phased-in starting 21 June 2016):
- FCs and NFCs above the clearing threshold (NFC+) required to centrally clear all eligible OTC derivatives
- Classes of clearing eligible derivatives are progressively defined by ESMA, with the first mandate adopted for G4 IRS and proposed for EEA IRS and iTraxx CDIs

Risk mitigation measures:
- Non-cleared OTC contracts require processes to measure, mitigate and monitor operational and counterparty risks
- NFCs- are only subject to basic risk mitigation requirements, while FCs and NFCs+ are subject to more onerous obligations

Margin requirements (phased-in from September 2016):
- NFCs- are exempt
- FCs and NFCs+ above an annually decreasing threshold shall exchange initial margin
- FCs and NFCs+ shall exchange variation margin according to detailed requirements

Reporting obligation (effective as of 12 February 2014):
- Ongoing quality issues with full and comprehensive reporting
- Reporting Services are offered by some market participants
- Any derivative trade has to be reported to a trade repository

**Requirements of different counterparties**

<table>
<thead>
<tr>
<th>Counterparty</th>
<th>Requirement</th>
<th>Clearing through CCP</th>
<th>Risk mitigation (if not cleared)</th>
<th>Reporting</th>
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<td>Basic risk mitigation</td>
<td>Extended risk mitigation</td>
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<td>Financial</td>
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<td>Natural</td>
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The illustration outlines the obligations/requirements a specific counterparty may be subject to. The requirements to be applied by the counterparties to a specific contract depend on the obligations both counterparties are subject to (e.g. a contract between a FC and a NFC- does not need to be cleared).
FinfraG – Swiss regulation of market infrastructure and OTC derivatives

Key points
- 19 June 2015: the Swiss Parliament passed the Financial Market Infrastructure Act (FMIA/FinfraG), adjusting the regulation of financial market infrastructures and derivatives trading in line with market developments and international requirements
- The implementing ordinances were adopted by the Federal Council on 25 November 2015 (FMIO) and by FINMA on 3 December 2015 (FMIO-FINMA)
- Although aligned to EMIR to a large extent, a regulatory gap remains in some key areas, preventing application of a single operating model for cross-border transactions

FMIA addresses the regulation of:
- Financial market infrastructures (FMI)
- Trading venues
  - Exchanges
  - Multilateral trading systems (MTF)
  - Organized trading systems (OTF)
- Post-trade infrastructures
  - Central Counterparties (CCP)
  - Trade Repositories (TR)
  - Central Securities Depositories (CSD)
  - Payment Systems
- Specific insolvency provisions
- Trading in derivatives (clearing, risk mitigation, reporting, trading on exchanges)
- Market conduct (as insider dealing, market manipulation)
- Challenges: differences between EMIR and FinfraG; ongoing legislative process; missing Level II drafts

Timeline:
- 1 January 2016: entry into force
- Phased-in implementation dates depending on counterparties classification:
  - 1 January 2017/1 July 2017: risk mitigation techniques
  - 1 September 2016/1 September 2017: Variation Margin
  - 1 September 2016 - 1 September 2020: Initial Margin
- Clearing, reporting and trading execution subject to further implementing acts by FINMA and 6 to 18 months implementing deadlines thereafter

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<td>NP</td>
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</table>

Do requirements apply?
- Yes
- Partially or conditionally applicable
- No

Differences FinfraG/EMIR
- Expected to be aligned
- "Swiss discount"

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### High-level comparison FinfraG-EMIR

<table>
<thead>
<tr>
<th>Area</th>
<th>FinfraG</th>
<th>Alignment</th>
<th>EMIR</th>
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<tbody>
<tr>
<td><strong>Scope: counterparties</strong></td>
<td>Financial counterparties (FC)</td>
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<td></td>
<td>Two categories: FC+/FC-</td>
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<td>One category: FC</td>
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<td></td>
<td>Non-Financial counterparties: NFC+ and NFC-</td>
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<tr>
<td><strong>Clearing</strong></td>
<td>FC+ and NFC+</td>
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<td>FC and NFC+</td>
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<tr>
<td><strong>Basic</strong></td>
<td>All counterparties</td>
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<td>All counterparties</td>
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<tr>
<td><strong>Portfolio reconciliation</strong></td>
<td>All FC and NFC+</td>
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<td>All counterparties</td>
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<tr>
<td><strong>Daily valuation</strong></td>
<td>FC+ and NFC+</td>
<td></td>
<td>FC and NFC+</td>
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<tr>
<td><strong>Collateral</strong></td>
<td>All FC and NFC+</td>
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<td><strong>Reporting</strong></td>
<td>All counterparties</td>
<td></td>
<td>All counterparties</td>
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</table>

