

23 June 2011

Addressing “Too Big To Fail”

The Swiss SIFI Policy

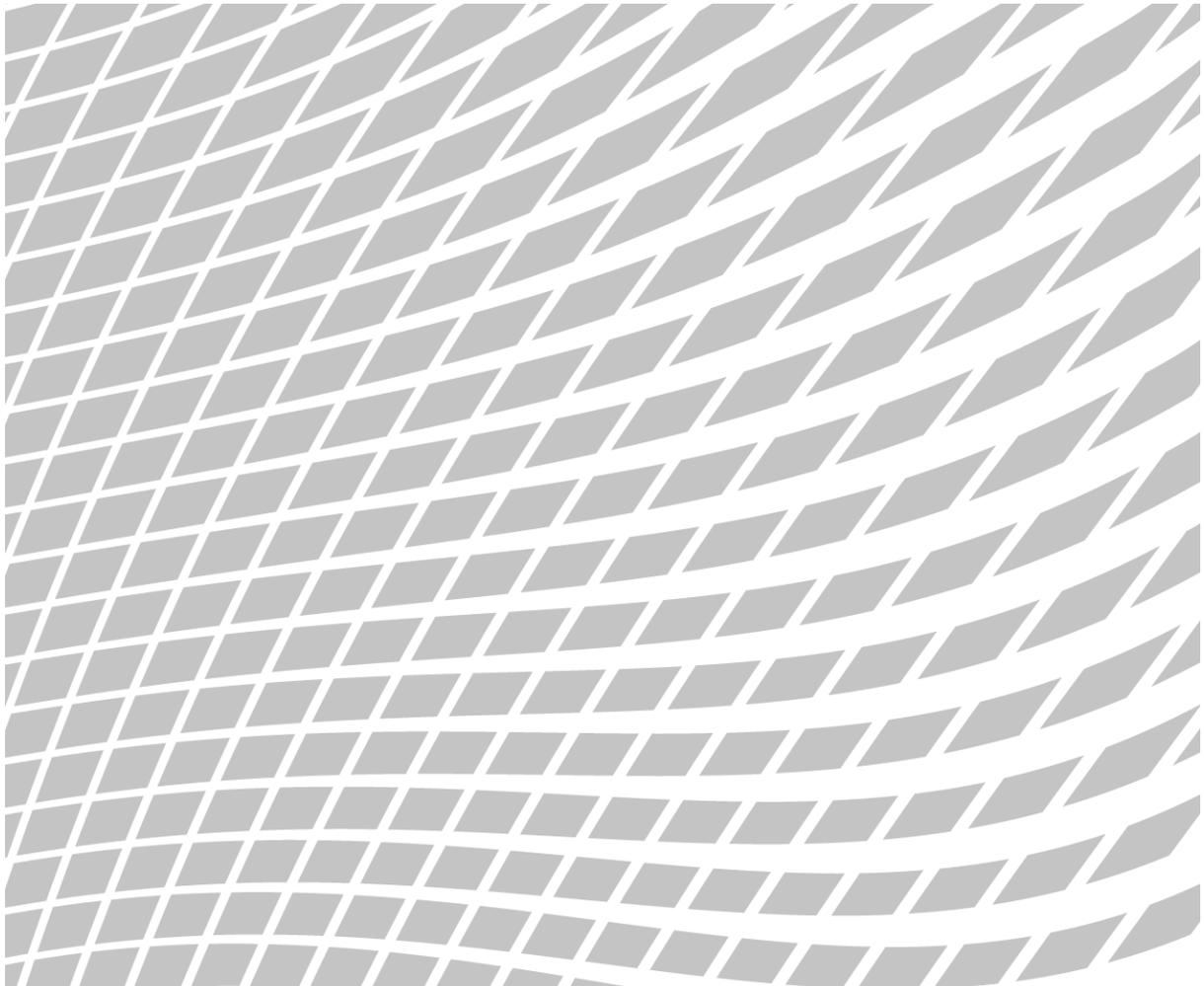


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1 Background

Two of the Swiss banks are not only systemically important for the Swiss economy, but may also be considered as institutions of considerable importance for financial stability at global level. Although they have significantly reduced their exposures in the aftermath of the crisis, the size of their balance sheets continues to amount to a multiple of the output of the Swiss economy. Both banks are considered as Globally Systemically Important Financial Institutions (G-SIFIs) and “Too big to Fail”.

Hence, the issue of “**Too big to fail**” (TBTF) is of great relevance for Switzerland. The Swiss Federal Government, the Swiss Financial Market Supervisory Authority FINMA and the Swiss National Bank have therefore decided to move rapidly towards measures strengthening the resilience of the Swiss Systemically Important Financial Institutions (SIFIs), limiting the economic impact of crisis in the financial system and promoting financial stability.

The starting point of the Swiss initiatives is the work of the commission of experts commissioned by the Swiss Federal Government to develop policy options on how to mitigate risks emerging from TBTF institutions in the Swiss economy. On 4 October 2010, the commission agreed on a proposal for a **Swiss SIFI policy framework**. What distinguishes the policy proposals is that experts were drawn not only from the relevant authorities and the science community, but also included members from the two Swiss big banks and from the insurance sector. All members of the commission endorsed the results. Currently, FINMA, SNB and the Swiss Federal Department of Finance are working on the practical implementation of these results into Swiss law. The necessary legal changes were sent to Parliament on 20 April 2011. This report describes the Swiss SIFI policy framework based on the proposal of the commission of experts and the dispatch of the Federal Council on strengthening financial sector stability.

