# Press release

Date 4 October 2010

---

# Commission of Experts submits package of measures to limit "too big to fail" risks

**The Commission of Experts appointed by the Federal Council is submitting a package of measures for the limitation of "too big to fail" risks posed by banks that are systemically important to the Swiss economy. At the heart of these unanimously agreed recommendations lie intensified capital requirements backed up by new capital instruments, as well as organisational measures to ensure the maintenance of essential services in payment transactions, the deposit business and lending business in the event of a crisis. These measures are supplemented by more rigorous liquidity requirements as well as a limitation of interconnectedness and cluster risks in the financial sector. These requirements for the two big banks designated as systemically important – Credit Suisse and UBS – go considerably further than the current standards. They are compatible with the new international requirements of the Basel Committee on Banking Supervision and the recommendations of the Financial Stability Board, and go further than these requirements too. The proposed policy mix is designed to prevent the state from being forced to step in again and assume significant financial risks in order to bail out a systemically important bank. The Commission of Experts recommends rapid implementation of the proposed policy mix.**

The "too big to fail" Commission of Experts appointed by the Federal Council is submitting a unanimously agreed package involving four core measures.

**Package of measures**

**1. Capital:** A comprehensive concept for capital is presented and specified. Three capital components form the core of the concept, which should significantly strengthen the liability coverage of systemically important banks:

- **The minimum requirement** for the maintenance of normal business activities.
- **The buffer**, which allows banks to absorb losses without falling short of the minimum requirement and without having to suspend normal business activities. The buffer takes into account the risk profile and the loss potential of banks.

- **The progressive component**, which ensures that systemically important banks have a particularly strong capital base. Moreover, this component gives the banks financial freedom of manoeuvre to deal with a crisis by implementing a previously drawn-up emergency plan. The level of this component rises progressively with the increasing systemic importance of the affected bank. This progressive component thereby creates an incentive for a bank to limit its systemic importance.

The concept applies both to the risk-weighted capital ratio and to the minimum level of capital as a proportion of the balance sheet total ("leverage ratio"). Where the risk-weighted capital ratio is concerned, the Commission of Experts has set out specific minimum requirements for the three components (cf. Appendix 1 and 2):

- Based on their balance sheets and relevant market shares at the time of writing, the overall capital requirements ("total capital") for Credit Suisse and UBS amount to some 19 percent of risk-weighted assets as per Basel III.
- 10 percent of the risk-weighted assets must be held in the form of "common equity" (capital of the highest quality in the form of paid-in capital, disclosed reserves and retained earnings following deduction of regulatory adjustments, e.g. goodwill and deferred tax assets).
- A proportion of the buffer (maximum 3 percent of risk-weighted assets) and the progressive component can be held by the two big banks in the form of contingent convertible bonds ("CoCos"), a new type of capital instruments. These bonds are automatically converted into equity capital when a bank's common equity ratio drops below a predefined level (the "trigger").

According to the proposals of the Commission of Experts, the overall requirements amount to a total of some CHF 75 billion per bank based on current balance sheet values, market shares and risk exposure levels. Based on the leverage ratio, this requirement corresponds to around 5 percent of the balance sheet total. The banks have an incentive and an opportunity to reduce this requirement by making adjustments to their balance sheets. Compared with the minimum requirements of Basel III, the Commission's proposals require the big banks to hold around 40 percent more common equity and around 80 percent more total capital. The difference between the international minimum requirements and the proposals of the Commission of Experts will narrow if the international minimum is increased by means of a surcharge for systemically important banks. The proposals of the Commission of Experts are also significantly higher than the requirements decreed by FINMA back in the autumn of 2008.

Where implementation of the capital requirements is concerned, the deadlines set by Basel III (staggered introduction with completion at the end of 2018) will apply. The establishment of the different capital categories will be supervised by FINMA and the SNB as part of the banks' capital planning process.