**Comments on differences (FinfraG view)**

- **Classification**: Additional category of small financial counterparties (FC-) for counterparties trading over a threshold of CHF 8bn in group gross notional amount terms (including hedging trades) over rolling 30 days. Possible FX effect as thresholds are set in CHF (v. EUR).
- **Products**: OTC derivatives as well as exchange traded derivatives in scope of FinfraG. However, exemption from clearing and risk mitigation for payment vs payment FX derivatives.
- **Intragroup exemption**: No notification/approval from a competent authority required under FinfraG. Crossborder transactions fully benefit from intragroup exemption, FinfraG does not require an equivalent third country regulation.
- **Risk Mitigation**: Minimum threshold for portfolio reconciliation requirement set at 50 uncleared OTC trades outstanding between counterparties. Frequency on the grounds of proportionality. Timely confirmation deadlines extended by additional working day. Collateral eligibility and FX haircut methodology not fully aligned with EMIR draft rules on margin.
- **Clearing**: Obligation to clear asset classes (still to be) mandated by FINMA and at a CCP (still to be) approved or recognized by FINMA. Phase-in period for NFC+ is 18 months under FinfraG as opposed to 3 years under EMIR. No frontloading requirement.
- **Reporting**: No requirement to report the beneficiary under FinfraG. Single sided reporting under FinfraG. FinfraG reporting to a TR to be authorised/recognised by FINMA.
- **Trading obligation**: FinfraG contains a trading obligation; however, application depends on international developments. Trading obligation in the EU/EEA shall be contained in MiFIR.
- **Supervision**: Compliance audit shall be performed through existing audit regime for both FC and NFC under FinfraG. No authority shall be established for non-financial counterparties.
EMIR/FinfraG - Analysis of counterparties and current operating model is key to respond to new OTC regulations

**Counterparty classification**

- Firms require representation from their counterparties to determine EMIR/FinfraG classifications
- Changes to legal documentation and the onboarding process are required
- NFCs and Swiss FCs must have a process in place for threshold calculation

**Trade reporting and trade repositories (TRs)**

- All exchange-traded and OTC derivatives contracts must be reported to a TR under EMIR (effective since 12 February 2014)
- Reporting services should be evaluated, especially by banks with clients domiciled in the EU/EEA
- Reporting to (possibly another) TR authorized or recognized by FINMA for dual regulated entities

**Non-cleared trade risk mitigation**

- Firms must enhance and document procedures for timely confirmations, dispute resolution, portfolio reconciliation and compression
- FCs and NFCs+ should also ensure compliance with valuation requirements

**Collateral and margin for non-cleared derivatives**

- Access to quality collateral will become critical for buy-and-sell firms alike
- Types of acceptable, fungible collateral will need to be specified and eligibility monitored
- Changes to margin models and processes must be implemented

**Clearing and CCPs**

- Timely, accurate and appropriately segregated exchanges of collateral for non-cleared OTC contracts are required
- The economics of the derivatives business will change given the need to factor clearing and collateral into pricing
- Firms must decide whether to become a clearing member, select clearing broker or utilize indirect clearing
- CCP, clearing broker and indirect clearer accounts must support omnibus and individual client segregation and portability, even for the existing exchange-traded products
- New requirements for CCP capital, margin, default waterfall and model review must be implemented
- Long-delayed EU-US CCP equivalence decision is awaited, in light of pending ICE Clear Europe recognition

**We observe...**

- Further delays regarding implementation for collateral and clearing requirements
- Execution venue trading mandate covered by FinfraG is treated outside of EMIR in the EU
- Analysis of connecting dots with other equivalent regulations regarding cross border trades
- Regulatory gap emerging from FinfraG may force pan-European firms to revisit current EMIR compliant operating models
- Single-sided reporting and inclusion of hedging trades into threshold calculation for NFCs proposed under EMIR review
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Thought Leadership

EMIR update event
Auditing FMIA
Margin for uncleared OTC derivatives
Financial Market Infrastructure Act
Risks and Data Security
Operational Risk – Planned revision of FINMA Circular 2008/21 and 2008/24

Background
As a reaction to the financial crisis as well as recommendations by the Basel Committee on Banking Supervision, FINMA revised the Circular 2008/21 “Operational risks - Banks” as of 1 January 2015. The revised Circular covers new requirements relating to qualitative aspects, e.g. “framework concept document”, risk appetite and tolerance as well as stronger linkage to the internal control system. The new specifications were covered as part of the 2015 regulatory audit.