The Swiss TBTF initiatives are **embedded in the global framework**, in particular that of the **Financial Stability Board** and the **Basel Committee**. A global alignment is paramount given the fact that SIFIs are active at international level and that any substantial regulatory arbitrage may **impact financial stability** from a **domestic** and **global perspective**. However, each country has to consider its own specific situation. Not only is the failure of a big institution a risk for the Swiss economy: the international exposure of the Swiss financial centre and its companies bears a greater responsibility for global financial stability. Switzerland has to implement the globally agreed regulations with a “**Swiss finish**” and to develop and put its initiatives into effect as soon as possible, ahead of those of several peer countries.

2 Defining systemic importance

2.1 Functional perspective

It is broadly agreed that the systemic importance of a financial institution arises out of the financial functions it provides to the general economy. At the same time, such financial institutions provide a

plethora of functions and services which are not systemically important or can be substituted easily and quickly. The proper classification of functions is of vital importance. While the set of systemically important functions should not be too narrow to sufficiently protect the economy from the fallout of a banking crisis, an excessively broad definition complicates crisis management and resolution actions, sets false incentives and reduces pressure to come up with market-based solutions in a crisis scenario.

Switzerland aims for a simple, straight-forward yet narrow definition of systemically important functions. According to current discussions, the following functions will presumably fall under this definition:

- payment operations;
- domestic deposits to ensure access to liquidity for payment transactions;
- loans and credit lines to non-financial enterprises;
- domestic mortgages with a maturity of less than 1 year.

However, the measures proposed are not limited to the systemically important functions as such, but eventually lead to **institutional requirements**. When determining capital surcharges, all activities of a SIFI are to be considered, as losses will most probably not be contained in a particular business line, but may impair systemically important functions as well. Also, when assessing the resolvability of a company, it is not only the systemically important activities which are looked at, but rather all functions the company performs, also from a cross-border perspective.

2.2 Institutional perspective

A company is deemed systemically important if it performs services that are essential to the overall economy and which cannot be substituted by other market participants within a reasonable time frame. The current Swiss initiatives therefore **focus on banks**. To assess the systemic importance of banks, the evaluation framework has been substantiated to include the following criteria:

- **market share** in systemically important business activities such as deposits, loans and clearing;
- **value of deposits** not covered by the deposit insurance regime;
- relation between the **balance sheet size and the gross domestic product**;
- **risk profile** of the company.

Evaluating these criteria naturally leads to designating the two big global Swiss banks, the Credit Suisse Group and UBS, as globally and domestically systemically important. Switzerland has decided to focus its initiatives on these two banks. Once the framework is in place, the initiatives may be extended to include domestic SIFIs. Given the fact that such D-SIFIs (Domestic Systemically Important Financial Institutions) operate in an environment and under conditions which are very different from those of a globally active bank, it is unlikely that a framework adequate for G-SIFIs can be directly adopted for D-SIFIs. However, the rationale – ensuring that D-SIFIs can fail without

disrupting systemically important functions and without the need for extraordinary public support – is the same.

Financial infrastructure providers, such as settlement organizations, exchanges and central counterparties, are also systemically important. However, the risks they handle are quite different from those banks are confronted with. The policy framework outlined in this paper is therefore not directly appropriate to deal with infrastructure providers.

3 Policy mix

SIFIs and the financial system as a whole must be capable of **surviving crises, even of larger scale, without public support** and taxpayers' money. The Swiss SIFI policy framework focuses on two major objectives. The first objective, **reducing the probability that a TBTF institution fails**, is pursued by two key measures:

- capital
- liquidity.

The second objective, **reducing the potential systemic fallout of a failure** of a TBTF institution, is pursued with measures **increasing the resolvability** of those companies:

- organization, and
- risk diversification.

The **key measures** - capital, liquidity, organization and diversification - are **not isolated**, but constitute an **integrated policy mix**. Capital and liquidity not only help to prevent crises, but also to set aside resources necessary to implement recovery measures or ultimately enable an orderly resolution of the company. Furthermore, the measures are to take effect at all phases. Capital and liquidity measures, which allow for easier restructuring or resolution by the supervisory authority for a bank in distress, provide incentives for the bank's management to reduce systemic risk when the company is still a going concern. Organizational measures, which facilitate recovery and limit the impact of failure, need to be designed, prepared and implemented when there is still enough time for diligent action.

Box 1: Pure size limits regarded as ineffective

The most appropriate way to tackle the TBTF issue would be to *prevent* institutions from becoming so big that the consequences of a failure would be too dangerous for the economy. **Size limits** could be expressed by imposing restrictions on the size of the balance sheet (absolute or relative, e.g. as a fraction of the country's yearly gross domestic product), on the market share or the level of interconnections with other financial institutions or the economy as a whole. Banks exceeding these limits would be ordered by law to reduce their exposure. While this concept sounds simple, the **effectiveness may not be evident**. From a macroeconomic perspective, the size of a financial

system is not only driven by supply. Reducing the exposure of single institutions may not lead to a contraction of the size of the financial system, but rather would cause **fragmentation and diversification** between many smaller market participants. Such a diversification may help to mitigate risks of isolated issues, but would **not be suitable to deal with systemic crises**. Business concentrated on a few big companies would migrate to smaller companies, all of them pursuing similar strategies and exposing similar risk behaviour. Crises of a larger scale would cause problems at many of those smaller companies and, at the same time, would render a group of small companies “**systemic in a herd**”. Strict limitations on the size of business activities have therefore only a limited potential to reduce the systemic risk, but may heavily **complicate any crisis management**, as such measures would then have to be applied to several companies at the same time. Of course, economies of scale and other efficiency considerations may also favour larger companies. However, such benefits are hard to quantify and did not play a substantial role in our considerations. As a result, we came to the conclusion that **imposing hard size restrictions is not an** appropriate approach to strengthen the resilience of the financial system.

