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?