Insights from performed audits and market analyses
Framework concept, risk appetite and tolerance
- The articulation of risk appetite and tolerance statements represented a significant challenge and was an area of major focus in 2015
- Identified weaknesses related to the mandatory elements of the “framework concept document”. Moreover, significant variation of scope and granularity of the framework concept document could be observed

Convergence of Operational Risk and the Internal Control System (ICS)
- Overall, stronger integration of the ICS with the operational risk framework can be observed
- In addition, the focus of the ICS is no longer limited to financial reporting as it increasingly also covers reporting, compliance and operational risks
- Compliance risks were an area of particular focus throughout 2015, and many banks identified these risks as representing a substantial portion of the key operational risks

Reporting
- Gaps remain within operational risk reporting:
  - internal reporting does not adequately cover external events
  - insufficient focus on disclosure requirements

Ongoing revision of FINMA Circular 2008/21 and 2008/24 expected for Q1/2016
Expected modifications:
- Stronger alignment of Circular 2008/21 and 2008/24 (“Supervision and internal control – banks”)
- Slimming down of Circular 2008/21: Adoption of the common standards applicable for all risk categories into the revised Circular 2008/24 (in particular responsibilities, “framework concept document”, control system)
- Expected modifications concerning Circular 2008/21:
  - Expansion of the principle of IT to include references to cyber risk
  - New principle focusing on cross-border risks
  - New principle focusing on critical control functions within systemically relevant Banks
  - Increased regulatory focus with respect to the ICS
  - The integration of topics such as risk culture and conduct risk
“Information leaving the organization unauthorized, uncontrolled and/or unwanted has become one of the top subjects in information security and cyber risk management. Data Leakage is a today’s challenge, not only for financial organizations, but for every organization owning valuable information.”

Source: Data Leakage Protection (10/2012), Swiss Banking Association (SBA)

FINMA Circular 2008/21 - Client data management and confidentiality is a management responsibility

Key points
The revised FINMA Circular 2008/21 “Operational risks at banks” entered into force on 1 January 2015. The new Annex 3 contains nine principles and a number of guidelines on proper risk management related to the confidentiality of client data processed and stored electronically. Those principles mainly deal with confidentiality incident risks that may occur also in view of the business models the financial organizations are running. Regulators and governments have increased their scrutiny of data leakage prevention (banking secrecy and laws).

Data leakage prevention triggers
- Business drivers
  - Digitalization (internal and external)
  - New distribution channels
  - Consumerization in the banking and insurance industry
- Information security
- Regulatory requirements
  - Circular 2008/7 outsourcing
  - Circular 2008/21 operational risks at banks
  - Additional domestic and foreign regulatory requirements
- Legal and privacy requirements
  - Data Protection Act (Swiss and EU)
  - Additional domestic and foreign legal requirements

Data leakage prevention enablers
- Data protection policies
- Asset/data management
- Data governance
- Technology in addition to people and process measures

EY’s conceptual data protection model

<table>
<thead>
<tr>
<th>Data Protection Program Components</th>
<th>Employees</th>
<th>Ex-Employees</th>
<th>Partners/Contractors</th>
<th>Hacker</th>
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<tbody>
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<th>Email Encryption</th>
<th>Auditing &amp; Monitoring</th>
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<th>Data Management/Monitoring/Auditing &amp; Reporting</th>
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<th>System &amp; Information Protection</th>
<th>Incident Response</th>
<th>Physical &amp; Environmental Protection</th>
<th>Continuity Management</th>
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Client Data Management - Financial services organizations must improve infrastructure to secure and protect client data

Observations & consequences

• The list of regulations continues to grow, and in response, compliance initiatives expand and consume corporate resources
• The increase in outsourcing of IT and business processes, as well as their management on behalf of third parties, entails new tasks and new rights, obligations and competencies; service providers are often unaware of the obligations to which their customers are subject and the impact this has on providing services
• Wise segregation of client identifying data is a powerful internal control, minimizing the potential impact on regulatory compliance and the reputation of the organization
• Appropriate segregation of duties is often not enforced and toxic combinations will continue to be a key (regulatory) issue for most (if not all) of the Swiss institutions in future years therefore, a well defined and pragmatic approach is necessary
• Some FS organizations are leveraging organizational/technical protection measures as enablers to make the operational model evolve, fulfilling the call for optimization
• Business, Legal, Compliance, and Security involvement will remain critical to ensure program success

Management agenda & prioritization

• How exposed are you to risks due to the involvement of third parties delivering services to your organization?
• What are your most valuable data assets, where, in which format, and by whom are they stored?
• Are you applying a holistic view on data with data in motion, data in use and data at rest?
• What does your target data architecture look like and is it suitable to support your company’s future challenges?

Start Client Data Management programs as soon as possible

• Make sure you get the scoping right

• Be mindful of third parties that are handling data on your behalf as compliance duties on client data management remain within the bank’s remit
Operational Risk – Getting fully compliant with Risk Data Aggregation and Risk Reporting Principles (BCBS 239)

Key points
- The BCBS 239 Principles are a set of supervisory expectations to move banks', particularly SIFIs, data aggregation capabilities to a level where supervisors, firms, and other users of the data are confident that the MIS reports accurately capture the risks.
- G-SIFIs were required to meet these expectations in full by 1 January 2016, with all other SIFIs were required to meet the expectations subsequently; however, some of the G-SIFIs did not meet the Principles on time.
- 14 defined principles should support banks to fundamentally improve in six key themes:
  1. Enhance the infrastructure for reporting key information, particularly that used by the board and senior management to identify, monitor and manage risk.
  2. Improve the decision-making process throughout the banking organization.
  3. Enhance the management of information across legal entities, while facilitating a comprehensive assessment of consolidated risk.
  4. Reduce the probability and severity of losses resulting from risk management weaknesses.
  5. Improve the speed at which information is available so decisions can be made more rapidly.
  6. Improve the organization's quality of strategic planning and the ability to manage the risk of new products and services.