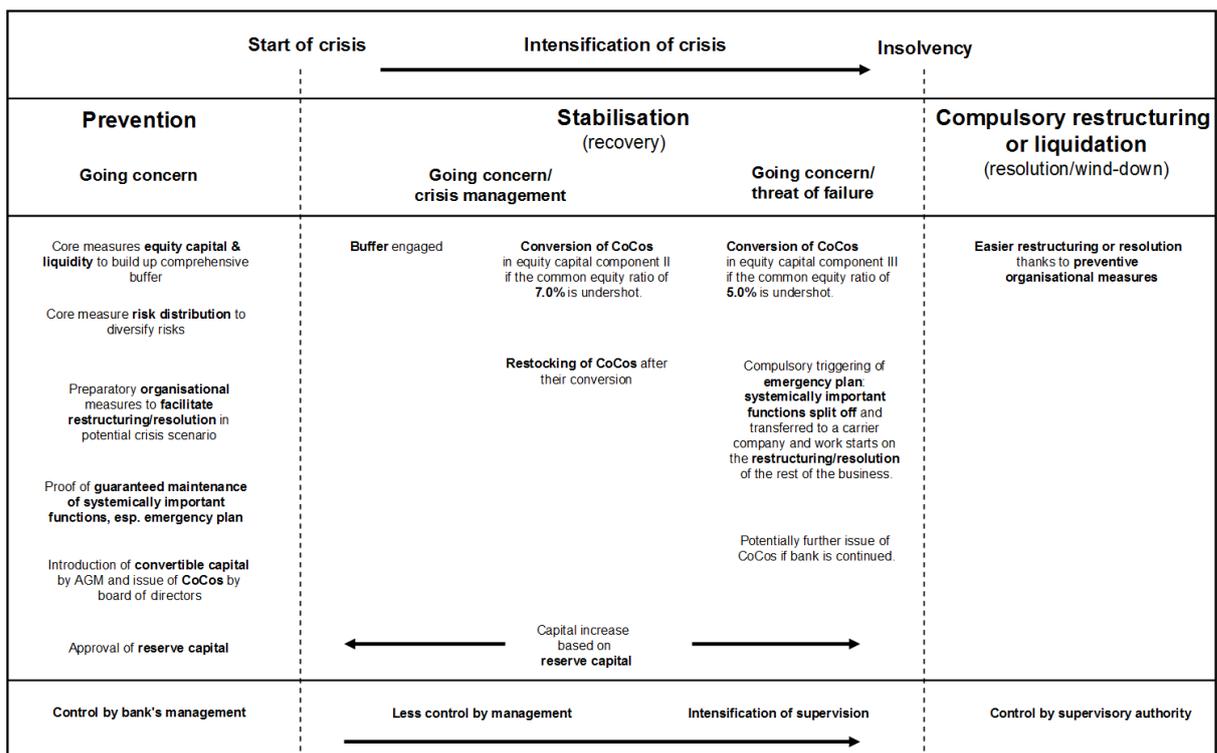


Figure 1: The Swiss SIFI policy mix (Source: final report drawn up by the "too big to fail" commission of experts, p. 53)

4 Capital and liquidity – reducing the probability of failure

Higher solvency and liquidity requirements reduce the probability that banks fall below minimum levels of capital and liquidity and therefore **reduce the probability of failure**. In addition, more solvency and liquidity may significantly **facilitate crisis management**, resolution or, in a worst case scenario, the liquidation of a company. Finally, as capital and liquidity requirements mostly depend on the volume and risk of a bank's business activities, they also create incentives to reduce size and risk.

Having a lower probability of failure, more flexibility for crisis management and greater incentives for size and risk reduction is especially important for systemically important institutions. These companies should therefore be subject to stricter requirements. For some years, large Swiss banks have been subject to a surcharge on top of the regular capital requirements, expressed as a multiple of the Pillar I level. In the wake of the crisis, higher liquidity requirements were quickly imposed. It is now proposed that the existing Pillar II measures are replaced by a system which allows for **improved calibration and to better reflect systemic importance**. The new system defines **surcharges** on the Basel baseline requirements (**capital quantity**), but also prescribes the **capital instruments** to be used (**capital quality**). Both dimensions have to be looked at in parallel. While the proposal significantly raises the minimum capital quantity, it also ensures that there is a **safety net to enable recovery and resolution** and that this safety net cannot be used, or even depleted, for day-to-day business activities. This allows for **restructuring a bank without forcing it into liquidation**. That way, the whole company, or at least parts of it, may have a realistic future after a crisis, which is paramount to secure the commitment of investors, clients and counterparties.

4.1 Quantity of capital

Switzerland proposes that the capitalization of systemically important banks should be defined by three components of capital which complement each other, but have distinct objectives. While the baseline requirements are used as going concern capital, the buffer helps to fend off crises. The surcharge serves as a reserve to restructure or resolve the company. The calculation of the components and the capital instruments employed are structured in accordance to these purposes.

