A Swiss response to systemic risk: the "too big to fail" draft banking legislation

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A. Why is the Swiss experience with regard to systemic risk of particular interest?

- The 2008/2009 global financial crisis and the UBS rescue; size of big banks and debate on systemic risk
- Key elements and originality of the Swiss approach
  - *Preventive measures*: tier-1 core capital up to 19 % of RWA for SIBs; New capital market instruments (CoCos)
  - *Prospective curative measures*: No compulsory separation between retail banks and investment banks; no Volcker rule. Emergency planning to preserve systemically important functions

B. Scope, purpose and justification of the new legislation [1]

- SIBs = banks, financial groups and bank-dominated conglomerates whose failure would cause considerable harm to the Swiss economy and financial system
- size, interconnectedness, substitutability
- SI functions = indispensable to Swiss economy, cannot be substituted in the short run (in particular domestic deposit and loan business and payment transactions)

B. Scope, purpose and justification of the new legislation [2]

- Designation of SIBs by the central bank after consulting FINMA
- Purpose:
  - reduce risks to stability of Swiss financial system originating from SIBs
  - ensure continuation of economically vital functions
  - avoid government bailout measures
- Compatibility with constitutional principles

C. First key element [1]: additional capital requirements

- Tier-1 core capital:
  - 4.5 % of RWA minimum requirement in common equity (as in Basel III)
  - 8.5 % buffer capital (of which up to 3 % in CoCos)
  - Up to 6 % progressive buffer capital (may be entirely in CoCos)
- Total: 19 % (Basel III: up to 9.5 %; UK Vickers Report: 10 % for retail banks, 17 to 20 % for large banking groups)

C. First key element [2]: additional capital requirements

- To be calculated both at group level and at the level of each entity of the group
- Competitive disadvantage ?
- Overall (not risk-weighted) leverage ratio of 5 %
- Supplemented by additional requirements with regard to liquidity and risk diversification [already in force]

C. First key element [3]: additional capital requirements

- New capital market instruments for the purpose of recapitalizing banks (with tax exemptions):
- Contingent Convertible bonds (CoCos)
  - "high-triggered" = automatic conversion if common equity falls below 7 % of RWA [to reinforce loss-absorbing capacity]
  - "low-triggered" = automatic conversion if common equity falls below 5 % of RWA [to finance transfer of systemically important functions to an independent entity]
- Write-down bonds (repayment waived in certain circumstances)

D. Second key element [1]: Emergency planning

- No compulsory separation between traditional deposit banking and investment banking ≠ UK Vickers report
- No restriction on proprietary trading ≠ Volcker rule in the USA
- Organizational measures including emergency planning *"ensuring the continuation of systemically important functions in the event of the bank's threatening insolvency"*

D. Second key element [2]: Emergency planning

- Responsibility of each SIB to provide evidence that organizational measures are sufficient
- If evidence insufficient, FINMA shall impose the requisite measures (potentially including setting up an independent entity in Switzerland)
- Discount up to 5 % on capital requirements may/should be granted in case organizational measures improve recovery prospects and resolvability beyond legal minimum
- In case of governmental bailout: restrictions on variable compensation (bonus payments)

E. Conclusion: Achievements and outlook

- Additional loss-absorbing capital would cover a new "UBS event", but sufficient in case of greater losses in the future ?
- Emergency planning compatible with general principles of bankruptcy law ? (equal treatment of creditors; multinational banking groups)
- Continuation of systemically important functions, but residual systemic risk: failure of investment bank without bail-out ?