**2. Organisation:** Organisational measures are designed to ensure the maintenance of systemically important functions (particularly payment transactions, the deposit business and the lending business) in the event of the insolvency of a systemically important bank. At the same time, they are designed to ensure that the remainder of the company can be resolved or wound down. As the organisational measures constitute substantial interventions in economic freedom and the guarantee of ownership, the subsidiary principle is to apply. It is the responsibility of each systemically important bank to organise itself in such a way that continuation of systemically important functions would be guaranteed in the event of a crisis. However, if a bank were unable to demonstrate its ability to maintain these systemically important functions, the supervisory authority would order the necessary organisational measures to be taken.

In the proposed package of measures (cf. Appendix 3), the combined impact of the measures relating to capital and organisation has a key role to play. If a systemically important bank's capital ratio falls below a certain level, the emergency plan is triggered, i.e. the systemically important functions are transferred to a new legal entity within a short space of time. At the same time, the contingent convertible bonds that the bank has to hold as part of the progressive component are converted into common equity. This ensures that the emergency plan can be implemented with an adequate capital base. If a bank exceeds the minimum organisational requirements and thus improves its resolvability, it will be rewarded by means of a rebate on the progressive capital component.

**3. Liquidity:** The proposals here largely correspond to the reforms that have already been implemented since the publication of the interim report of the Commission of Experts. The liquidity regime which entered into force in June 2010 should now be given legal form.

**4. Risk diversification:** Measures to improve the diversification of risks are part of the adjustments also envisaged in other jurisdictions, notably the EU. One of the objectives of these measures is to reduce the degree of interconnectedness within the banking sector so as to limit the dependence of other banks on systemically important banks.

**Required legal basis**

With these core measures, the Commission of Experts has identified those measures that most effectively reduce the risk associated with systemically important companies without unnecessarily restricting the affected banks' economic freedom of manoeuvre. The measures have an impact in different areas. In part, they have a preventive effect and are designed to prevent insolvency. In part, they have a curative effect and are designed to minimise the negative repercussions of insolvency. At the same time, they should ensure the maintenance of systemically important functions in the event of insolvency so as to prevent the state from being forced to save an entire bank simply in order to secure these functions. The bankruptcy of a systemically important bank is therefore envisaged as a real possibility, thereby removing the distorting effect of an implicit state guarantee. Due to their different objectives and different points of application, all the core measures

are necessary if the "too big to fail" problem is to be tackled effectively. The Commission of Experts has therefore aligned the core measures with one another and accordingly proposes a package of measures ("policy mix").
Legislative adjustments are necessary for this policy mix to be implemented. The Commission of Experts has therefore drafted a partial revision of the Banking Act, which creates the necessary legal foundation for this implementation.

## Economic repercussions

Despite all the uncertainty surrounding the underlying model calculations, a cost/benefit analysis clearly indicates that the net effect of the proposed measures will prove positive. The permanent benefits that will arise through a strengthening of the stability of the financial system, an improved crisis prevention structure and the consistent implementation of the originator principle are likely to significantly exceed the transition costs resulting from the increased rigour of capital and liquidity requirements. Given that the costs of implementation depend on the length of the transition period, sufficiently long transition periods should be granted.

## Further measures

Additional measures should also be taken to increase financial stability even further. The ongoing revision of the Banking Act should further improve bank insolvency law in Switzerland. The key aims of this revision are to make the insolvency procedure more flexible, maintain individual bank services through the transfer of important functions to a "bridge bank" and ensure simplified recognition of foreign bankruptcy orders and other restructuring acts of foreign authorities. At the same time, there should be a strengthening of attempts to improve international coordination. In the area of market infrastructure, improvements should be made by introducing central counterparties in the market for over-the-counter derivatives (derivatives traded outside exchanges between two market participants).

A number of other measures currently being discussed at an international level were analysed but not pursued further because they would interfere excessively with the banks' business models, would create false incentives or did not seem to be a suitable means of combating the "too big to fail" problem effectively and efficiently.

## Rationale and background

The recent global financial and economic crisis has demonstrated that the dire predicament of a systemically important financial institution poses a serious threat to the entire economy. This directly endangers not only the stability of the financial system but also, as a result, all sectors of the real economy. The failure of such a financial institution therefore poses a systemic risk. In the event of a crisis, the state cannot, and will not, allow such an institution to fail if the maintenance of systemically important functions is not guaranteed. In other words, the institution is "too big to fail" and therefore enjoys an implicit state guarantee. The corresponding support measures distort competition, and in an extreme case could put an excessive strain on the financial flexibility of the affected states. For this reason, lasting measures to contain the "too big to fail" problem are urgently required.