4.1.1 Basel III as a baseline requirement

Just as every banking institution, Swiss SIFIs have to fulfil the **baseline capital requirements** as defined in the Basel framework and its Swiss domestic implementation. The baseline requirement amounts to **8% of the company's risk weighted assets (RWA)**.

The Basel Committee has proposed substantial amendments to its capital accord (Basel III). Switzerland is committed to implement the Basel III proposals within the internationally agreed time frame. The revised rules will be applicable to all banks in Switzerland regardless of their systemic relevance. Switzerland implemented **ahead of time** a subset of the rules, mostly centred **around trading book rules ("Basel 2.5")**. All banks concerned are already required to meet these extended rules since 1 January 2011.

4.1.2 Buffer to increase loss absorbency

The last crisis revealed that banks meeting or even exceeding the statutory capital requirements may experience **losses at such a scale and speed** that they may significantly fall below the minimum capital levels within a short period of time. Countermeasures implemented by companies, such as fire sales of liquid assets, accelerated these developments, caused **contagion** to other financial companies and market segments, and could only be impeded by vast **interventions undertaken by governments and central banks**. Hence, while capital levels as required by Basel II/III and national regimes were **never designed to absorb tail risks** of large, internationally active institutions, they were too small to prevent a system-wide contagion. By increasing capital requirements for systemically important financial institutions, contagion could be bounded or at least slowed. Switzerland will therefore implement a capital conservation **buffer of 8.5% RWA on top of the Basel III minimum capital requirements for all banks of 4.5% RWA**. This buffer will be limited to systemically important financial institutions, as the contagion potential of smaller or mid-size firms is curtailed. However, as part of the supervisory process, we also will require specific buffers for non-SIFI banks if their size, business activities and risk profile mandate capital resources exceeding the Basel baseline rules.

In contrast to the countercyclical buffer discussed by the Basel Committee, neither size nor usage of the Swiss capital conservation buffer is directly dependent on the macroeconomic environment. The banks have to schedule when and how they increase their capital in so-called 'good times' above the requested threshold. However, a bank will be allowed to make use of the buffer in bad times (e.g. when it faces significant losses). As soon as the profit situation improves, the buffer has to be refilled. The size of the buffer has been calibrated considering the experiences of previous crises and model calculations.

4.1.3 Systemic surcharge

Banks with a higher systemic importance should maintain a higher solvency. Additional solvency gives the bank's management, counterparties and regulators alike **more time to act**, especially to protect the bank's systemically important functions. Higher systemic importance often comes with a more complex organizational set-up and multifaceted business activities which in turn lead to more difficult and time-consuming crisis management measures. In addition, linking systemic importance with solvency requirements makes systemic importance **expensive** and provides for **incentives to reduce** it.

As a third major component, a **progressive systemic surcharge** consisting of two parts is therefore proposed:

- a **market share**-based surcharge taking into account a bank's share in the Swiss domestic loan and deposit market; and
- a **size**-based surcharge that considers the size of a bank's balance sheet.

The relationship between market share, size and the resulting surcharge is **linear**.

Given the current situation of the Swiss big banks, both components of the systemic surcharge will result in additional capital requirements amounting to **6% of the risk weighted assets**. **Total capital will demand 19% of RWAs** (i.e. 4.5% RWA minimum capital requirements under Basel III, the capital conservation buffer of 8.5% RWA, as well as the progressive surcharge of 6% RWA based on current calibration).

Box 2: Capital planning enables banks to fulfil upcoming requirements

As part of the regular supervisory requirements, FINMA expects companies to perform a prospective capital planning. Part of this process is a systematic gap analysis of the institution's current capital situation and future capital needs, taking into account regulatory requirements, the strategy and the risk situation of a company, as well as its projected profitability in the economic cycle.

FINMA has been closely following the capital planning process and its implementation of the systemically important banks. Even if the proposed TBTF framework has not yet been enacted, FINMA has already requested these banks to aggressively build up capital in order to fulfil upcoming requirements along a front-loaded transition path.

4.2 Quality of capital

4.2.1 Common equity

The new Basel III rules include substantial measures to increase the quality of capital on which the Swiss SIFI framework draws. 4.5% of risk-weighted assets of the baseline requirements and 5.5% of the RWA of the buffer have to be held in common equity. This results in **at least 10% of risk-weighted assets to be held in common equity**.

4.2.2 Contingent convertible bonds (CoCos)

Contingent convertible bonds (**CoCos**) are debt obligations that convert or become convertible to equity if a specified event occurs. Once converted, CoCos are **fully loss absorbing without triggering the** company default. The trigger may be discretionary or well defined upon issuance of the bond. The Swiss SIFI framework proposes CoCos which **automatically** trigger if the **common equity tier 1 capital ratio** (CET1) of a company falls below predefined levels. Since the thresholds are predefined, pricing models for such instruments can be applied accordingly. In order to be accepted under the Swiss SIFI policy, CoCos have to be structured so that they are eligible as a Basel capital instrument.

