On 1 January 2015 the revised regulations of CISO-FINMA regarding the use of derivatives under the commitment-II approach came into force. The new requirements are bringing about new challenges but also chances for providers of Swiss funds.

**Summary of key changes**

- Transition rules for implementation until 1 January 2016
- Implementation of European “Commitment approach” according to CESR-Guideline 10-788 into Swiss law
- Extended definition of “global exposure” of funds by adding two more components.
- Exclusive view on creation of “market risk” by use of derivatives opens up new possibilities for asset management techniques
- More rigorous requirements for the recognition of a netting- or hedging arrangement

**What’s new?**

In the course of the revision of CISO-FINMA the commitment-approach II for the measurement of risk connected with the use of derivatives has been fundamentally revised. The overall goal of the revision was to close the gap to the corresponding European regulation, especially the CESR-Guideline 10-788 on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS. The most significant changes are explained in more detail below.

**Determination of the global exposure of the fund**

So far the global exposure of a fund consisted of two components: the net assets and the net attributable amount of derivatives. According to the new provisions two more components are added to the global exposure: attributable amounts from derivative components (so far only required for structured products) and investment techniques (see illustration). Financial instruments with derivative components are for example convertible securities or credit-linked notes. Such instruments have to be unbundled and be treated separately for the determination of the global exposure of the fund. A fund can also obtain exposure to market risk through the reinvestment of received collateral in the context of securities lending or repo transactions as well as through physical short selling. Repurchase transactions or securities lending transactions must be taken into consideration for the determination of the global exposure if additional leverage is generated through reinvestment of collateral.

**Focus on market risk**

The confusing separation of the gross and net global exposure from derivatives in the categories market-, credit- and currency risk has been abandoned. The revised CISO-FINMA aims at measuring risk related to leverage as a whole without focus on specific peculiarities of risk. As a consequence, derivatives where a corresponding amount of cash equivalents is allocated to so that the combination of the derivative and cash equivalent equals a direct investment in the underlying instrument without creating an additional...
market risk or leverage ("synthetic replication of a physical investment") may be excluded from the calculation of the global exposure from derivatives.

**Requirements for netting or hedging**

Art. 36 CISO-FINMA includes clear descriptions of the terms "netting" and "hedging" and defines conditions when a netting- or hedging arrangement can be assumed for the purpose of the calculation of the net global exposure from derivatives. The conditions are stricter than the requirements under the old CISO-FINMA. As a general rule a derivative and its underlying can only be netted if they relate to the same underlying asset and no material residual risk is left by the combination of the two instruments. As for hedging, Art. 36 para. 2 CISO-FINMA defines five criteria for the presumption of a hedging relationship, which are significantly stricter than the requirement under the old CISO-FINMA. Notwithstanding the defined criteria, financial derivative instruments used for currency hedging purposes such as currency forwards, may be netted at any time when calculating the global exposure. Furthermore, CISO-FINMA provides a specific exception to the defined criteria for hedging for duration hedging.

**What does this mean for asset managers and management companies/SICAVs?**

Generally, due to the requirements described in Art. 70 CISO-FINMA, risk management is now seen as a function with extended reach throughout the organization. This fact in itself will have product providers reevaluate the organization of their current risk management function. Specifically, asset managers of Swiss-domiciled funds will be affected depending on the scope and complexity of the use of derivatives within the products they manage. The respective monitoring processes to ensure that the fund can be managed in a compliant way will have to be adjusted.

Especially in case of extensive use of derivatives or financial instruments with derivative components as well as leverage from investment techniques such as securities lending and borrowing, the effort may be considerable and require an automated solution. The use of financial instruments with derivative components or structured products may turn out to be rather complex in practice. It will most likely be up to the asset manager to determine beforehand if the necessary information is available to unbundle the derivative component from the underlying asset. A solution may be the application of the model-approach according to Art. 38 CISO-FINMA which, however, requires prior approval from FINMA and is more demanding on technology and specific know-how. On the other hand, asset managers that aim to synthetically replicate an investment in underlyings are benefiting from the easing of the requirements for risk coverage. This is especially relevant in the case of ETF’s, where an index is replicated by the use of a total return swap. Also, the investment in “synthetic” commodities combined with a currency hedge will become more attractive. Asset managers and management companies/ SICAVs will have to train their staff in the risk management and/or compliance departments in order to ensure effective monitoring of the adherence to the requirements. Adjustments in their risk monitoring systems may be necessary. The extended requirements of Art. 71 CISO-FINMA will have to be considered in the companies’ risk policies. In the areas of netting and hedging (especially duration netting), stringent guidance will have to be provided to the asset managers in order to avoid any misinterpretations and – as a result – unintended risk. Finally, the reinvestment of collateral will have to be monitored more closely or be prohibited entirely. Any new calculation methods or interpretation of standards will have to be implemented into the respective risk monitoring systems.

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**Global exposure of the fund**

<table>
<thead>
<tr>
<th>Net assets of the fund (+)</th>
<th>Net global exposure from derivatives</th>
<th>Attributable amounts due to investment techniques (+)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Attributable amounts of individual derivatives and derivative components, calculated as laid out in Appendix 1 of CISO-FINMA (= Gross global exposure from derivatives (+))</td>
<td>Attributable amounts resulting from netting and hedging permitted according to Art. 36 CISO-FINMA (-)</td>
<td></td>
</tr>
</tbody>
</table>
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We help clients align their risk management functions, defining their risk policies for the use of derivatives or offer support on the valuation and analysis of complex financial products.

For further information is available on our website: kpmg.ch

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