The Commission of Experts was appointed by the Federal Council in November 2009 with a mandate to review the economic risks posed by large companies and highlight potential solutions to contain the "too big to fail" problem. The Commission is chaired by Peter Siegenthaler, former Director of the Federal Finance Administration, and includes representatives of authorities, academia and the private sector. The Commission submitted an interim report back in April 2010 (cf. http://www.sif.admin.ch/dokumentation/00514/00519/00592/index.html?lang=en).

**Information:** **Peter Siegenthaler**, Chairman of the Commission of Experts, queries via Mario Tuor, Head of Communications, SIF, tel. +41 (0)31 322 46 16.

**Thomas Jordan**, Vice-Chairman of the Commission of Experts, Vice Chairman of the Governing Board of the SNB, queries via Werner Abegg, Head of Communications, SNB, tel. +41 (0)44 631 32 67.

**Patrick Raaflaub**, Vice-Chairman of the Commission of Experts, Director of FINMA, queries via Alain Bichsel, Head of Communications, FINMA, tel. +41 (0)31 327 91 70.

Appendix 1: Comparison of capital requirements
Appendix 2: Illustration of requirements in billions of francs
Appendix 3: Schematic representation of the package of measures

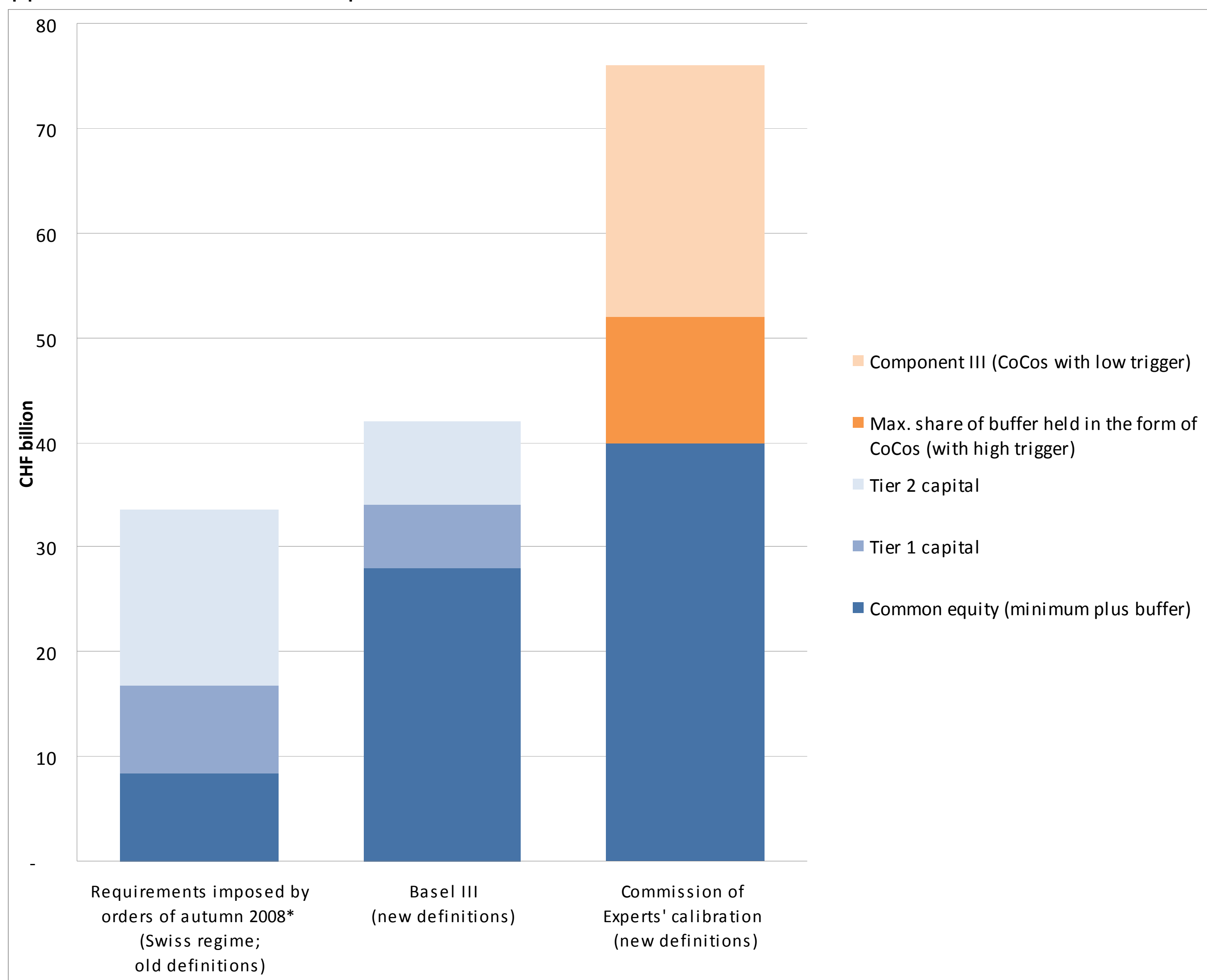
## Appendix 1: Comparison of capital requirements