Depending on the actual trigger point, CoCos have different characteristics. **CoCos with low triggers** (5% CET1) convert to equity just before a company's capital situation falls below the minimum requirements. The contribution of low-trigger CoCos to the stability of the company is limited, as the capital ratio may exceed the regulatory minimum even in severe crisis situations. However, if the situation deteriorates rapidly, **low-trigger CoCos generate capital necessary to implement crisis management measures**, may prevent the bank from being put in receivership and, in a worst case

scenario, **provide funds for an orderly resolution**. Since they trigger just before resolution procedures would have to start, it is ensured that the capital is not used for going concern business activities. Because the conversion takes place just before resolution or even before liquidation procedures commence, the **risk premium** of a low-triggering CoCo is **rather small**.

CoCos with high triggers (7% CET1) convert when the company's capital situation is deteriorating, but the company is still well above the minimum requirements. **High-trigger CoCos further improve the loss absorbing capacity of a company**. In this way, high-trigger CoCos contribute to the stabilization of a company before harsher restructuring actions are necessary. The conversion also contributes to **systemic stability**. CoCo holders may even benefit from a subsequent recovery of the company as they participate in the **upside potential of equity**. However, it is paramount that the company's management is rapidly able to **regain the trust** of its investors. The conversion of CoCos may therefore serve as an important **wake up call** for the management, the company's stakeholders and regulators, and also help to strengthen market transparency. Of course, the **risk premium** of high-trigger CoCos is nearer to that of equity and is expected to be **substantially higher** than the premium of non-convertible debt instruments.

The **usage of CoCos eligible under the proposed regime is strictly limited**. On top of the Basel and Swiss minimum capital requirement of 4.5% CET1, the Swiss additional capital conservation buffer of 8.5% RWA may consist of CoCos to a maximum of 3% RWA. These CoCos must have a high trigger, forcing conversion when the company's capital ratio undercuts 7% CET1. The progressive surcharge of 6% RWA is planned to include only CoCos. As part of the resolution scheme, those CoCos conceptually convert at a capital ratio of 5% CET1.

The characteristics of CoCos are crucial to determine the viability of these instruments. This includes considerations on the issuing price, the event triggering conversion, the conversion ratio as well as the legal set-up of the instrument. Instruments with inappropriate terms have the potential to destabilize institutions and markets in a crisis situation, rather than improving resilience. FINMA has therefore decided to follow the issuance of such instruments closely. In order to become recognized under the capital framework, FINMA has to approve the term sheets of the actual issues. Experience has shown that supervisory guidance on this matter facilitates finding an adequate balance between interests of the issuing bank, investors and supervisory objectives.

4.2.3 Write-off bonds

The Swiss policy proposal also includes write-off bonds (bonds with claims waiver). These are deemed equivalent to CoCos, provided that their terms lead to equivalent positions of counterparties from an economic point of view which also means that the conditions triggering a write-down would be similar to those causing a conversion of CoCos. Write-down bonds would be recognized under the capital requirements framework to the extent that an actual write-down improves the capital ratio of a company. Consequently, in order to be recognized under the capital requirements regime, the terms of such prescriptions would have to be approved by FINMA.

The concept of write-off bonds was primarily introduced to open up the possibility of enhancing capitalization by contingent instruments also for firms that are not stock companies and therefore

cannot issue shares. This ensured that all firms can benefit from the introduction of contingent instruments into the capital requirements framework.