Observations & consequences
- A convincing Overarching Data Governance and Comprehensive Data Strategy serves as the foundation for a consistent Firm-Wide Process for Delineation and Decomposition of Risk Data; the Delineation needs to be diligently executed across the institution, leading back from the risk measures in scope to their ultimate source.
- Unifying and rationalizing Data Dictionaries and Taxonomies of risk data repositories and its documentation are of fundamental importance for closing gaps regarding data accuracy. Furthermore, responsibilities over quality controls need to be solidified and be as robust as those applicable to accounting data.
- In order to ensure Adaptability of Data Views and capability to address ad-hoc data requests along arbitrary views, the dimensions by which data shall be aggregated, sliced and disabled needs to be determined. Furthermore, a process should be defined ex-ante for the expansion of dimensions should novel requests occur, e.g. during times of stress.

Management agenda & prioritization
- Plan for an independent evaluation of the compliance with the Principles, either by internal or external auditors.
- Partially compliant banks need to prepare a remediation plan that highlights the reasonable timeline for reaching full compliance.
- Given the Principles are now effective, be prepared for tests of the aggregation and reporting capabilities by regulators.
Key points
The advent of the digital world and its inherent interconnectivity has generated a new playing field of vulnerabilities. What we used to know and do are no longer sufficient to protect us from the onslaught of new and emerging cyber threats and attacks, which could lead to brand and reputation damage, loss of competitive advantage, legal/regulatory noncompliance and steep financial damage.

- Cybersecurity is far beyond an IT-only issue
- Organizations worldwide now recognize that cybersecurity risks are a top-three concern
- Business-as-usual activities, such as new product launches, mergers and acquisitions, and market expansion now have a cyber dimension
- The adoption of mobile and cloud-based operations and services dramatically increases and changes the risk landscape of our professional and personal lives
- We live and operate in an ecosystem of digitally connected entities, people and data, increasing the likelihood of exposure to cybercrime

Financial authorities and regulators worldwide, including FINMA, have recently placed more focus on cyber threats, the associated risks and the countermeasures FIs are taking.

In the UK, the Financial Authorities have defined the CBEST testing framework to deliver controlled, bespoke, intelligence-led cyber security tests. The tests replicate behaviors of threat actors, assessed by government and commercial intelligence providers as those posing a genuine threat to systemically important FIs.

Another example addressed to FIs is the US NIST “Framework for Improving Critical Infrastructure Cybersecurity”, which relies on a variety of existing standards, guidelines, and practices to enable critical infrastructure providers to achieve resilience. This framework is increasingly referenced and used as a basis by different regulators around the world, including FINMA.

Can you answer “yes” to these five key questions?

1. Do you know what you have that others may want?
2. Do you know how your business plans could make these assets more vulnerable?
3. Do you understand how these assets could be accessed or disrupted?
4. Would you know if you were being attacked and if the assets have been compromised?
5. Do you have a plan to react to an attack and minimize the harm caused?

Valued assets

- Intellectual property
- People information
- Financial information
- Business information (strategy, performance, transactions)
Business Continuity Management

Key points
• The Swiss Bankers Association’s (SBA) self-regulatory guidelines are aimed at its members and contain best-practice recommendations to be used in the preparation of an institution-specific BCM policy; policies should take into account the specific circumstances of the institution in question, in particular its risk situation and systemic relevance
• Three sections of these Recommendations are recognized by FINMA in its Circular 2008/10 “Self-regulation as a minimum standard” and are regarded as binding minimum standards under supervisory law, compliance with which is verified by auditors; the definition of a Business Continuity Management Strategy (section 4.4), the completion of a Business Impact Analysis (BIA) (section 4.5.1) and the formulation of Business Recovery Options (BRO) (section 4.5.2) are binding
• BRO are defined as follows: “Definition of the fundamental procedure for maintaining or restoring continuous business activity in the event of a loss of critical resources (including a definition of risk acceptance, analysis of potential courses of action and fundamental decisions on the provision of replacement resources); BRO are based on the BIA and form the basis for Business Recovery Plans”
• Periodic review of the BIA is required: “Yearly review of the BIA, and the type and scope of this review should be geared in particular towards the institution’s specific risk situation”

Relevant FINMA and SBA regulation
FINMA Circular 2008/10 “Self-regulation as a minimum standard” Margin no. 7 “Recommendations for Business Continuity Management (BCM)” of August 2014, limited to subsections:
• 4.4 Business Continuity Management Strategy
  • 4.4.1 Business Impact Analysis
  • 4.4.2 Business Recovery Options