| | **Previous requirements** (definition of risk-weighted assets and capital categories as per **Basel II**) | | **New requirements** (definition of risk-weighted assets and capital categories as per **Basel III**) | |
|---|---|---|---|---|
| | **International standard (Basel II)** | **Swiss regime for big banks** (orders of autumn 2008) | **International standard (Basel III)** | **Proposal of Commission of Experts** |
| | | **Valid as of 2013**[1] | **Valid as of 2013, with transition period up to the end of 2018** | |
| **I. Minimum requirement** | 8% total capital, of which at least:<br>2% common equity<br>4% tier 1 | same as Basel II | 8% total capital, of which at least:<br>4.5% common equity<br>6% tier 1 | same as Basel III, notably<br>4.5% common equity[2] |
| **II. Buffer** | - | 8% total capital, of which at least:<br>2% common equity<br>4% tier 1 | 2.5% common equity | 8.5% of which:<br>min. 5.5% common equity<br>max. 3% CoCos<br>trigger at 7% common equity |
| **III. Progressive component** | - | - | *Surcharge for systemically important banks yet to be defined* | 6% CoCos<br>(given current size and market share of the big banks)<br>trigger at 5% common equity |
| | | **Total requirements:** | **10.5% total capital of which min. 7% common equity** | **19% total capital of which min. 10% common equity** |

[1] The current status is shown. Banks are required to meet their capital requirements mainly with Tier 1 capital. In the final status, i.e. after the transition period ends in December 2020, half the Tier 1 minimum capital and the buffer must continue to be held in common equity according to the old definition. Hybrid Tier 2 instruments would also theoretically be eligible in a minority holding, but these are not very common in the banking system and their importance is therefore negligible.

[2] In addition, the Basel minimums regarding total capital (8%) and Tier 1 (6%) must be satisfied. All CoCos of component II and component III are eligible as long as they comply with the relevant criteria of the Basel Committee. All CoCos (in the buffer and in the progressive component) must at least meet the criteria for Tier 2 capital at all times.

Appendix 2: Illustration of requirements in CHF billion




**(*)** The orders of autumn 2008 come into effect in 2013. These are designed to continuously improve the quality of capital up to the final status in 2021.

Given risk-weighted assets of CHF 400 billion (including credit valuation adjustment, prior to adjustment measures by banks), the calibration of the Commission of Experts implies a **total capital requirement of CHF 76 billion per bank**.

**Explanation of terms:**

**Common equity:** The narrowest definition of capital, which only includes capital available for the absorption of losses so as to maintain the bank as a going concern (e.g. share capital, retained earnings and disclosed reserves). **Tier 1:** Core capital available to the bank on an open-ended basis (e.g. paid-in capital, disclosed reserves, retained earnings). Certain hybrid capital instruments (combination of debt and equity capital) may also be counted under this definition. **Tier 2:** Supplementary capital with limited loss-absorbing capacity (e.g. subordinated bonds, undisclosed reserves, hybrid capital instruments).

Appendix 3: Schematic representation of the package of measures