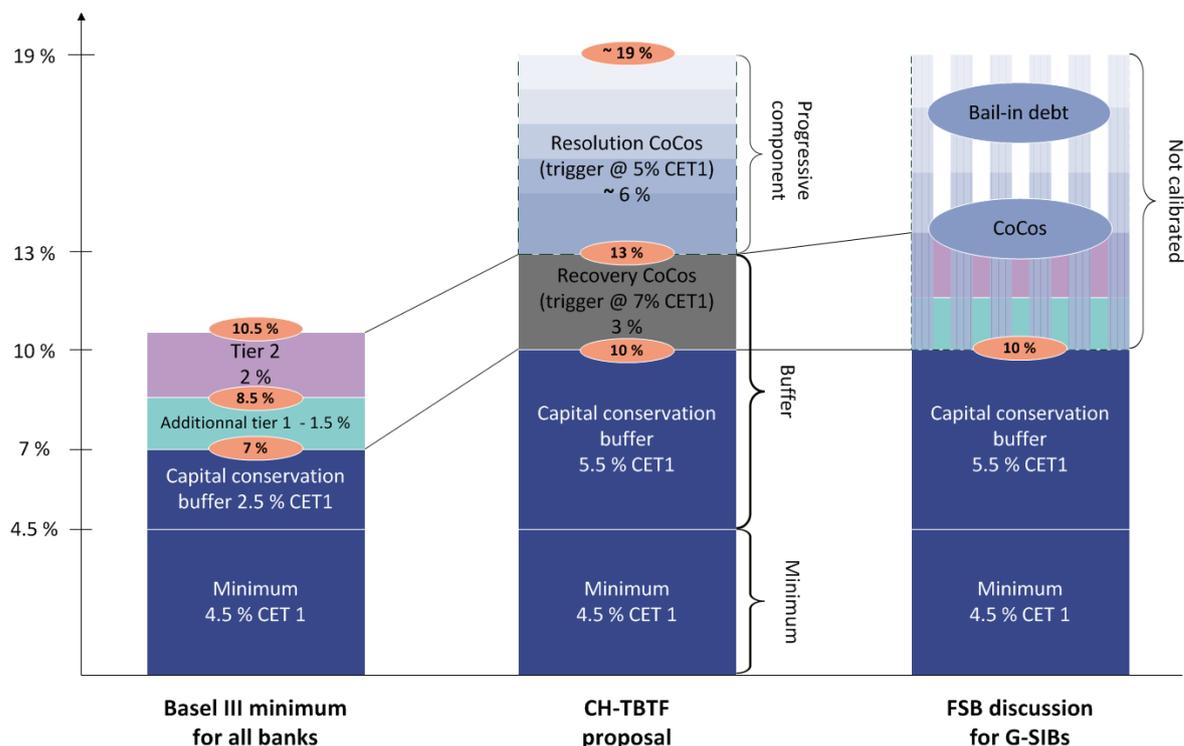


Figure 2: Illustration of proposed capital components and structure

Box 3: Bail-ins

At international level, the concept of “bail-ins” has gained significant traction. Under a **statutory bail-in** regime, certain debt classes would be converted to equity triggered by a **discretionary decision of the bank’s supervisor**, while the bank is still a **going concern**. The loss absorbing potential of equity would be effectively extended to debt and subsequently to the whole balance sheet without forcing the bank into bankruptcy. In theory, the concept is elegant: it completely removes the possibility of a TBTF bank failure as it could employ bail-ins to sufficiently generate capital. In practice, however, the concept has several drawbacks.

Substantial parts of a bank’s debt would **not be available for a bail-in**. This especially holds true for **big retail banks**, which to a large extent refinance themselves by **deposits** (insured or uninsured). In reality, debt holders would have to know from the beginning that their claims can be bailed in, resulting in an “opt-in” arrangement, such as the issuance of bail-in able bonds. Also, the concept of bail-ins comes with considerable legal challenges, as the inherent discrimination of certain debtor classes may be difficult to uphold. More convergence on international level in regard to key issues such as the

definition of triggers, the point of non-viability as well as a common understanding on debt classes available for bail-in would have the potential to significantly enhance the viability of the bail-in concept in an international context.

Whereas at international level bail-ins seem to trigger only as a “**last line of defense**”, i.e. just before the bank stops fulfilling the statutory capital requirements and, in normal circumstances, would have to go into liquidation, the Swiss SIFI framework provides for a **significant stake of low trigger CoCos** at a level of 5% CET1. These instruments will be also activated when there is **reasonable concern** that the bank is heading towards over-indebtedness, facing serious liquidity problems or does not fulfill its refinancing obligations anymore (equivalent with the **point of non-viability**). As a result, the probability of a conversion of a bail-in able bond (via administrative write down or debt-to-equity swap) is only slightly higher than that of a normal bond of a bank without any bail-in arrangements. Hence, the **risk premium** of a bail-in able bond may be rather **small**. While this outcome may be welcomed by companies and their shareholders, the **incentive to reduce the size and risk** of a company’s business activities may be too **little or non-existent**. In addition, because bail-in proceedings are proposed for significant financial institutions only, smaller and mid-size firms may face a **competitive disadvantage** in favour of big and systemically important companies, effectively **amplifying the TBTF** issue rather than mitigating it.

For all that, Switzerland has decided to include a bail-in mechanism in its Swiss SIFI framework in compliance with the international initiatives (e.g. FSB), but to stay, at the moment, with its definitions of the triggers and point of non-viability. This decision may be reassessed in face of a possible international consensus and the future availability of a cross-border resolution framework.

4.3 Liquidity

The last financial crisis made it very clear that the existing liquidity requirements had substantial deficiencies. The Swiss regime did not take into account the special situation of large, complex and internationally active banking institutions. Today, the situation has changed. In Switzerland, FINMA has tightened the liquidity requirements for big banks, **applying stress scenarios modelled on the experiences of the recent crisis**. The new requirements are already in force and banks are implementing them. The Swiss implementation is largely based on the Basel consultation paper of December 2009 and goes beyond that proposal in certain areas. Compared to the December 2009 proposition, the current Basel initiatives have been diluted. This will result in the Swiss SIFI liquidity regime **significantly extending a future international consensus**.

5 Improving resolvability – reducing the impact of failure

Although the probability of failure of a SIFI is effectively reduced by the capital measures as described above, **failure of a SIFI is still possible**. Therefore arrangements should be in place whereby, if prevention fails, a SIFI can **exit the market in a controlled manner**. Contagion or damages to the financial system and the economy as a whole have to be reduced as much as possible. The best

measure to reach this would be an internationally harmonized resolution and insolvency regime for SIFIs or banks in general. However, chances of success in the near future are small. Either way, even such a resolution regime would not solve problems arising out of the interconnectedness of SIFIs and would therefore be only one element on the way to reducing the impact of failure.

5.1 Organizational requirements to support recovery and resolution

The last crisis has shown that the lack of preparedness of the private sector and authorities alike to dissolve SIFIs in crisis scenarios is a main driver of the TBTF issue. Hence, solutions are needed to manage operational and legal complexity of big banks in “going concern” as well as “gone concern” scenarios. This involves measures to improve recovery and resolution of a SIFI as well as a sound and effective framework for crisis management.

The Swiss TBTF proposal is threefold. First, systemically important banks will be required to **demonstrate their resolvability** not only with regard to systemically important functions, but globally. Second, the proposal does not only focus on the resolution phase but also considers **effective recovery arrangements** as equally important. It is crucial that companies prepare and implement measures which are able to effectively stabilize banks in a crisis and avoid resolution scenarios to the greatest extent possible. Third, supervisory **authorities acquire an explicit role in preparing recovery and resolution** as well as its implementation. If banks fall short of the supervisory requirements and expectations, FINMA has the power to order the implementation of measures improving resolvability.