Swiss Bankers Association recommendations for Business Continuity Management (BCM) as of August 2013
• 4.1 Definition and scope
• 4.2 Responsibilities
• 4.3 Risk analysis
• 4.4 Business Continuity Management Strategy (binding minimum standard)
• 4.5 Elements of Business Continuity Management
  • 4.5.1 Business Impact Analysis (binding minimum standard)
  • 4.5.2 Business Recovery Options (binding minimum standard)
  • 4.5.3 Business Recovery Plans
  • 4.5.4 Business Continuity Reviews
  • 4.5.5 Business Continuity Tests
• 4.6 Crisis management
• 4.7 Reporting, communication and training
  • 4.7.1 Reporting
  • 4.7.2 Communication
  • 4.7.3 Training and awareness raising
Outsourcing/offshoring – Lack of risk prioritization leads to greater scrutiny for regulated institutions

Key points

• Offshoring or outsourcing to third-party providers and the procurement of services of banking functions and processes continues to be on the rise
• Service providers are often unaware of the regulatory and legal obligations to which their customers are subject
• Service recipients remain fully responsible for outsourced processes, but rarely have a full overview of what is outsourced to which party and what the associated risks are
• In an environment with increased outsourcing and offshoring activities, firm-wide oversight of third-party providers and the capability to maintain a central risk profile of vendors needs to be a key management focus point

Observations

• Existing regulatory initiatives such as FINMA Circular 2008/7 Outsourcing and FINMA Circular 2008/21 Operational risks at banks are in the process of being revised; revisions will further clarify requirements with respect to IT and cyber risks, fully including those related to service providers
• FINMA has established a regulatory environment to facilitate client onboarding through digital channels which is often performed by service providers; in the interests of international competitiveness, the Swiss Bankers’ Association (SBA), which has issued a response to the propositions made, sees it as imperative that this be amended. The Circular is scheduled to enter into force in March 2016
• The EU data protection reform – General Data Protection Regulation (GDPR) – implies a heightened degree of scrutiny and enforcement from EU regulators, with fines reaching up to €100m. GDPR extends to all foreign companies processing personal data of EU residents; while the EU does not have the regulatory authority to hold companies domiciled solely in Switzerland in contempt, their branches based in EU countries could be prosecuted. This extends to services obtained from third-party providers
• EU’s response to cybersecurity – the draft Network and Information Security Directive (NISD) – is close to finalization; regulated institutions will need to demonstrate that robust cybersecurity defense programs are in place, including adequate preventative measures and the correct tools to deal with and report breaches; this too extends to services obtained from third-party providers

Have you asked yourself

• What is our approach to installing a common sourcing strategy and outsourcing and offshoring framework?
• Do we have a clear picture of the main objectives and drivers of our sourcing strategy?
• Do we have an overview of what services are provided to us by which party?
• Do we know what the most relevant risks associated with the outsourced/offshored processes are?
• Do we have a clear view on how to mitigate those risks and control outsourced or offshored processes?
• Do we have sufficient confidence in our supervision of third-party providers in line with regulatory, soon to be revised, requirements such as FINMA Circular 2008/7 and 2008/21 Appendix 3?
• Do we have fallback scenarios in place in case third-party providers do not deliver as agreed or operations seize altogether?
**Key points**

Regulators have three main objectives in mind:
- To secure an appropriate degree of protection for consumers
- To protect and enhance the integrity of the financial system
- To promote effective competition

However, Conduct Risk is not a one-size-fits-all concept and it is not static. Thus, firms must define what Conduct Risk and good conduct means for their specific business, and update their definition continuously based on lessons learned, changing regulatory expectations, as well as changes to business operations and models.

In summary, Conduct Risk entails the idea that every decision a firm and its staff make must lead to a fair outcome for customers, and that firms need to prove that processes are geared towards ensuring this is the case.

Every part of a firm’s governance, risk and compliance framework is affected by Conduct Risk. Hence, it has become imperative to have a strong Conduct Risk Management program integrated into the firm’s wider operational risk framework to strengthen relationships with clients, improve overall returns in a sustainable way, and prevent high levels of both regulatory and public scrutiny.

**Background in Switzerland**

- FINMA has included the promotion of integrity, transparency and client protection in business conduct as one of its strategic goals for the period of 2013-2016
- The Swiss regulation on Conduct Risk can be found in numerous acts and regulatory documents; in general, the financial market legislation requires the establishment of an adequate organization corresponding to the proposed business activities to grant assurance of proper business conduct
- The main purpose of this requirement is to maintain public confidence in those institutions and safeguard the reputation of the financial center
- As part of the assurance of proper business conduct, FINMA requires the provision of risk management as well as internal directives describing processes and responsibilities for risk business undertakings; specifically, it must detect, mitigate and monitor market, credit, default, settlement, liquidity, reputational, operating, and legal risks
- Furthermore, banks need to comply with external and internal regulation and therefore maintain a compliance function
- Finally, rules of conduct for securities dealers with clients are determined by the Stock Exchange Act
Conduct Risk - Our integrated Conduct Risk solution

**Challenges**
- Demonstrate effective identification, management and mitigation of Conduct Risks; firms (and management) are made responsible for failures
- Holistic coverage across all lines of defense, more emphasis on responsibility of front office and risk culture

Regulators world-wide list Conduct Risk as one of the main contemporary risks within the FS industry, with a clear trend to hold management and individuals accountable.

**Conduct Risk: “The risk that the way in which a firm and its staff carry out business results in unfavorable outcomes for consumers, market integrity or effective competition”**

**Conduct Risk drivers and impact on your business**

<table>
<thead>
<tr>
<th>Inherent factors</th>
<th>Structures &amp; behavior</th>
<th>Environmental</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Biases and heuristics</td>
<td>• Conflicts of interest</td>
<td>• Regulatory and policy changes</td>
</tr>
<tr>
<td>• Information asymmetries</td>
<td>• Culture and incentives</td>
<td>• Technological developments</td>
</tr>
<tr>
<td>• Inadequate financial capability</td>
<td>• Ineffective competition</td>
<td>• Economic and market trends</td>
</tr>
</tbody>
</table>

**Main business impact**

- Regulatory scrutiny
- Risk rating/capital cost
- Reputation damage
- Growth constraints
- Revamp and workaround TOM
Conduct Risk - Holistic approach to Conduct Risk

Three major risk culture challenges
EY is committed to helping companies integrate Conduct Risk into the wider framework, demonstrate how customers are being protected and meet demands based on:

- A robust, kept-fit-for-purpose set of controls to continually monitor and mitigate Conduct Risk
- A sound risk culture of integrity and treating stakeholders fairly, which complements the existing risk framework by addressing the root causes and more dynamic aspects of risk
- A risk framework that leverages predictive analytics in order to quantify Conduct Risk exposure and allow proactive identification of inadequacies and failures in business conduct and fraudulent behavior

Integrating Conduct Risk into everyday decisions and systems
Moments that matter (MtM) are instances firms’ employees experience on a daily basis when they must typically apply their own judgment and make Conduct Risk-relevant decisions that are material to the organization.

Firms need to identify the MtMs that are fundamental for their Conduct Risk exposure based on industry best practice analysis and leveraging existing approaches in the organization, such as risk and control self-assessments and process maps.
Conduct Risk - To what extent is risk culture an issue

**Three major risk culture challenges**

**Coherency of risk culture**
- Without a clear and coherent risk culture approach, risk is not taken in accordance with the organization's risk appetite
- There is no clear understanding of, or control over, how peoples' mindsets, behavior and decisions impact the organization's risk profile

**Implementation and alignment**
- While some organizations have an approach to managing their risk culture, it is often general and lacking depth, and fails to target risk behavior and decisions at the most crucial moments
- Organizations struggle to identify these moments or appropriate strategies to ensure change efforts are relevant and practical for the people who deal with risks in their daily activities

**Measurement and monitoring**
- Few organizations have a framework in place for the measurement and monitoring of risk culture
- Those that do frequently rely on a patchwork of criteria and methods, making interpretation and management difficult, inconclusive and costly

**EY’s risk culture framework**

Aligning risk vision with outcomes through behavioral change

---

*Drawing on our extensive experience managing risk and risk culture, EY has identified three major risk culture challenges that most financial services organizations are facing today.*
Conduct Risk – Predictive analytics

Three major risk culture challenges
Analyses based on individual human expertise are often subjectively biased, susceptible to tunnel vision and can lead to the misassessment of risks. In contrast, EY’s powerful analytics approach will enable you to preemptively protect your organization and your clients from Conduct Risk and to take advantage of new business opportunities:
• Data-driven analytics can provide independent, deeper insights that tell you where to expect your next Conduct Risk case or exposure
• With predictive analytics, you can make more timely and accurate decisions about what policies, processes and systems you need to implement or enhance based on more precise impact assessments
• Advanced analytics can help you expose networks of perpetrators who have so far outsmarted conventional controls and escaped detection

EY’s predictive analytics solution approach

- Collect potential factors
- Autonomous or manual
- Trades
- Behavioral profiles
- Compliance breaches etc.