5.1.1 Preconditions for effective resolution

The effectiveness of resolution procedures is subject to various preconditions which have to be implemented significantly before an actual resolution case has to be solved. First, there must be a **viable legal framework for resolution** of financial intermediaries in place on national level. Such a regime should not only provide the appropriate tools to authorities, but should also govern responsibilities – ideally by designating a single resolution authority and thereby allowing for swift intervention without national coordination issues. Switzerland already has such a regime in place, not only for SIFIs, but for banks in general. Second, there has to be a better understanding of how **national resolution regimes interact in a cross-border crisis scenario**. While supervisors and resolution authorities may be able to mitigate such issues by entering into formal or informal agreements, they can only do so within their national frameworks. It is therefore important to understand the interplay of national regimes in a cross-border context and to set up appropriate pre- and in-crisis coordination procedures. For its SIFIs, the Swiss authorities have a long-standing tradition of cooperation with key jurisdictions. These arrangements have recently been formalized within crisis management groups and supervisory colleges. However, actual resolvability is ultimately a characteristic of a single company operating under several defined legal frameworks. Hence and finally, **firms have to prepare themselves to allow for their effective resolution** in both systemic as well as idiosyncratic crisis scenarios with the **ultimate objective being to protect systemically important functions**. This involves the organization and legal set-up of the company, its governance

and control processes, intra-group interdependencies regarding capital and liquidity as well as, ultimately, their position vis-à-vis their counterparties.

5.1.2 Preparing for recovery and resolution

The Swiss proposal requires banks to be **organized at any time** in a way that facilitates resolution in a crisis situation. The ultimate objective is to protect the narrowly defined systemically important functions of a SIFI, **not the bank itself**. SIFIs are expected to prepare their **organizational, operational and structural set-up** so that their specific recovery and resolution plan can be executed rapidly and effectively. While the Swiss proposal does not prescribe how to reach these objectives, SIFIs are required to demonstrate their recovery and resolution plans (RRPs) to the regulator in detail. The RRP process places the responsibility to define plans for recovery and resolution on the companies.

Box 4: Current Swiss resolution framework for banks

Failures of domestic banks in the 1990s demonstrated the ineffectiveness of general bankruptcy procedures and tools to handle bank insolvency cases and eventually led to the development of a **specialized resolution regime** for banks. Effective since 2004, the regime has been applied successfully in several cases, including those in a cross-border context.

FINMA as the sole bank resolution authority: As a supervisory authority, FINMA has exclusive responsibility for bank bankruptcy and restructuring proceedings. It has a wide range of tools at its disposal to enable it to take preventive measures when the requirements of prudent practice are not complied with, and to rectify existing irregularities. In the event of persistent capital inadequacy or liquidity problems, FINMA can take measures that may lead to restructuring or bankruptcy proceedings. The fact that sole responsibility lies with FINMA ensures continuity and rapid action, as it knows the bank concerned and already has comprehensive information about it. FINMA is also solely responsible for the entire bankruptcy and restructuring proceedings. It appoints and oversees the liquidators or those entrusted with restructuring. If necessary, it can also become involved in the liquidation itself.

Early intervention: FINMA can step in as soon as a bank is unable to comply with the capital adequacy requirements for an extended period or experiences liquidity problems, or if there are other indications of impending insolvency. No formal evidence of over-indebtedness or inability to meet payment obligations is required before restructuring or liquidation proceedings are initiated.

Tailor-made solutions: The individual measures can be tailored to the situation at hand, and can be implemented either individually or jointly in restructuring or bankruptcy proceedings. They do not have to be carried out in a particular order. The initiation of restructuring proceedings does not necessarily require a moratorium. As long as the interests of its creditors are safeguarded, the bank can remain in business. Moreover, the measures do not need to be made public unless they directly affect the rights of third parties.

Restructuring as an alternative to liquidation: If there is a realistic prospect of success, FINMA can carry out a restructuring plan. Decisions taken in restructuring that fall within the powers of the annual

general meeting, such as capital increases, do not require the agreement of the shareholders. The aim of these provisions is to speed up the restructuring proceedings. Only the creditors may reject a restructuring plan, and then only if they represent more than half of the non-privileged claims. In this case, FINMA will order the bank's liquidation (bank bankruptcy).

Recognition of foreign insolvency measures: If a foreign authority takes measures concerning a foreign bank or securities dealer with a branch or assets in Switzerland, FINMA is responsible for recognising those measures. Once the claims of those creditors whose claims are protected and privileged under Swiss law have been satisfied, the proceeds of the liquidation of assets located in Switzerland are turned over to the foreign proceedings.

Equal treatment of Swiss and foreign creditors: All creditors of the bank and of its foreign branches are entitled to participate in the bank bankruptcy proceedings initiated in Switzerland, and are to be accorded the same privileges. They must, however, allow any sums they have received in foreign proceedings against the bank or its assets to be offset against their entitlement in Switzerland.

5.1.3 Evaluating resolvability

FINMA will develop criteria on how to assess the viability of recovery and resolution plans. While the details will be defined by a future revision of the Banking Ordinance, FINMA has already come up with a catalogue of criteria to be implemented with a **scorecard approach**. This will also enable the construction of a "**Resolution Effectiveness Test**" (RET) as an objective and transparent benchmark.