- Obtain as much data as possible and potentially relevant for predictive analysis, internal, external, structured or unstructured
- No expert-based pre-weighting of factors required
- Labelled or unlabeled data

- Calculate a white-box score using
- Rules
- Machine learning algorithms
- Ensemble methods
- Regression statistics
- ...
- Optimize the analytics model
- Update profiles

- Apply predictive engine
- Scoring model
- Output

- Assess & transfer results

- Interpret scoring results
- Evaluate the white-box calculation rationale
- Display output to users using dashboards, reports or other apps
- Calibrate model parameters

- Are you mainly relying on individual human expertise to interpret data and draw conclusions about risk?
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Reporting and Accounting
IFRS 9 - Financial instruments

Key points for classification
- Classification is a matter of fact and is not based on intentions
- Only relatively simple instruments in the right business model qualify for amortized cost measurement
- Liquidity buffers might not qualify for the amortized cost model as they are in a hold to collect and sell business model
- Derivatives embedded in financial assets are no longer bifurcated; instead, the entire financial asset is measured at FVTPL
- The classification of liabilities as well as most criteria for applying the fair value option (FVO) remain the same
- For liabilities to which the FVO is applied, fair value changes due to an entity’s own credit risk are recognized in OCI

<table>
<thead>
<tr>
<th>Contractual cash flow characteristics</th>
<th>solely payments of principal and interest</th>
</tr>
</thead>
<tbody>
<tr>
<td>Business model</td>
<td></td>
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<tr>
<td>Hold financial assets in order to collect contractual cash flows</td>
<td>Amortised cost</td>
</tr>
<tr>
<td>Hold to collect contractual cash flows and sell financial assets</td>
<td>FVOCI</td>
</tr>
<tr>
<td>Neither of the above</td>
<td>FVPL</td>
</tr>
</tbody>
</table>

Key points for hedge accounting
- IFRS 9 hedge accounting aims to better reflect the impact of risk management in the financial statements
- No quantitative retrospective bright line tests for the hedge effectiveness; however, the hedge ineffectiveness still has to be measured and recognized
- IFRS 9 broadens the scope of eligible hedged items, for example in the area of risk components and groups of items
- Option to continue applying the hedge accounting requirements of IAS 39 until the IASB has finished its macro hedging project

<table>
<thead>
<tr>
<th>Risk management strategy and objective</th>
</tr>
</thead>
<tbody>
<tr>
<td>Economic relationship</td>
</tr>
<tr>
<td>Credit risk does not dominate</td>
</tr>
<tr>
<td>Hedge ratio does not create ineffectiveness</td>
</tr>
</tbody>
</table>

Hedge accounting
IFRS 9 - Financial instruments

Key points for impairment

- The incurred loss model of IAS 39 was criticized for its lack of timely recognition of credit losses and the absence of useful and relevant forward-looking information
- The expected credit loss (ECL) model of IFRS 9 seeks to address those weaknesses by requiring the recognition of a credit loss allowance for all financial assets based on ECLs, as well as through enhanced disclosures on ECLs and related credit risk
- On initial recognition, an entity will recognize a loss allowance based on ECLs from default events possible within the next 12 months
- IFRS 9 likely increases the loss allowance on transition
- If the credit risk increased significantly since initial recognition, an entity will then recognize ECLs resulting from all default events that are possible over the entire life of the asset
- The IASB has set up a transition resource group for discussion of implementation challenges

- IFRS 9 introduces a single impairment model for debt instruments measured at amortized cost and at fair value through other comprehensive income, loan commitments and financial guarantee contracts
Key points

• The IASB and FASB (the Financial Accounting Standards Board) have issued a converged, principles-based revenue standard
• IFRS 15 is more prescriptive and contains more application guidance than the current revenue standard
• Specifically, the standard provides more guidance on multiple element contracts and variable consideration
• There is no one-size-fits-all approach for transition

Step 1:
Identify the contract(s) with a customer

Step 2:
Identify the performance obligations in the contract

Step 3:
Determine the transaction price

Step 4:
Allocate the transaction price to the performance obligations

Step 5:
Recognise revenue when (or as) each performance obligation is satisfied

Banking & Capital Market considerations

Services that are in scope of the standard (not exhaustive):
• Asset management services
• Portfolio management and custody services
• Cash management and payment processing services
• Administration services for customer deposit accounts (for example ATM fees)
• Credit card interchange and reward programs

Applying IFRS 15 may bring the following challenges:
• Fees, specifically performance and some asset based fees, may be classified as variable consideration; variable consideration will not be recognized as revenue until it is highly probable that a significant reversal in the amount of cumulative revenue will not occur
• The recognition of upfront fees, for example for the issuing fund units, depends on whether the fees relate to a separate performance obligation, for example separate from asset management fees
• Incremental costs of obtaining a contract will be recognized as an asset if the costs are expected to be recovered
IFRS 16 – Leases

Key points
- Lessees will have a single accounting model for all leases, with exemptions for leases of ‘low-value assets’ and short-term leases
- Under this model, all leases, including those currently classified as operating leases, will be on balance sheet as right-of-use assets with corresponding lease liabilities
- Sale-and leaseback transactions will also result in the recognition of a right-of-use asset with a corresponding lease liability
- Lessor accounting is substantially unchanged
- A contract is, or contains, a lease if:
  - There is an identified asset (explicit or implicit)
  - The contract conveys the right to control the use of an identified asset for a period of time in exchange for consideration, i.e. throughout the period of use the customer would have the right to direct the use of the identified asset and obtain substantially all of the economic benefits from directing its use