The assessment of a company's resolvability will drive two supervisory decisions: First, the Swiss framework will define a **minimum standard** every Swiss SIFI has to fulfil. If a company falls short of these expectations, FINMA will have the power to intervene and **order the implementation of measures** which will bring the company on par with the minimum requirements.

Second, if a bank demonstrates that they have significantly increased their resolvability **in excess of the minimum requirements**, they may be eligible for a **capital rebate** on the systemic surcharge. Such a rebate would be subject to **strict conditions**. Banks would have to prove that they have implemented comprehensive and effective measures to facilitate resolvability and to limit the impact of failure for all of their business activities at a **domestic and international level**. Specifically, limiting the impact on systemically important functions alone would not qualify for a rebate.

A SIFI's RRP may favour systemically important functions and discriminate other SIFI stakeholders in Switzerland and abroad. This is deemed acceptable to protect the overall economy. However, the RRP plan is not isolated, but has to be seen within the context of the significantly extended capital requirements. These reduce the probability of failure and, therefore, shrink the potential of discrimination. Also, equal treatment and adequate capitalization in a global perspective, i.e. of all parts of a company even in a resolution scenario, will be considered as an element of the resolution effectiveness assessment.

Box 5: Bank levies and resolution funds deemed ineffective

For implementation of the emergency plan in crisis situations, banks can draw on the capital held as a systemic surcharge. Just protecting systemically important functions keeps the capital intensity of a resolution plan reasonably low which in turn allows regulators to require banks to hold the necessary capital on their own in the form of a systemic surcharge. Under this arrangement, **system-wide resolution funds are considered neither necessary nor efficient**. Having analyzed these ideas, it is believed that in an acceptable time frame funds may never be of a size to cope with systemic crises. Requiring banks to build up capital for contingency measures on their own balance sheet also **reduces moral hazard**.

5.2 Minimum diversification to reduce concentration risk

Having few big banks may lead to **risk concentration** and a 'single point of failure' in the financial system, as smaller and mid-size market participants may become dependent on the services of SIFIs and prone to contagion. Hence, diversification improves financial stability and reduces the TBTF issue. Consistent with the new EU-regulation Switzerland will improve the existing regulation of **limits on risk concentration** between banks by imposing per counterparty limits on interbank exposures whereby the risk weight of exceeding exposures is increased. However, the new risk concentration limits affect all banks and not merely SIFIs. Further measures are to be developed to reduce interconnectedness. **Operational interconnectedness** has to be considered as well, as many smaller banks have outsourced operations to SIFIs or access the financial infrastructure through them.

Box 6: No restrictions on business activities

'Volcker Rule'-like restrictions are not being proposed. Narrowly defined restrictions have the potential to **crowd out business activities into other market segments**, eventually **building up systemically important risks beyond the scope of financial market regulation and supervision**. Therefore, having banks conducting such activities in a controlled manner and in observance of appropriate capital requirements is favoured. Companies will be able to continue such operations, provided they are able to fulfil the corresponding capital requirements and that the impact and consequences of such activities are considered in the recovery and resolution planning process.

6 Additional measures

6.1 Leverage ratio

All capital components (baseline requirement, buffer, systemic surcharge) are defined in reference to **risk-weighted assets** and are therefore directly dependent on the valuation and risk assessment of the exposure. In order to put a backstop on the expansion of a company's balance sheet and to mitigate deficiencies in the risk assessment models, a **risk-neutral measure** should supplement the risk-based capital requirements.

Switzerland implemented a **leverage ratio** as a risk-neutral backstop measure **back in 2008**. As part of the SIFI policy, the leverage measure will have to be **redefined** based on the Basel III leverage ratio definition. Independently from challenges resulting from the accounting methodology and the termination of exceptional measures to the national economy, recalibration has to take into account the systemic importance of the banks concerned. The new calibration criteria are supposed to include the size of the bank by imposing **progressive** requirements.

6.2 Intense supervision and international cooperation

Intense supervision of SIFIs is important **in all phases of the economic cycle** as is **international coordination**. The Swiss supervisor has implemented a risk-based approach for deciding on the intensity of supervision. By definition, SIFIs belong to the most intensely supervised companies. Given the international exposure of SIFIs, Switzerland will continue to work closely with host supervisors of those countries where Swiss SIFIs have a substantial market position. This cooperation has already been formally established within **supervisory colleges**. In addition to these colleges which deal with day-to-day supervisory issues, crisis management colleges have been created to **discuss, improve and assess recovery and resolution** preparations of a SIFI in an **international scope**.

7 Conclusion

The Swiss SIFI policy framework describes a diverse **policy mix of preventive and curative measures**. Increased capital requirements strengthen the solvency of SIFIs and their loss-bearing capacity, while at the same time providing incentives to reduce systemic importance. If prevention fails, capital instruments, which are already available on the bank's balance sheet, can be used to restructure the company and to protect a narrow set of systemically important functions. Organizational requirements mitigate the current lack of effective resolution frameworks at least to a certain extent. Completed by improved risk concentration limits and liquidity requirements, the Swiss SIFI proposal reduces contagion risk and improves preparation for effective crisis management.

Today, however, **financial stability is a global issue** which cannot be tackled by one country alone, particularly in the case of globally operating banks. It is therefore essential that the international initiatives continue and eventually come up with an effective framework for SIFIs.