Main impacts
The main impacts for lessee accounting are summarized below:
- The recognition of right-of-use assets and corresponding lease liabilities will increase total assets; this will likely have an impact on debt/equity and other balance sheet related KPIs as well as risk weighted assets
- Operating expenses for leases will decline, however amortization and interest expenses will increase
- Amortization and interest expense are separately recorded; a front-loading impact may decrease net profit in the early stages of a lease
- Principal payments are shown within financing activities, interest payments are presented according to chosen policy in line with IAS 7; this presentation will generally increase operating cash-flow

Lessees and lessors will have additional disclosure requirements compared to current accounting.

The IASB issued IFRS 16 ‘Leases’ in January 2016. The standard will be effective on 1 January 2019. Early application permitted if IFRS 15 has already been applied or is applied at the same date as the new leases standard. The standard is to be applied retrospectively with certain transition relief.
IFRS application - Impact of negative interest rates

Key points

Presentation of negative interest
- Negative interest on assets does not meet the definition of interest revenue and should not be part of interest income
- Negative interest on assets should not offset with positive interest on assets; the same principle applies to negative interest on liabilities
- Preferably, negative interest should be presented as a separate line item as part of net interest income on the face of the income statement, or at least be disclosed in the notes

Valuation
- Negative interest has an impact on discount rates
- Valuation models may not be able to process negative rates, and may produce nonsensical outputs

Embedded derivatives
- IAS 39 requires separating an embedded interest rate floor if that floor is above the market rate of interest (i.e. the floor is in the money)
- Such floors are currently present in mortgages which currently do not exist without an explicit or implicit floor; as there is no market for un-floored mortgages, banks have concluded that a floor can never be above the market rate of interest

Hedge accounting
- Negative rates may lead to an asymmetry, in that the interest rate on loans may be floored at zero percent whereas the variable leg on the swap is not
- Common methods to measure effectiveness, such as linear regression, may no longer be valid as the past is no longer a good predictor of the future

Swiss interest rates have been significantly negative since the SNB action in January 2015 and are expected to remain negative in the future. Other jurisdictions have negative interest rates as well.
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Thought Leadership

Applying IFRS  
A closer look at new revenue recognition standard

Applying IFRS  
Classification of financial instruments under IFRS 9

Applying IFRS  
Impairment of financial instruments under IFRS 9

Applying IFRS  
Hedge accounting under IFRS 9
FinIA - Financial Institutions Act

Background
The Federal Council has stated1: “With the FinIA, supervision of all financial service providers who operate an asset management business in any form whatsoever is to be governed in a uniform piece of legislation. In principle, the rules for financial institutions that already require a license under existing law will be taken over from the applicable pieces of legislation without any material changes being made, but they will be harmonized in a differentiated manner according to their activity. The managers of individual client assets as well as those who manage the assets of Swiss occupational benefits schemes will also require a license in the future.”

Subject Matter and purpose from the Federal Act on Financial Institutions2
Article 1
1. This Act governs the requirements for acting as a financial institution.
2. Its purpose is to protect the investors and clients of financial institutions, and the proper functioning of the financial market.

Roadmap

| Status                                                                 | • Consultation phase finalized  
|                                                                      | • Dispatch of the Act available  
|                                                                      | • Final Act awaited  
|                                                                      | • Changes possible  

Planned set into force • 1 January 2017

Key points
• Supervision over all financial institutions in asset management
• Asset management regarding assets of people with whom the asset manager has business or family ties as well as solely within the context of employee participation schemes are not in scope of this act
• Supervision
  • By FINMA: Securities firms, manager of collective assets, fund management companies
  • By an oversight authority according to the Financial Supervision Act: Asset managers, trustees
• Grandfathering clause
  • FIs already possessing authorization for the corresponding activity are not required to obtain new authorization (fulfilment of FinIA’s requirements within 1 year of its entry into force)
  • Asset managers for individual portfolios who have performed their activity for at least 15 years shall not be required to obtain new authorization if they do not accept new clients

1 Source: http://www.admin.ch/aktuell/00089/index.html?lang=de&msg-id=53561
2 Source: http://www.news.admin.ch/NSBSubscriber/message/attachments/41570.pdf
• No major material changes (compared to today’s BankA, SESTA, CISA) for
  • banks
  • securities dealers
  • fund management companies
  • asset managers of collective investment schemes
  • Securities dealers renamed to security firm (“Wertpapierhaus”/“maisons de titres”)

Approval cascade of financial institutions

Key terms
• The asset manager manages individual portfolios or only limited collective investment schemes (only for qualified investors or below specific thresholds)
• The trustee manages the separate fund, ensures its value is maintained and employs it in a restricted manner
• The manager of collective assets manages commercially asset on behalf and on the account of collective investment schemes and pension schemes
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